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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
Assistant District Counsel

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS:FI&P

SUBJECT: Interest on Dividend Accumulations

This Field Service Advice responds to your memorandum dated September 9, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer =
Percentage A =

ISSUES

Whether Taxpayer is correctly accounting for interest credited on policyholder dividends left on deposit with Taxpayer.

CONCLUSIONS

The first two arguments presented by Exam carry substantial litigating hazards, and should not be pursued. We agree with Exam, however, that the definition of "policyholder dividends" set forth in § 808 includes the interest on deposited policyholder dividends at issue in this case. Accordingly, Taxpayer should account for such interest payments as required by § 808.

FACTS

Taxpayer issues participating life insurance policies that provide for the payment of policyholder dividends. The dividends are declared at the end of each calendar year, payable in the following year on the condition that the policy remain in force on its anniversary. The policyholder is offered a number of elections as to the application of the dividends once payable. One of the elections is to leave the dividends on deposit with Taxpayer. The accumulated dividends will earn interest at a rate to be declared by Taxpayer each year, but is guaranteed to be no less than Percentage A per year. Interest is payable only for amounts left on deposit for full policy years. Taxpayer routinely declares interest at a rate substantially in excess of the guaranteed rate, but generally no greater than the state prevailing assumed interest rate.

Under annual statement accounting, a liability must be established for interest accrued (by the passage of time) as of the balance sheet date, but not yet credited to the policyholders' accounts. Thus, for a policy with a July 1st anniversary date, six months of interest will be reported for statutory accounting purposes.

For tax purposes, Taxpayer claims a deduction under I.R.C. § 808 for the dividends credited to the policyholder. With respect to those dividends left on deposit, Taxpayer reports premium income pursuant to § 808(e), and claims a reserve deduction under § 807(c)(4). Taxpayer claims only the reserve deduction, without the corresponding premium/dividend treatment, for the interest accrued on such policies.

The Service has determined that the deduction for interest paid on dividend accumulations is subject to the accrual method of accounting and that the deduction does not satisfy the "all-events" test for such deduction prior to the end of each policy year. Taxpayer contends that it is entitled to use the method of accounting for such interest which it uses in accounting for such interest on its annual statement.

LAW AND ANALYSIS

Section 807(b) allows a deduction for increases in reserves, and § 807(a) requires that decreases in reserves are included in income. Section 807(c) identifies those reserves which are taken into account under § 807. Section 807(c)(4) identifies as an included reserve "dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts." Taxpayer maintains that because dividend accumulations is a specifically defined reserve under § 807, the accrual accounting method does not apply to interest credited to such reserves.

At the outset, it should be noted that if it is determined that the accrual accounting method is applicable to such interest payments, the effect would be to delay accrual until the year the interest is credited to the policyholder's account. See Rev. Rul. 79-218; 1979-2 C.B. 260; See also, Rev. Rul. 67-352, 1967-2 C.B. 176; People's Bank and Trust Co. v. Commissioner, 50 T.C. 750 (1968).

Exam has raised three possible arguments for the position that the deduction for interest credited on dividend accumulations is subject to the accrual accounting method: (1) that the accrual method is required for § 807(c)(4) reserves; (2) that § 807(c)(4) reserves do not include interest until credited to the policyholder's account; and (3) that part of the interest itself qualifies as a policyholder dividend, and therefore is subject to the accrual method under § 808. You have determined that the first and second arguments are not defensible, but that the third argument is defensible. We shall address separately each of these arguments.

Argument One -- The accrual method is required for § 807(c)(4) reserves.

The first argument is that the accrual method is required for § 807(c)(4) reserves. Section 811 provides, in general, that life insurance companies must report their income and deductions using the accrual method of accounting and that NAIC accounting must be followed unless the rules of accrual accounting dictate a contrary result. As described above, NAIC accounting rules allow recognition of an increase in reserves for interest accrued until year end. Exam interprets § 811 to dictate that, although NAIC rules apply to "insurance-type" reserves such as life insurance reserves, this is not an "insurance-type" reserve and therefore accrual accounting rules should govern. The reserve at issue is not an "insurance type" reserve in the sense that it does not involve life, health or accident contingencies, but only debt-type obligations.

