2003 Insurance Tax Year in Review: Part II - Product Tax Matters

by Frederic J. Gelfond

In the second installment of a four-part report, Frederic Gelfond, Deloitte & Touche, Washington, summarizes specific insurance guidance from 2003, including the final split-dollar regs and proposed regs that address the use of tax-preferred life insurance and annuity contracts for tax avoidance on investment earnings.

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Introduction

[1] New guidance on investor control and diversification! Final split-dollar life insurance regulations! A taxpayer victory in court involving broad-based life insurance -- and administrative and legislative activity, as well! Even public guidance under section 7702! It has been a year filled with movement on a number of issues that have dominated the conversation in the insurance product tax area for a very long time. The pages that follow address the more significant of these events, and also seek to put them in perspective, as there are still a number of important questions that are yet to be answered.

[2] Consistent with other parts of this Year in Review article, brief discussions of the selected developments are provided along with references to the appropriate issue of *The Insurance Tax Review* for a more complete discussion and full text. For convenience, Tax Analysts's citations and headnotes are included in the areas designated "Citation" and "Overview," respectively. In addition, Tax Analysts's headlines are utilized to introduce each development discussed.

Variable Contracts

Treatment of Asset Income Underlying Variable Contracts

[3] **Citations:** Rev. Rul. 2003-91; 2003-33 IRB 347 (July 23, 2003). For the full text, see *The Insurance Tax Review*, September 2003, p. 469; *Doc 2003-17246 (7 original pages)* [**PDF**]; or *2003 TNT 142-18*.

[4] **Overview:** This revenue ruling contains guidance on the circumstances under which the holder of a variable contract would be considered the owner of the assets that fund the variable contract.

[5] **Discussion:** Taxpayers continue to develop a variety of life insurance and annuity structures involving variable, or separate account, products. Meanwhile, the Internal Revenue

Service (Service) continues to scrutinize these transactions, whether conducted through an offshore private placement, as part of a broad- based purchase by a bank, or anything in between. Central to all this is the role, if any, that the Service's "investor control" doctrine will play in determining whether the insurance nature of a given transaction will be respected for federal income tax purposes. Some taxpayers contend that the diversification requirements adopted by Congress in 1984 rendered the investor control doctrine obsolete. The clear position of the Service, however, is that the doctrine retains its vitality, despite this action by Congress to define what types of variable products are to be afforded insurance tax treatment. Moreover, the present revenue ruling clarifies that the Service considers the doctrine to be relevant not only to the annuity structures that were the subject of all of the previous public guidance in this area, but to life insurance transactions as well.[1]

[6] Even if one accepts the notion that the doctrine is still viable, the next issue is how it should be applied. Historical guidance indicates that it involves a highly fact-specific analysis; but the Service has never provided much more than a general articulation as to how it may be applied, or provided any significant detail regarding the authority upon which its application is based. Further, the examples described in many of the prior rulings in this area bear little resemblance to the products being marketed today. If the current ruling does nothing else, it provides the IRS's view of a pristine variable product from an investor control perspective.

[7] This leaves the question, however, of what factual variances to product structures the Service would consider compliant with the investor control doctrine. For example, the ruling indicates that there will never be more than 20 subaccounts to which policyholders may allocate their funds. Many products currently being marketed offer significantly more than 20 subaccounts.

Treatment of Partnership Interests Underlying Variable Contracts

[8] **Citations:** Rev. Rul. 2003-92; 2003-33 IRB 350 (July 23, 2003). For the full text, see *The Insurance Tax Review*, September 2003, p. 473; *Doc 2003-17252 (7 original pages)* [**PDF**]; or *2003 TNT 142-19*.

[9] **Overview:** Using a variety of situations, Rev. Rul. 2003-92 demonstrated instances under which the holder of a variable annuity or life insurance contract would be considered the owner of the partnership interests that fund the variable contracts if interests in the partnerships are available for purchase by the general public.

[10] **Discussion:** Rev. Rul. 2003-92 essentially makes public the guidance presented in last year's LTR 200244001 (May 2, 2002) dealing with private investor partnership (PIP ruling). That ruling took an expansive view of what it means for an investment to be publicly available for purposes of applying the investor control doctrine.

[11] As noted in our discussion of insurance product tax issues in 2002:

> As Archie Bunker might have said, 'This ruling is a real PIP.' It is certainly a shot across the bow to the notion that investor control lives . . . at least in the minds of the Service. Moreover, it is rumored to be merely a precursor to another more encompassing release -- perhaps a revenue ruling -- that will have a significant impact on private investment partnership and other segregated asset account arrangements.[2]

[12] By putting this in revenue ruling form, the Service has merely stated a bit louder the position for which taxpayers were already on notice based on the publication of last year's private guidance. In combination with the stringent factual scenario described in Rev. Rul. 2003-91, the message taxpayers should take from these releases is not just that the Service will continue to seek to apply the investor control doctrine where it deems appropriate, but also, that it will seek to interpret it in a consistent fashion when dealing with PIP and similar situations.

