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Federal Insurance Income Tax Update

November 18, 2010

Patient Protection and Affordable Care Act

PL 111-148
HR 3590

Patient Protection and Affordable Care Act

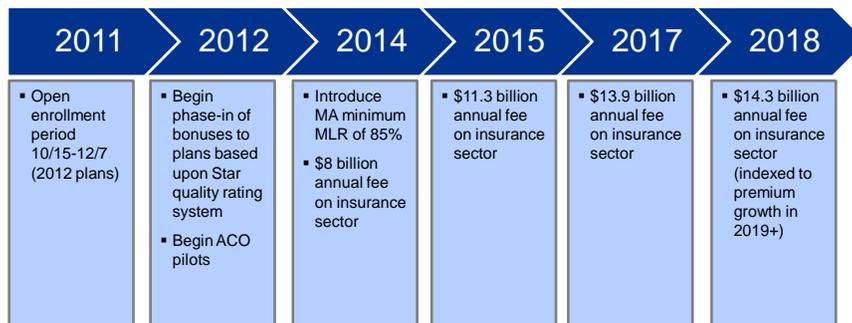
Important Features:

- An annual fee on health insurance providers
- Mandatory Form 1099 reporting
- Inclusion of annuities in the definition of unearned income subject to the 3.8 percent Medicare tax imposed on certain individuals
- 40 percent excise tax on high-cost employer health plans
- \$500,000 section 162(m) limitation
- Elimination of the employer deduction for the portion of retiree prescription drug coverage offset by Medicare Part D coverage
- Limitation on eligibility for section 833 benefits to otherwise qualifying Blue Cross Blue Shield organizations

Health Reform

- Medicare Advantage provisions:
 - Moves benchmarks closer to parity with FFS
 - Bonuses for quality
 - 85% minimum MLR beginning in 2014
 - Medical costs to include medical management / quality expenses
 - Limits annual selling season: October 15 – December 7 (2012 plans)
- Insurance industry tax beginning in 2014
- Accountable Care Organization pilots are a potential positive
- Lengthy implementation timeline creates opportunity for policy/political changes

The Timeline of Reform



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Form 1099 – Processing an IRS B-Notice

- IRS Sends out B-Notice lists twice a year: fall and spring (relates to immediately prior year 1099s)
- Most penalties assessed for name/TIN mismatch or missing TINs
- New requirements related to first & second B-Notice letters:
 - Which notice you send depends on the number of times within a three calendar year period the payee has appeared on the list.
 - IRS will not tell you how many times a payee has appeared. Company must track all notifications over that three year period.
- First appearance (First Notice)
 - First B-Notice letter sent – IRS language
 - Form W-9
 - Payee responds with Form W-9
- Second appearance (Second Notice)
 - Second B-Notice letter sent – IRS language
 - No Form W-9
 - Payee must obtain government documentation of the payee's correct name and TIN
- Deadlines for processing B-Notice list
 - 15 business day from 'basis date': mail B-Notice letters to payees
 - 30 business days from 'basis date': backup withhold on payments to payees who have not responded to the letters
- B-Notice mailing contents
 - Envelope with bold and conspicuous "Important Tax Document Enclosed" or "Important Tax Return Document" language on it
 - Required B-Notice letter – first or second
 - Form W-9 (if first notice)
 - Return envelope (optional)
- Processing and documenting a Company's handling of B-Notices is important as this is how you get penalties waived
- IRS has announced back-up withholding audits on the increase
 - Potential for increased revenues
- Form 1099 penalties to increase from \$50 to \$100 (starts for 2010 Form 1099s filed in 2011)
- IRS TIN matching program should be utilized

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2010 Tax Legislation: Section 162(m)(6) Compensation Limitation

- Health Act – Limits on Deductibility of Compensation for “Covered Health Insurance Providers”
- The new code Section 162(m)(6) limits the deduction for compensation to the amount of \$500,000.00 for compensation paid to employees, directors and independent contractors for years 2013 and after.
Impact on compensation earned during years 2010 to 2012 and deferred until 2013 and later.
- One definition of covered health insurance provider for years 2010 through 2012-health insurance coverage under Section 9832 (b)(1).
- Another definition for years 2013 and later- any health insurance company which has 25% or more of its gross premiums from health insurance for “minimum essential coverage”.

WellPoint Inc. v. Commissioner

- WellPoint Inc. v. Commissioner, 599 F.3d 641 (7th Cir. 2010)
 - The Seventh Circuit (affirming the Tax Court) held that an insurance company is not entitled to deduct as business expenses the amounts it paid to settle lawsuits and for related legal and professional expenses, finding that the suits were to resolve its title to assets and the expenses are capital expenditures.