In North Central Life Insurance Company v. Commissioner, 92 T.C. 254 (1989), the court determined the proper method of accounting for certain retroactive rate credits under former § 818, the predecessor to § 811. The court ruled that in applying § 818, "insurance-type reserves" were subject to NAIC accounting rules, but that other items were to be accounted for using tax accrual rules. NAIC accounting rules allow a deduction for an increase in reserve prior to the satisfaction of the "all-events test" under accrual accounting. The Court reasoned that under insurance accounting rules, reserve items correspond to premium income received. If premiums were to be taxed as received but deductions allowed only as they later became fixed, the result would be to tax very large sums of money as income when in fact those amounts will never really become income because they will have to be paid out to policyholders and other claimants. Therefore the court did not consider insurance accounting to be inconsistent with accrual accounting provisions.

The Court defined "insurance-type reserves" to be those included in former § 810(c). Former § 810(c) is similar to current § 807(c) in that it identifies the same types of reserves for which increases and decreases are taken into account as deductions and additions to income, respectively. Dividend accumulations and other amounts held at interest were, as now, identified as a reserve item. Under this reasoning, all reserves identified under § 807(c) qualify for NAIC accounting rules.

The North Central analysis is of continued relevance. Section 807(c) defines those items which will be deductible or includible in income as increases or decreases in reserves. The term reserve is commonly used to distinguish an estimated amount set aside for a future liability from a current liability. Unless a reserve account is specifically authorized by the Code, no deduction will be allowed for amounts set aside to cover a liability not yet incurred. World Airways, Inc. and World Air Center, Inc. v. Commissioner, 62 T.C. 786 (1974). Although some of the items included in § 807(c) do not involve insurance type contingencies, they are included in § 807(c) because Congress intended them to be treated as insurance reserves. Otherwise, there would be no need for a special provision for such items, because they would be deductible under general rules applicable to trade or business expenses. This interpretation is supported by the legislative history to § 807, which generally reflects that NAIC reserve methods apply in absence of specific provisions in § 807 to the contrary. S. Rept. 98-169 (Vol. 1) 541 (1984).

On the basis of the foregoing, we conclude that this argument carries significant hazards in this case, and we recommend that you not pursue it.

Argument Two -- Section 807(c)(4) reserves do not include interest until credited to the policyholder's account.

The second argument is that the reserve described in § 807(c)(4) for "dividends and other amounts, held at interest" only includes interest after it is credited to the policyholder’s account, which does not occur until after the policy anniversary date. A literal reading of the phrase "dividends and other amounts, held at interest" would restrict the reserve to the account balance upon which interest is computed. Under this interpretation, interest cannot be deducted as an increase to reserve until the policy anniversary date, when the interest is actually included in the policyholder’s account balance.

Although a literal reading of the provision appears to support Exam's position, we conclude that such a literal reading is not appropriate in this instance. In the present case, all increases in the account balance, including increases due to the additional dividends, are not credited until the policy anniversary date. Nevertheless, this fact, per se, does not preclude such amounts from being taken into account under the reserve method set forth in § 807.[1] Moreover, even assuming a distinction could be drawn between interest and other increases in the account balance, this argument would result in more than one accounting method being applicable for the same reserve. Finally, the legislative history of § 807 specifically provides that, unlike the treatment under the 1959 Act, the deduction for increases in § 807(c) reserves would take into account both premiums and assumed interest "credited to the reserves." S. Rept. 98-169 (Vol. 1) 539 (1984). Thus, we conclude that Congress did not intend that the reserve be limited to changes actually credited to the policyholder's account balance.

We also note that Exam, in suggesting a literal interpretation of § 807(c)(4), implicitly argues that interest cannot be included in the reserve until the all-events test has been satisfied. We have rejected this argument, supra.

On the basis of the foregoing, we conclude that this argument carries significant hazards in this case, and we recommend that you not pursue it.

Argument Three – Part of the interest itself qualifies itself as a policyholder dividend and, therefore, is subject to the accrual method under § 808.