Regulations Target Use of Annuity Contracts, Life Insurance as Tax-Avoidance Vehicles

[13] **Citations:** REG-163974-02 (July 29, 2003). For the full text, see *The Insurance Tax Review*, September 2003, p. 465; *Doc 2003-17631 (12 original pages)* [**PDF**]; or *2003 TNT 146- 11).*

[14] **Overview:** The Service issued proposed regulations to curb the use of tax-preferred life insurance and annuity contracts for tax avoidance on investment earnings.

[15] **Discussion:** Some have taken the view that these proposed regulations would remove what appears could be a taxpayer- favorable rule that makes it easier for holders of variable life insurance and annuity contracts to apply look-through treatment to assets of nonregistered partnerships for purposes of satisfying diversification requirements. Others view them as providing a useful clarification of highly complex regulations involving the diversification of look-through rules.

[16] Regardless of the perception one might have about this release, there are additional meaningful changes that the Treasury and the Service should consider incorporating into any final regulations. These would include such things as: expanding the types of investors -- e.g., qualified tuition plans -- permitted to hold interests in a fund to which the look-through rules may be applied; and clarifying the applicability of the look-through rules in situations involving fund-of-funds or master feeder arrangements. With respect to the latter item, private guidance has been issued; but similar to Rev. Rul. 2003-92, it would be useful for the Service to set forth its taxpayer-specific position in a more authoritative voice.

Fraternal Benefit Society's Variable Contracts Eligible for Look-Through Treatment

[17] **Citations:** LTR 200344003 (July 29, 2003). For the full text, see *The Insurance Tax Review*, December 2003, p. 933; *Doc 2003-23533 (6 original pages)* [**PDF**]; or *2003 TNT 212-23.*

[18] **Overview:** The Service ruled that variable contracts issued by a section 501(c)(8)[3] fraternal benefit society will be eligible for section 817(h)(4) look-through treatment.

[19] **Discussion:** The look-through rules permit owners of interests in a regulated investment company (RIC) to look through the RIC to its underlying assets for purposes of satisfying diversification requirements. In order to utilize the look-through rules, however, all the beneficial interests in the RIC must be held by one or more insurance company segregated asset accounts, and public access to the RIC may be available only through the purchase of a variable contract. In the present case, the fraternal benefit society was not taxed as an insurance company under subchapter L of the code. The Service found, however, that for

purposes of utilizing the look-through rules, it was only necessary that the fraternal benefit society factually qualify under the general insurance company test set forth under prior-law regulations, regardless of the fact that it was not taxed as an insurance company for other code purposes.

[20] Time will tell how the rationale of this ruling might come into play in other tax matters -- e.g., in situations involving tax questions regarding the insurance company tax status of an entity that may not qualify as such for state law purposes; or where there may be an attempt to distinguish between the treatment of a transaction for insurance company versus policyholder tax purposes.

Annuity Contracts

In General

[21] **Citations:** LTR 200313016 (Dec. 20, 2002). For the full text, see *The Insurance Tax Review*, May 2003, p. 813; *Doc 2003-7916 (17 original pages)* [**PDF**]; or *2003 TNT 61-14*. LTR 200305018 (Oct. 24, 2002). For the full text, see *The Insurance Tax Review*, March 2003, p. 432; *Doc 2003-2818 (9 original pages)* [**PDF**]; or *2003 TNT 22-26*. LTR 200323012 (Feb. 20, 2003). For the full text, see *Doc 2003-13812 (6 original pages)* [**PDF**] or *2003 TNT 110-28*.

[22] **Overview:** This series of rulings provides guidance on application of longstanding tax rules to new product structures.

[23] **Discussion:** In LTR 200313016, the IRS provided several rulings under section 72(s), an area nearly devoid of administrative guidance. Considering the harsh result of a failure under this provision, the various rulings are certainly welcome. Importantly, they indicate that there is sufficient room within section 72(s) for companies that are finding it necessary from a marketing standpoint to add flexibility to their contracts relative to distributions upon the death of the contract holder.

[24] While LTR 200313016 focused on alternative payment options upon the death of a contract holder, LTR 200305018 addresses the tax treatment of payments made by an insurance company under an annuity contract together with a proposed rider that provides the holder alternative means of accessing cash in the contract prior to the annuity starting date. The product at the heart of this case is representative of the types of contracts being designed to satisfy consumer demands for such mechanisms.