Life Insurance Companies

Overview – Life Insurance Companies

Corporate Tax

- Terminal Dividends – PLR 200948042
- Reserves – American Financial Group
- Segregated Asset Amounts 953(d) Companies – PLRs 201027038 & 201038008
- Section 351 & Revenue Rule 94-95 – PLR 201006002
- Section 338(h)(10) – PLRs 201015028 & 201026008

Investment Tax

- Finance Reform and IRC Section 1256 Contracts
- Impairment and IRC Section 166

Product Tax

- Annuity Tax – Partial Annuitization
- Annuity Tax – Partial Exchange
- Policyholder Tax 7702/7702A – Revenue Procedure 2010-28

Other

- Foreign Life Branch – CCA 201013001

Corporate Tax – PLR 200948042: Terminal Dividends

- The Taxpayer issues “participating” life insurance policies that entitle policyholders to receive two types of dividends: annual dividends and termination dividends.
 - An annual dividend is payable to each policyholder on the anniversary date of his or her policy, and represents a share of the Taxpayer’s divisible surplus earned from business operations during the preceding year.
 - A termination dividend is a one-time dividend payable to certain policyholders when the policy terminates due to the death of the insured or the maturity or surrender of the policy.
- The Taxpayer accrues and deducts on December 31 of each taxable year the amount of dividends that will become payable with anniversary dates in January of the following year on the basic amount of the annual dividend to policyholder accounts prior to December 31.
- PLR concludes that following “all events” test that:
 - The Taxpayer may not accrue and deduct the taxable year annual dividends on an insurance policy that, under the terms of the policy, may become payable during the first month of the succeeding taxable year.
 - The Taxpayer may not accrue and deduct in the taxable year the lesser of the termination dividend or annual dividend that, under the terms of the policy, become payable in the succeeding taxable year.
 - Liability is a “Payment Liability”.

Corporate Tax – Reserves American Financial Group, 105 AFTR 2d 2010-1587

- At issue was the application of AG 33 to annuity contracts issued before 1995
- IRS argued that AG 33 constituted a change to CARVM and reserves for contracts issued before 1995 could not take AG 33 into account.
- Taxpayer agreed that AG 33 was not a change to CARVM but was an interpretation of the proper application of CARVM.
- Court found for the Taxpayer.
- Government has appealed.

Corporate Tax – Segregated Asset Accounts of Electing Section 953(d) Companies – PLR 201027038; PLR 201038008

- At The separate accounts to which the company allocates all or part of the amounts received under life insurance and annuity contracts issued by the company, which pursuant to foreign country law, are segregated from the general asset accounts of the company, will be treated as accounts that are segregated from the general asset accounts of the company, "pursuant to State law or regulation."
- Pursuant to foreign country law, these accounts are segregated from the company's general accounts. The ruling addressed whether the separate accounts should be treated as accounts segregated from the general asset accounts of the company, "pursuant to State law or regulation."
- Anomalies cited as bases for conclusions:
- If the separate account products are denied variable account status, the diversification rules of section 817(h) and the regulations there under will not apply to the separate account products. The result will be that the separate account products will be recognized as life insurance contracts without meeting the diversification rules. Congress' stated purpose in enacting the diversification requirements, to discourage the use of tax-preferred variable annuity and variable life insurance primarily as investment vehicles, would be subverted.
- A foreign insurance company that elected to be treated as a domestic insurance company under section 953(d) would be able to issue separate account products that do not meet the diversification rules, but nevertheless qualify as life, endowment, or annuity contracts. The inside buildup on the electing foreign company's non-diversified contracts would not be subject to current taxation, while the inside buildup on non-diversified contracts issued by domestic companies would be subject to current taxation.

Corporate Tax – Section 351 & Revenue Rule 94-45 PLR 201006002

- Reaffirms that assumption reinsurance will qualify for IRC treatment as per Revenue Ruling 94-45.
- Ruled on a series of exchanges done by an international group.
- In general no gain or loss will be recognized except that the transferee company will recognize as ordinary income gain affiliated with market discount bonds.
- Indemnity reinsurance may not be sufficient.

Corporate Tax – IRC Section 338(h)(10) PLR 201015028; PLR 201026008

- Reconfirmation of use of IRC 338(h)(10) in a spin off
- Parent and Seller plan to dispose of more than 50% of NewCo
- NewCo was formed to acquire all the stock of certain Parent subs
- Seller will enter into a binding agreement with an unrelated third party and will enter into a firm commitment underwriting agreement to effect the subs of NewCo common stock in an IPO
- An affiliate of Parent may act as one of several underwriters in an IPO
- PLR (10) concluded that Parent on behalf of Seller and NewCo will be eligible to make the election under IRC Section 338(h)(10)

Investment Tax – Finance Reform and IRC Section 1256 Contracts

- "2010 Financial Regulation Act" amends Code Section 1256 and broadens the list of contracts that are excepted from the definition of Section 1256 that is excepted from mark-to-market treatment.
- Section 1256 contracts are mainly regulated futures contract, foreign currency contract, non-equity option, dealer equity option, and dealer securities futures contract.
- Section 1256 contracts are marked-to-market at year end.
- Any capital gain or loss on a Section 1256 contract that is marked-to-market is treated as if 40% of the gain or loss is short-term capital gain or loss, and as if 60% of the gain or loss is long-term capital gain or loss.
- For tax years beginning after the enactment date, the 2010 Financial Regulation Act provides that all of the following are excepted from the definition of a Section 1256 contract: Any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.
- The change addresses the re-characterization of income as a result of increased exchange-trading of derivative contracts by clarifying that Code Section 1256 does not apply to certain derivatives contracts transacted on exchanges.