The third argument is that interest on dividend accumulations in excess of guaranteed rates qualifies as policyholder dividends under § 808. Life insurance companies calculate the deduction for policyholder dividends in accordance with accrual accounting principles. § 808(c)(1); National Life Insurance Co. v. Commissioner, 96 F.3rd 639 (2d Cir. 1996). Therefore, if excess interest on dividends qualifies as a policyholder dividend under § 808, it should be accounted for under accrual accounting principles.

The fact that dividends, if left on deposit, would also qualify as increases to § 807(c)(4) reserves should not lead to a different result. Section 808(c)(1) specifically directs that the accrual accounting method be used in accounting for policyholder dividends. Section 808 applies to policyholder dividends whether or not they are left on deposit, and in fact, as more fully discussed below, applies to specific amounts left on deposit. Therefore, we conclude that § 807(c)(4) can not

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[1] We note that other code sections may impose additional restrictions. E.g., § 808 (limiting timing of deduction for policyholder dividends).

be read to accelerate the timing for deductions otherwise qualifying as dividends under § 808.

Section 808(a) defines policyholder dividends as any dividend or similar distribution to policyholders in their capacity as such. Section 808(b) provides that, for purposes of Subchapter L, the term "policyholder dividend" includes--

> (1) any amount paid or credited (including as an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the Company or the discretion of the management,
>
> (2) excess interest,
>
> (3) premium adjustments, and
>
> (4) experience-rated refunds.

Section 808(d)(1) defines "excess interest" as any amount in the nature of interest paid or credited to a policyholder in his capacity as such, and in excess of interest determined at the prevailing State assumed rate for such contract.

The legislative history states that for purposes of § 808(d)(1), amounts in the nature of interest include all amounts paid for the use of money, regardless of the designation adopted by the payor or payee, and include interest payments with respect to amounts left on deposit. See Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Deficit Reduction Act of 1984 611 (Comm. Print 1984) (the "Bluebook").

The amounts in question are amounts in the nature of interest paid to the policyholder in his capacity as such, with respect to amounts left on deposit. Thus, to the extent that the rate exceeds the prevailing state assumed rate, the amounts would qualify as policyholder dividends under § 808(b)(2).

It could be argued that interest on dividend accumulations does not qualify as policyholder dividends even if they satisfy the criteria of § 808(b)(1) because interest on indebtedness is not "dividends and similar distributions to policyholders in their capacity as such" as defined in § 808(a). In UNUM Corporation v. United States, 130 F.3rd 501 (1st Cir. 1997), the Court held that amounts that may qualify under § 808(b) are not policyholder dividends unless they also satisfy § 808(a). This is consistent with the legislative history of § 808, which states that the section was intended to include any distribution to a policyholder that is the "economic equivalent of a dividend." H.R. Conf. Rep. No. 98-861, at 1056 (1984).

Sections 808(b)(2) and 808(d)(1), however, specifically include within the definition of policyholder dividends interest on indebtedness. Therefore, it must follow either that § 808(b) is not restricted by § 808(a), or that Congress considered interest on indebtedness, if otherwise satisfying § 808(b), to be the economic equivalent of a dividend.

In UNUM, supra, the Court held that a policyholder dividend was not subject to the limitations of § 316(a), and therefore was payable from sources other than earnings and profits. Nevertheless, it identified certain criteria that were the essential characteristics of a policyholder dividend. The payment must be based on the contractual relationship between the policyholder and the insurer. It must be a unilateral distribution. It must be a recurrent return paid to policyholders by a going corporation in the ordinary course of business. Finally, and of most importance in the context of that case, it must leave the owner's equity interest in the company intact.

All of these criteria have been met in the instant case. The payment is pursuant to the contract between the policyholder and the insurer. The policyholder does not give up anything in exchange for the payment. The payments are made recurrently in the ordinary course of the business of the insurer. They do not impact on the policyholder's equity interest in the company.