[25] In LTR 200323012, the IRS continues to keep the shackles off taxpayers seeking to enter into "one for two" annuity exchanges. To this extent, this release follows the lead of prior rulings. The ruling is also informative for its guidance as to who will be treated as the obligee for section 1035 purposes under a complex arrangement involving legal ownership of an annuity by a grantor trust. Finally, this ruling also brings us back to section 72(s) to the extent that one of its two holdings is reminiscent of some potential open questions in the law relating to situations where conflicts might arise -- for example, in situations involving nonspousal joint ownership.

Section 1035 Exchanges

[26] **Citations:** Notice 2003-51; 2003-33 IRB 361 (July 9, 2003). For the full text, see *The Insurance Tax Review*, August 2003, p. 322; *Doc 2003-16281 (4 original pages)* [**PDF**]; or *2003 TNT 132-10*. Rev. Rul. 2003-76; 2003-33 IRB 355 (July 9, 2003). For the full text, see *The Insurance Tax Review*, August 2003, p. 315; *Doc 2003-16280 (3 original pages)* [**PDF**]; *2003 TNT 132- 11*. LTR 200342003 (July 9, 2003). For the full text, see *The Insurance Tax Review*, December 2003, p. 937; *Doc 2003-22663 (5 original pages)* [**PDF**]; or *2003 TNT 202-30*.

[27] Despite its qualified acquiescence to the Tax Court decision in *Conway v. Commissioner*, the Service's continuing concern regarding partial section 1035 exchanges is reflected in Notice 2003-51. Moreover, in the notice, the Service has suggested that it may utilize what it deems to be a broad grant of authority under the annuity tax rules to craft regulations intended to prevent potential abuse in this area. The Service has clearly articulated the source of its concerns: essentially, circumvention of the "income first" annuity distribution rules. It would be interesting to see if its proposed creation of a presumption, albeit rebuttable, of tax avoidance in situations involving a distribution within 24 months of an exchange could withstand being challenged as an overreach of authority.

[28] In both Rev. Rul. 2003-76 and LTR 200342003, the Service has finally provided some guidance on how to allocate basis among the contracts that are the subject of a partial exchange. Both rulings basically call for a ratable allocation of basis based on cash surrender value. Rev. Rul. 2003-76 sets forth a similar methodology for allocating investment in the contract.

[29] Neither of these rulings, however, provides any further guidance on how to distinguish between "basis" and "investment in the contract," an issue that is likely to move to the forefront as the life settlement industry continues to rapidly evolve.

Private Annuities

Annuity Excepted From Original Issue Discount (OID) Debt Definition

[30] **Citations:** LTR 200352001 (Sept. 10, 2003). For the full text, see *Doc 2003-27091 (4 original pages)* [**PDF**] or *2003 TNT 248-12*.

[31] **Overview:** A private annuity obligation is not characterized as a debt instrument and is exempt from original issue discount provisions as the agreement does not contain any terms that significantly reduce the probability that the total annuity payments to the taxpayer will increase commensurately with longevity.

[32] **Discussion:** At the most basic level, this ruling confirms -- in the event there was any lingering doubt -- that it is possible to create a private annuity that will be respected as an annuity subject to the insurance tax rules.

[33] The issuance of this ruling, however, is a reminder of a long-time debate among commentators relating to the treatment of certain variable annuity contracts under the OID definitional rules set forth in section 1275. That is, whether, despite the negative implication that may be drawn from the face of section 1275, an annuity can escape classification as a debt instrument even if it does not satisfy one of the exceptions set forth in section 1275 for life annuities and annuities issued by companies subject to tax under subchapter L.

Corporate-owned Life Insurance (COLI)

[34] AEP's motion for rehearing was denied on July 9, and its petition for certiorari was denied on January 12, 2004. The Sixth Circuit will, nevertheless, likely be revisiting the issue of broad-based, leveraged COLI as the government appeals the *Dow Chemical* decision, its first judicial loss in this area. It appears that several other courts will also have the pleasure of hearing leveraged COLI cases as a number of taxpayers refused to accept the government's "final" settlement offer and are headed down the litigation path.

[35] It is not surprising that the Service feels emboldened by its many successes in the leveraged COLI area, and that it has now greatly expanded the types of broad-based life insurance arrangements it is closely scrutinizing.