Investment Tax – Impairments – SSAP 43R

- Recently adopted SSAP 43R requires insurers to allocate other than temporary impairment (OTTI) charges between interest-and non-interest-related declines in the value of all loan-backed and structured securities.
- The requirements are similar to those in U.S. GAAP.
- SSAP 43R defines a non-interest-related decline in value as one caused by the issuer's fundamental credit problems. An interest-related decline in value is caused by increases in the risk-free interest rate and/or general credit spread widening.

Investment Tax – Impairments – SSAP 43R

- If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance-sheet date, the insurer must determine whether the following circumstances exist and, if so, recognize a loss:
- If the insurer intends to sell the security or does not have the intent and ability to retain the security until its amortized cost is recovered, the security is other-than-temporarily impaired.
- A realized loss is recognized for the entire difference between the security's amortized cost and its fair value at the balance sheet date.

Investment Tax – Impairments – SSAP 43R

- If the insurer does not expect to recover the entire amortized cost from the present value of the security's future cash flows, it cannot assert it has the ability to recover the security's amortized cost even though it has no intent to sell and has the intent and ability to retain the security.
- The security is therefore other-than-temporarily impaired. A realized loss is recognized for the non-interest-related decline, which is the difference between the security's amortized cost and the present value of cash flows expected to be collected.
- OTTI related to interest-related declines is not recognized.

Investment Tax – Impairments – SSAP 43R

- SSAP No. 43R applies to investments held as of September 30, 2009, and to new investments purchased and held by the reporting entity after September 30, 2009.
- It supersedes SSAP No 98 and paragraph 13 of SSAP No. 99.

Investment Tax – Impairments – Tax Issues

- Section 166 vs. section 165 deduction
- Determination of the amount of partial worthlessness
 - Is it the same as the OTTI charge?
 - Pre and Post SSAP 43R
 - Write down to fair value vs. present value of cash flows

Product Tax – Annuity Taxation 2010 Small Business Act – Partial Annuitization

- In Rev. Proc. 2008-24, the IRS had ruled on the treatment of the partial exchange of annuity contracts, but specifically stated that the ruling did not apply to partial annuitization, which is the conversion of only a portion of an annuity, endowment or life insurance contract into annuity payments.
- In Rev. Proc. 2010-3, IRS identified partial annuitization as a no ruling area that is under study by IRS.
- Under 2010 Small Business Act, the basic annuity taxation rule Code Sec. 72(a)(1) is retained without change. However, the 2010 Small Business Act added a new rule that will permit the partial annuitization of a nonqualified annuity, endowment, or life insurance contract.
- Effective for amounts received in tax years beginning after 2010.

Product Tax – Annuity Taxation – PLR 201038012

- LTR 201038012 Partial Exchange qualified under section 1035.
- Ruling sought because insurer issued letter that a withdrawal from the retained contract following the partial exchange precluded section 1035 treatment.
- Taxpayer argued that because he had attained the age of 59½ years, the withdrawal should qualify as a tax-free exchange under §4.01(b) of Rev. Proc. 2008-24.
- IRS Ruled in favor of the Taxpayer.

Product Tax – Policyholder Tax 7702/7702A

Revenue Procedure 2010-28

- The 2001 CSO tables became the prevailing commissioners' standard tables during calendar year 2004, and have been adopted by all 50 states.
- Unlike the 1958 Commissioners Standard Ordinary Mortality Tables ("1958 CSO tables") and the 1980 Commissioners' Standard Ordinary Mortality Tables ("1980 CSO tables"), the 2001 CSO tables extend to age 121.
- As a result, an increasing number of issuers now develop contracts with maturity dates beyond age 100, even though the qualification of a contract as a life insurance contract (and as a MEC) is tested using computational rules that deem the contract to mature between the day on which the insured attains age 95 and the day on which the insured attains age 100.
- Revenue Procedure 2010-28 addressed this stating that the service will not challenge the qualification of a contract as a life insurance contract under §7702, or assert that a contract is an MEC under §7702A, if the contract satisfies the requirements of those provisions using all of the Age 100 Safe Harbor Testing Methodologies of this revenue procedure.

Thank You

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