It could also be argued that Congress intended that § 808(b)(2) be the sole basis upon which interest payments could qualify as dividends under § 808. There is nothing in the statute, however, that indicates whether Congress considered any of the § 808(b) items to be mutually exclusive. Any of the payments described in § 808(b)(2) through (b)(4) could also qualify under § 808(b)(1) if the payments were not fixed in the contract but based on company experience or management discretion. Section 808(b)(1) by its terms is susceptible to a broad reading, and there is nothing in § 808(b) that limits its applicability.

The legislative history of § 808, interpreted in the context of prior law, further supports the conclusion that Congress did not intend to restrict the broad language of § 808(b)(1).

Former § 811 imposed substantial limitations on the amount of the deduction for policyholder dividends. Therefore, the determination of whether an item qualified as a dividend was quite significant. Under § 811(a), policyholder dividends were defined as dividends and similar distributions to policyholders in their capacity as such. Section 811, however, specifically excluded from the definition of policyholder dividends "interest paid" as defined in former § 805(e). Interest paid included amounts in the nature of interest, whether or not guaranteed, on insurance or annuity contracts, which did not involve, at the time of accrual, life, health, or accident contingencies. Treas. Reg. § 1.805-8(b)(2). It included interest paid on dividends left on deposit with the company, as well as "excess interest dividends, " generally defined as interest on other amounts left on deposit with the company, e.g., as a settlement option. These amounts were included in determining the policyholder's share of investment yield under § 805, and were also taken into account as reserves under former § 810(c)(4). Rev. Rul. 72-253, 1972-1 CB 204; PLR 8702002, (Sep. 12, 1986). Since they were already excluded from income, they were not deductible as a dividend in determining gain from operations.

The legislative history underlying former § 811 indicates that Congress considered the criteria now found in § 808(b)(1) to be the benchmark for determining whether a payment was a policyholder dividend. It indicates that Congress excluded interest paid under § 808(e) from this definition to make clear that excess interest payments on contracts not involving insurance contingencies were not policyholder dividends even though they met this criteria. H. Rep. No. 34, 86th Cong. 1st Sess. , 1959-2 C.B. 813. This language is also to be found in Treas. Reg. § 1.811-2(a).

The regulations implicitly acknowledged that but for § 811, interest paid could qualify as a policyholder dividend, as reflected in the following language in Treas. Reg. § 1.811-2(a):

> In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which during the taxable year contains a right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders.... However the term does not include interest paid (as defined in section 805(e) and paragraph (b) of § 1.805-8) or return premiums (as defined in section 809(c) and paragraph (a)(1)(ii) of § 1.809-4). Thus, so-called excess-interest dividends and amounts returned by one life insurance company to another in respect of reinsurance ceded shall not be treated as dividends to policyholders even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of the management.

Although excess interest on contracts involving life contingencies did not qualify as interest paid, there was controversy as to whether such interest qualified as policyholder dividends, even through such interest was not fixed in the contract but depended on the experience of the company or the discretion of management. This type of excess interest was defined in PLR 8236069 (June 11, 1982) as follows:

> The term ‘excess interest’ [refers] to that portion of the amounts credited to a policyholder’s account above the minimum amount or rate guaranteed in the contract to be credited. Often the minimum guaranteed amount or rate is the same as the amount or rate used for state reserve valuation purposes. The term ‘excess interest’ as used here should not be confused with the term ‘excess-interest dividends’ which is used in sections 1.805-8(b)(2) and 1.811-2(a) of the Income Tax Regulations.

In Rev. Rul. 82-133, 1982-2 C.B. 119, the Service ruled that excess interest on deferred annuity contracts paid at the discretion of management was a policyholder dividend. This ruling had also been applied to universal life policies. PLR 8236069, (June 11, 1982).

In 1982, Congress considered the treatment of excess interest credited to deferred annuity contracts. Congress was concerned that Rev. Rul. 82-133 which would treat such amounts as policyholder dividends, would place certain products at a competitive disadvantage. It therefore amended § 805(e) to provide that certain excess interest payments on annuity contracts qualified as interest paid. It noted that although competitive concerns were driving this decision, "the legal issue concerning excess interest was unsettled." It also provided grandfathering relief for excess interest on contracts which did not qualify as annuities, such as universal life policies. Congress, however, left open the issue of whether such amounts are properly treated as interest or policyholder dividends for years after January 1, 1982. Staff of Joint Committee on Taxation, 97th Cong., 2d Sess., <u>General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982</u> 359 (Comm. Print. 1983).