District Court Rules IRS Improperly Denied Dow Chemical's Deductions on COLI Plans

[36] **Citations:** *Dow Chemical Company, et al. v. United States*; 00-10331-BC (Mar. 31, 2003). For the full text, see *The Insurance Tax Review*, May 2003, p. 759; *Doc 2003- 8335 (140 original pages)* [**PDF**]; or *2003 TNT 64-7*. *Dow Chemical Co., et al. v. United States* No. 00-10331-BC (E.D. Mich. Aug. 12, 2003). For the full text, see *The Insurance Tax Review*, October 2003, p. 595; *Doc 2003-19615 (9 original pages)* [**PDF**]; or *2003 TNT 172-10*.

[37] **Overview:** A U.S. district court held on March 31 that Dow Chemical Co. was entitled to deductions claimed for interest on loans secured by its broad-based COLI policies.

[38] **Discussion:** This is a big win for taxpayers after the disappointing court rulings of *CM Holdings*,[4] *Winn-Dixie*,[5] and *AEP*.[6] In those cases, the courts ruled against the taxpayer in disallowing interest deductions related to certain COLI transactions. In *Dow Chemical*, the court held that Dow Chemical's COLI transactions had economic substance. This is the first loss for the government in a leveraged, broad-based COLI case, although the courts that rendered the prior broad-based COLI decisions rejected portions of the government's arguments.

[39] This case may signal a line being drawn with respect to when an interest deduction related to a broad-based, minimum deposit COLI purchase will be respected. While the *Dow Chemical* decision is being appealed to the Sixth Circuit, the Northern Division of the Eastern District of Michigan (as opposed to its Sixth Circuit counterpart in the Southern District of Ohio, which heard the *AEP* case) has drawn a distinction between those cases where there is an opportunity for mortality gains and losses and those where it suggests such contingency has been eliminated.[7]

[40] If these decisions do nothing else, they demonstrate that not all leveraged COLI policies are cut from the same cloth, and they make a strong statement that distinctions among arrangements must be analyzed and respected. This, unfortunately, is not the approach the Service has taken towards the wide variety of leveraged COLI transactions that have been under examination and before Appeals over the course of the past several years. This was most recently manifested in a "take it or leave it, one size fits all" settlement offer it briefly put on the table for all taxpayers with post-'86, broad-based, leveraged COLI policies, irrespective of any differences in transactional facts.

[41] Another important aspect of this case is that the court came to its conclusion regarding the taxpayer's plans for administering the policies regardless of its possession of prepurchase illustrations that highlight means of administering the policies in a way that might not generate positive pretax cash flows or likely would not for nearly 20 years. In both this case, and elsewhere, the Service has relied on illustrations to serve as the primary reference point for demonstrating taxpayer intent. As evidenced by the *Dow Chemical* decision, any indicia of intent reflected on the face of these and other types of third-party marketing materials, are not, by themselves, sufficient for this purpose.

[42] As noted above, the Service has become more aggressive in terms of the types of broad-based life insurance cases -- both leveraged and unleveraged -- that it is examining. Only time will tell whether the standard that appears to be emerging from these cases will result in the Service adjusting its posture regarding the taxpayers it is currently scrutinizing.

Bank-owned Life Insurance

[43] Beginning approximately two years ago, the Service embarked upon a broad-ranging expedition seeking information relating to broad-based and other life insurance transactions entered into by large and small banks throughout the country. In fact, some banks have received information document requests with over 100 questions relating solely to this issue.

[44] Now that the initial phases of its journey are complete, the Service is currently focusing its scrutiny on a small sample of identified banks, as it seeks to finally determine whether there is cause to raise a challenge in this area under any of approximately four potential specific issues. It is anticipated that the Service will decide within the next several months whether it will further pursue any efforts in this area.

Business-owned Life Insurance, Generally

[45] On the legislative front, the recent pension bill that passed the Senate Finance Committee, contained a proposal by Sen. Jeff Bingaman, D-N.M., to generally eliminate the exclusion for death benefits received by businesses on former employees who were not employed by the company during the year prior to death.[8] As one might suspect, this provision was met with a groundswell of opposition from the insurance industry that resulted in an amendment proposed by Sen. Kent Conrad, D-N.D. Conrad's amendment sets forth conditions for businesses purchasing life insurance on employees, which, if met, will enable such businesses to continue to exclude death benefits. Members of the insurance industry have voiced their support for the Conrad amendment, in the event that this bill is put before the full Senate.

[Editor's note: On January 14, Senate Finance Committee Chair Charles E. Grassley, R-Iowa, released a draft proposal to reform COLI policies. See p. 161 for coverage.]

[46] A hearing that was scheduled to specifically address the Bingaman and Conrad proposals resulted in a number of newsworthy comments, including a statement that did not directly deal with the primary matter being discussed. In his opening remarks, a Deputy Assistant Treasury Secretary for Tax Policy indicated that while Congress has previously enacted legislation that eliminates most of the perceived abuses surrounding the use of leverage to purchase life insurance contracts, "the IRS will still challenge those specific arrangements it believes are sham transactions or lacking economic substance." That comment, in and of itself, is not surprising. What is significant, however, is that he made the remark in the context of a

discussion regarding pre-1986 transactions that he acknowledged have been continually grandfathered from the interest deduction limitation rules enacted at that time and in subsequent legislation.

[47] Another witness, representing the General Accounting Office (GAO), described the findings of a GAO study on business-owned life insurance. She explained some of the concerns expressed by various regulatory bodies in this area, including the IRS. Among the issues that the IRS indicated it is looking into are: (1) whether companies with variable insurance products are exercising proscribed "investor control" over the assets underlying their insurance products; and (2) whether funds used by certain organizations to acquire life insurance policies are indirectly sourced in debt. The first of these items is one that most observers have been generally aware the Service is looking at. The official's mention of the second item, however, provided confirmation that the Service is, in fact, examining this issue. The primary potential consequence of somehow being able to indirectly trace funds used to purchase a life insurance policy to debt would presumably be a loss of deductibility of certain interest payments.

Split-Dollar Life Insurance

IRS Issues Final Regulations on Split-Dollar Life Insurance Arrangements

[48] **Citations:** T.D. 9092; 68 F.R. 54336-54361 (Sept. 11, 2003). For the full text, see *The Insurance Tax Review*, October 2003, p. 607; *Doc 2003-20325 (101 original pages)* [**PDF**]; or *2003 TNT 177-5*. Rev. Rul. 2003-105; 2003-40 IRB 696 (Oct. 6, 2003). For the full text, see *The Insurance Tax Review*, October 2003, p. 642; *Doc 2003-20326 (2 original pages)* [**PDF**]; or *2003 TNT 177-6*.

[49] **Overview:** The Service issued final regulations on income, employment, and gift taxation of split-dollar life insurance arrangements. The final regulations provide guidance to persons who enter into split-dollar life insurance arrangements after September 17, 2003, and to any split-dollar life insurance arrangement entered into on or before September 17, 2003, that is materially modified after September 17, 2003.

[50] **Discussion:** "[THEY] FINALLY DID IT!"[9]

[51] No, the Service did not blow up the world, as mankind did in "Planet of the Apes." But it did set forth a rule that appears to, in some instances, effectively currently tax the inside build-up of a life insurance contract. It is perhaps the most egregious of the provisions set forth in the final split-dollar regulations, and the one that represents the most blatant disregard of the statutory scheme for taxing life insurance.

[52] A number of other items in the related proposed regulations that wrought outcries from tax professionals also were not given much attention by Treasury and the Service. Notably, the final regulations: retain the artificial and rigid two-regime approach that fails to account adequately for the economic reality of the split-dollar life insurance arrangements; incorporate overly formalistic notions of policy ownership; contain a curious definition of "current access" to cash value; improperly deny basis, or investment in the contract, to "nonowners" who pay premiums; improperly elevate a section 61 tax theory over the specific section 72 rules governing life insurance; and pay no heed to reasonable requests for additional transitional relief.

[53] Treasury and the Service worked long and hard on these regulations in an effort to resolve uncertainty over the taxation of split-dollar arrangements. The only remaining uncertainty is how long it is going to take before these new rules are challenged in court.

[54] In any event, the final regulations, together with the Rev. Rul. 2003-105 declaration rendering much of the earlier guidance in this area obsolete, have created a new landscape that will dramatically alter the manner in which these products are designed and marketed.

Life Insurance Contract Qualification

IRS Reviews Cash Distribution on a Challenge in Life Insurance Benefits

[55] **Citations:** Rev. Rul. 2003-95, 2003-33 IRB 358. For the full text, see *The Insurance Tax Review*, October 2003, p. 643; *Doc 2003-18805 (3 original pages)* [**PDF**]; or *2003 TNT 159- 5*. LTR 200333029 (May 6, 2003). For the full text, see *Doc 2003-18719 (7 original pages)* [**PDF**] or *2003 TNT 159-54*. LTR 200327037 (Mar. 27, 2003). For the full text, see *Doc 2003-15927 (7 original pages)* [**PDF**] or *2003 TNT 129-69*. LTR 200328027 (Apr. 10, 2003). For the full text, see *Doc 2003-16427 (7 original pages)* [**PDF**] or *2003 TNT 134-53*. LTR 200329040 (Apr. 16, 2003). For the full text, see *Doc 2003-16940 (6 original pages)* [**PDF**] or *2003 TNT 139-54*. LTR 200320020 (Feb. 2, 2003). For the full text, see *The Insurance Tax Review*, July 2003, p. 150; *Doc 2003-12280 (6 original pages)* [**PDF**]; or *2003 TNT 96-41*.