In addition to these disputes, there was litigation with respect to return premiums and experience-rated refunds as to whether such amounts were paid on terms which reflected the experience of the company or the discretion of management, or otherwise qualified as policyholder dividends.

The legislative history underlying § 808 reflects that Congress was well aware of this unsettled state of current law. In describing present law, Congress cited the exclusion for interest paid and the discretionary test set forth in the regulations. It also referred to excess interest, which it as amounts in the nature of interest paid or credited to policyholders at a rate in excess of the rate used under the contract for purposes of computing the company's reserve deduction. It noted that taxpayers had taken the position excess interest payments credited to insurance reserves were not policyholder dividends, even though such amounts were discretionary. In describing § 808, the Bluebook explained:

> The Act adopts a broad definition of the term policyholder dividends to include any distribution to a policyholder that is the economic equivalent of a dividend. Thus, in addition to any amount paid or credited to policyholders (including an increase in benefits) when the amount is not fixed in the contract but depends on the experience of the company or the discretion of management, the term policyholder dividends specifically includes excess interest, premium adjustments, and experience-rated refunds. In this regard, the Act corrects a possible deficiency of prior law which may have permitted companies to avoid the limitations on policyholder dividends through the use of excess interest and experience-rated products rather than traditional dividend paying products.

Staff of Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Deficit Reduction Act of 1984 611 (Comm. Print 1984)

As the foregoing indicates, Congress was well aware that absent specific restrictions such as the exclusion for interest paid, the discretionary test set forth in prior regulations, now found in § 808(b)(1), was susceptible to a broad reading, although there were ongoing disputes as to its scope. Not only did Congress not attempt to restrict the definition of policyholder dividends to resolve this controversy, it expanded the definition, both by removing the limitation for interest paid and by making clear that certain payments were covered whether or not they qualified under § 808(b)(1). Therefore, absent express Congressional statement to the contrary, we conclude that the restrictive definition of excess interest in § 808(d)(1) was not intended to limit the more expansive definition set forth in § 808(b)(1).

Therefore, we agree with Exam's position that interest on dividend accumulations in excess of guaranteed rates qualifies as policyholder dividends under § 808.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Argument One

As explained, supra, the Tax Court in North Central held that "insurance-type reserves" were subject to NAIC accounting rules. The Court further defined "insurance-type reserves" to be those included in former § 810(c). Former § 810(c) is similar to current § 807(c) in that it identifies the same types of reserves for which increases and decreases are taken into account as deductions and additions to income, respectively. Dividend accumulations and other amounts held at interest were, as now, identified as a reserve item. Under this reasoning, all reserves identified under § 807(c) qualify for NAIC accounting rules.

Furthermore, although some of the items included in § 807(c) do not involve insurance type contingencies, they are included in § 807(c) because Congress intended them to be treated as insurance reserves. Otherwise, there would be no need for a special provision for such items, because they would be deductible under general rules applicable to trade or business expenses.

For the following reasons, it is unlikely that a court would accept Exam's first argument. Due to the substantial litigating hazards which this argument presents, we recommend that you not pursue it.

Argument Two

As explained, supra, a literal reading of the phrase "dividend accumulations, and other amounts, held at interest" provided in § 807(c) would restrict the reserve to the account balance upon which interest is computed. The items included in § 807(c), however, are generally not subject to accrual accounting rules. Even assuming a distinction could be drawn between interest and other increases in the account balance, this argument would result in more than one accounting method being applicable for the same reserve. Furthermore, the legislative history suggests that Congress did not intend that the reserve be limited to changes actually credited to the policyholder's account balance.

[redacted]

Argument Three

The legislative history underlying § 808 suggests that Congress intended that the term "policyholder dividend" be broadly construed. [redacted]

Please call if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel

By: ______________________________
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