[56] **Overview:** In Rev. Rul. 2003-95, the Service provides guidance on the application of rules under section 7702(f)(7) relating to the taxation of distributions made in connection with a reduction in benefits. The Service also issued a number of rulings granting waivers for certain failed contracts.

[57] **Discussion:** WOW! Guidance under section 7702(f)(7)! See Rev. Rul. 2003-95. Hopefully, it is just a precursor to the much broader set of regulatory guidance taxpayers have been waiting for since the enactment of section 7702 in 1984. After all, even the Service, by its own words, demonstrates a need for clarification of the rules in this area. In fact, no less than three of the above- cited section 7702(f)(8) waiver rulings this year dealt with failures attributable to some form of "misinterpretation" of the rules. See, for example:

- LTR 200328027 -- In dealing with yet another failure due to a taxpayer's application of "footnote 53," the Service stated, "the errors are a possible misinterpretation of the mechanics of section 7702 with respect to these types of Contracts."
- LTR 200329040 -- "The legislative history is not clear as to the use of the attained age increment-decrement method, nor is there a specific requirement for its use in section 7702(f)(7)(A).
- LTR 200320020 -- "Although the requirement set forth in [the Code] refers only to the determination required for the cash value accumulation test, and does not expressly apply to the guideline premium limitations, this provision is the only direction provided by Congress as to how [these] charges . . . are to be considered from a computational standpoint. The legislative history, moreover, is absent of any indication that there be two separate standards. . . . [A]bsent any indication to the contrary . . . we conclude that [the Code] implicitly requires. . . .

[58] The Service has been very reasonable in its approach towards the granting of waivers;

however, such private guidance, albeit available for general publication in redacted form, cannot be relied upon by other taxpayers.

[59] As noted in Part I of this article (Federal Insurance Tax Matters), the Service has purchased software intended to facilitate insurance company tax reserve audits, as well as to test section 7702 compliance. Although the Service has indicated that it is not planning to currently use the software for section 7702 purposes, presumably it anticipates doing so in the future. Perhaps it would be more beneficial for the Service to dedicate resources towards the development of interpretative guidance that would assist in preventing contract failures before it invests in additional methods to challenge insurance companies on their application of complex rules for which there is a virtually undisputed need for clarification.

[60] Finally, there is at least one specific issue on the near horizon for which insurance companies have been crying out for guidance, and which has been placed on the Treasury/IRS 2003-2004 business plan: i.e., what to do when 2001 CSO becomes the prevailing law -- for example, how to determine reasonable mortality, deal with potential material change issues, and manage the cash value corridor, not to mention tax reserves under section 807.

Captive Insurance Companies

Premiums Paid to Captive Insurer Are Not Deductible

[61] **Citations:** TAM 200323026 (Feb. 7, 2003). For the full text, see *The Insurance Tax Review*, July 2003, p. 133; *Doc 2003-13826 (10 original pages)* [**PDF**]; or *2003 TNT 110-6*.

[62] **Overview:** The IRS in technical advice memorandum 200323026 concluded that payments made by a parent corporation and its operating subsidiaries to a related foreign captive insurer were not deductible as "insurance premiums" under section 162.

[63] **Discussion:** Among the Service's findings in this technical advice memorandum were that the foreign captive subsidiary was, according to the Service, grossly undercapitalized (one-twentieth of the capital recommended by the taxpayer's own feasibility study); the captive insurance company received two-thirds of its premium income from a single sibling corporation; and the contracts between the captive and its siblings and parent corporation were so informal that a contract was not signed until the fourth policy year for claims-made coverage allegedly commencing on day one, year one. Moreover, day one of the policy occurred about a month before the captive insurance company was even formed. The IRS compared these facts to the facts in Rev. Rul. 2002-90 and found the captive in the TAM did not qualify as an insurance company for federal income tax purposes. Specifically, the IRS stated that although the captive was adequately capitalized for local law purposes, it was not adequately capitalized to pay the liabilities it purportedly assumed in the alleged insurance contracts -- e.g., it did not have enough capital to cover even a single loss event. Further, receipt of two-thirds of the premium income indicated to the Service that there was a lack of risk distribution and that the informality of the agreements evidenced a lack of substance to the transaction. Although the IRS did not specifically rely on this fact, there were also parental guarantees of performance provided in the TAM.

[64] Since the IRS's abandonment of the economic family theory, it has been "advertising" that it will continue to heavily scrutinize captive insurance transactions under facts-and-

circumstances type analyses. For those taxpayers that have been clamoring for more guidance as to the types of facts the Service will deem to be "bad," the taxpayer in this case just might serve as the poster child for what not to do. Here the Service glommed onto what it apparently deemed to be a lack of a serious intent to provide insurance coverage. One aspect of the ruling that is curious, however, is the fact that the Service looked to the number of insureds rather than the number of independent risks being covered in finding there was a lack of risk distribution. One could foresee this becoming a matter of controversy should such a methodology be applied in a case involving less controversial facts.

Other Product Tax Developments

IRS Clarifies Which Insurance Companies Qualify for Tax Exemption

[65] **Citations:** Notice 2003-35; 2003-23 IRB 992 (May 9, 2003). For the full text, see *The Insurance Tax Review*, June 2003, p. 968; *Doc 2003-11700 (2 original pages)* [**PDF**]; or *2003 TNT 91-50*.

[66] **Overview:** The Service issued a reminder that an entity must qualify as an insurance company for federal income tax purposes in order to be treated as a tax-exempt organization under section 501(c)(15).

[67] **Discussion:** This notice is significant since the IRS observed that it would challenge a claim of tax-exempt status under section 501(c)(15) whether the claim is made "pursuant to an existing determination letter or on a return." Historically, these determination letters have been issued without scrutinizing qualification of the requesting entity as an insurance company.

[68] The notice adds that taxpayers claiming to be tax-exempt pursuant to section 501(c)(15) should consider whether they are engaged in arrangements described in Notice 2002-70, which would thus be treated as listable transactions. This is yet another strong indication of how broadly the Service intends Notice 2002-70 to be read.

Subsidiary Liquidation Won't Affect Life or Annuity Contracts

[69] **Citations:** LTR 200303028 (Oct. 2, 2002). For the full text, see *The Insurance Tax Review*, March 2003, p. 437; *Doc 2003-1588 (3 original pages)* [**PDF**]; or *2003 TNT 13-23*.

[70] **Overview:** The Service ruled that the liquidation of two life insurance companies into their life insurance company parent will not adversely affect the subsidiaries' life insurance or annuity contracts.

[71] **Discussion:** The Service ruled that a liquidation of two life insurance subsidiaries into their parent will not affect the date on which the subsidiaries' policies were issued, entered into, or purchased, provided that the liquidation does not materially change the terms and conditions of those contracts except for a change in obligor. This is similar to the approach the Service has historically taken in cases involving a structural change to the issuer.

Service Outlines Taxation of Benefits Under Life Insurance Riders

[72] **Citations:** LTR 200339015 (June 17, 2003). For full text, see *The Insurance Tax Review*, November 2003, p. 790; *Doc 2003-21145 (4 original pages)* [**PDF**]; or *2003 TNT 188-17*.

LTR 200339016 (June 17, 2003). For full text, see *Doc 2003-21146 (4 original pages)* [**PDF**] or *2003 TNT 188-18*.

[73] **Overview:** The Service ruled on the tax treatment of benefits that an individual would receive under cash value life insurance contract riders pertaining to critical illness and disability.

[74] **Discussion:** Both of these rulings illustrate a straightforward application of the tax rules governing health and disability benefits. In each of these cases, the riders at issue are attached to cash value life insurance products, and include coverages defined in the separate riders and that are triggered in the event of death of a spouse or child, chronic illness, disability, or critical illness. This fact does not cause a tax issue in either case. The products are, however, illustrative of the types of policies being developed today that seek to combine the benefits of life insurance with protection against catastrophic medical needs and loss of income. This demand is also manifest in the growth of the life settlement industry. That is, many policyholders enter this market because of changes in estate planning needs, or because they no longer want or need their policies. Increasing numbers of people are also learning that there is perhaps a more profitable alternative to policy surrender that takes advantage of the values in their life insurance policies during a time of financial need -- i.e., by selling their policies to investors, many of whom are seeking to package and securitize them as a new asset class.

Company's Funding Agreements Are Not Insurance Contracts

[75] **Citations:** TAM 200325001 (Feb. 13, 2003). For full text, see *The Insurance Tax Review*, August 2003, p. 324; *Doc 2003-14961 (9 original pages)* [**PDF**]; or *2003 TNT 120-10*.

[76] **Overview:** In technical advice, the Service has concluded that funding agreements between an insurance company and institutional investors are not insurance or annuity contracts for tax purposes for which reserve items under section 807(c)(3) or 807(c)(4) are recognized.

[77] **Discussion:** Some contracts issued by insurance companies qualify as insurance for purposes of the life insurance company qualification test. Some contracts issued by insurance companies do not qualify as insurance for purposes of the life insurance company qualification test, but nevertheless qualify as insurance for purposes of measuring insurance company taxable income. Some contracts issued by insurance companies qualify as insurance for neither purpose, even though they may perform economically in a manner similar to those that do. Got that?

[78] Well, either way, the funding agreements that are the subject of the current technical advice fall in the latter category. According to the Service, this is primarily because they provide no purchase rate guarantees and the only risks being transferred are investment risks. The introduction to last year's discussion of product tax issues indicated that the age old question of "what is insurance?" -- or rather, what will be respected as such for tax purposes -- persists despite years of searching for the holy grail of an answer. This ruling provides yet another pixel in the bitmap of authorities on this issue.

Conclusion

[79] As noted at the outset of this article, there was movement in 2003 on a number of significant issues. In the year ahead, perhaps a number of other questions at the forefront of conversation will be answered as well. For example, will Treasury and the Service provide any more guidance under section 7702 -- and if so, what direction will it take?Will there really be another round of legislation that changes the tax treatment of business-owned life insurance? If not, will the Service attempt to make its own law through a challenge to a bank's treatment of its life insurance policies, or through a proposed adjustment to a pre-1986 leveraged contract? What might the president or one of the presidential aspirants propose during this election year? More dividend or capital gain tax relief -- or perhaps some other vehicle that might also be viewed as an alternative to annuities, such as a new savings incentive program? Finally, what will become of the split-dollar life insurance market in light of the 2003 final regulations -- or might those rules be successfully challenged in court?

[80] While new tax rules undoubtedly affect the products being developed, what effect will the development of new products have on the current rules? Will a new alternative risk vehicle whose design is driven by the convergence of the insurance and capital markets result in new regulation? Do the rules currently in place adequately address the questions that might arise as a result of the burgeoning life settlement market? Finally, how might the current body of captive insurance case law be applied now that the Service has finally indicated its willingness to rule in that area?

[81] Time will tell.

FOOTNOTES

[1]An article to appear in a coming edition of *The Insurance Tax Review* will provide a detailed discussion of the evolution of the investor control doctrine and how it has been articulated in the historical guidance.

[2]*See* Frederic J. Gelfond. "2002 Insurance Tax Year in Review: Part II -- Product Tax Matters." *The Ins. Tax Rev.*, Feb. 2003, p. 43.

[3]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (Code).

[4]*IRS v. CM Holdings Inc.* (In re *CM Holdings Inc., et al.*), 301 F.3d 96 (3rd Cir. 2002), *aff'g* 254 B.R. 578 (D. Del. 2000). For the full text of the Third Circuit's opinion, see *The Insurance Tax Review*, Oct. 2002, p. 503; *Doc 2002- 19191 (16 original pages)* [**PDF**]; *2002 TNT 161-10* ; or for the full text of the district court's opinion, see *The Insurance Tax Review*, Dec. 2000, p. 1014; *Doc 2000-26945 (154 original pages)*; or *2000 TNT 203-5* .

[5]*Winn-Dixie Stores Inc. v. Commissioner*, 113 T.C. 254 (1999) (for the full text, see *The Insurance Tax Review*, Dec. 1999, p. 1331; *Doc 1999-33731 (81 original pages)*; or *1999 TNT 202-6*); aff'd, 254 F.3d 1313 (11th Cir. 2001) (for the full text, see *The Insurance Tax Review*, Aug. 2001, p. 285; *Doc 2001-18038 (4 original pages)* [**PDF**]; or *2001 TNT 127-61); cert. denied*, __ U.S. __, 122 S.Ct. 1537 (2002).

[6]*American Electric Power Inc. v. United States*, __ F.3d __, 2003 FED App. 0125P (6th Cir.), *aff'g* 136 F. Supp. 2d 762 (S.D. Ohio 2001), *cert. denied* __ U.S. __ (2003). For the full text of

the Sixth Circuit's opinion, see *The Insurance Tax Review*, June 2003, p. 927; *Doc 2003-10647 (9 original pages)* [**PDF**] or *2003 TNT 82-11*; for the full text of the district court's opinion, see *The Insurance Tax Review*, April 2001, p. 657; *Doc 2001-5282 (26 original pages)* [**PDF**]; or *2001 TNT 36-8*.

[7] The government had requested that that court reconsider its decision based on one of the court's individual findings that certain withdrawals constituted factual shams; and thus the transaction as a whole was a sham. As the government requested, the court modified its earlier opinion; but rather than granting the government the ruling it desired, the court instead ruled that the withdrawals were not factual shams.

[8] The National Employee Savings and Trust Equity Guarantee Act (NESTEG).

[9] *See* Charlton Heston, as astronaut George Taylor in "Planet of the Apes," upon his discovery that mankind, through nuclear war, had destroyed the world as he knew it (20th Century Fox, 1968).

END OF FOOTNOTES

Tax Analysts Information

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