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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 DISTRICT COUNSEL,

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

SUBJECT: Items taken into account for purposes of calculating reserves for life insurance companies

This Field Service Advice responds to your memorandum dated December 8, 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 =
Year 1 =
Year 2 =

ISSUES

(1) Whether I.R.C. § 807(e)(1)(B), which provides a special rule requiring that the net surrender value of pension contracts be reduced by surrender charges, applies to pension reserves taken into account under § 807(c)(4);

(2) If so, whether § 807(e)(1)(B) applies to surrender charges that may not be applied due to contingencies reflected in the underlying contract.

CONCLUSIONS

(1) Section 807(e)(1)(B) applies to reserves taken into account under § 807(c)(4) that are attributable to group pension plan contracts. Accordingly, such reserves must be reduced by any surrender charges provided in the contracts.

(2) Section 807(e)(1)(B) is applicable to the reserves at issue regardless of whether the surrender charges are subject to contingencies.

FACTS

Taxpayer is a qualifying life insurance company under § 816. Included among the products marketed by Taxpayer are group pension annuity contracts sold to employee groups in both the public and private sectors. The contracts at issue are group annuity contracts which were sold to and used as funding vehicles for private sector qualified pension plans covered by § 401, and for public sector deferred compensation plans covered by § 457; consequently, the contracts meet the definition of "pension plan contracts" set forth at § 818.

The contracts at issue offer both fixed and variable options to participants, and are presently in the "accumulation phase." Accordingly, Taxpayer's reserves with respect to these contracts reflect amounts held to accumulate towards the purchase of fixed and variable annuities for individual participants. The reserves for both of these products are stated to be held at "full fund value," i.e., the reserves are computed principally with reference to the amounts held on deposit. Taxpayer and the agent agree that the statutory valuation method applicable to these contracts is the Commissioners' Reserve Valuation Method (CRVM).[1]

Most, if not all, of these group annuity contracts contain temporary annuity purchase rate (APR) guarantees. In addition, the group contracts provide for surrender charges, referred to in the contracts as "contingent deferred sales charges," which are applied upon the withdrawal of funds in certain situations.

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[1] We understand that under CRVM, an insurer is required to accumulate the funds it holds under a contract at the interest rate guaranteed under the contract, and to discount this accumulated amount back to the calculation date utilizing the appropriate interest rate under statutory accounting rules. Unless the interest rate guaranteed under the contract and the statutory interest rate are the same, a reserve so calculated will be different than the accumulation value of the contract on the same date.

These surrender charges do not apply in cases of death, disability, financial hardship, or annuitization, and the amount of the surrender charge declines each year that the contract is in effect, ultimately being phased out entirely.

The agent and Taxpayer agree that Taxpayer's reserves attributable to the group annuity contracts should be taken into account under § 807(c)(4), which includes in reserves amounts for dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts. The parties agree that § 807(c)(4) is the appropriate code section because the contracts are presently in the accumulation phase, and the contracts provide temporary, rather than permanent, purchase rate guarantees. In contrast to Taxpayer's position, however, the agent argues that Taxpayer's reserves with respect to the group contracts should have been reduced by taking into account potential surrender charges. The agent has proposed adjustments accordingly with respect to Year 1 and Year 2.

LAW AND ANALYSIS

Issue 1:

Section 807(c)(1)-(6) sets forth a list of six categories of reserves that life insurers must take into account in determining income. Section 807(a) provides that net decreases in § 807(c) reserves during the taxable year are included in the taxpayer's gross income under § 803(a)(2), while § 807(b) provides that net increases in § 807(c) reserves during the taxable year are taken into account as a deduction under § 805(a)(2). Only one of the six types of reserves, set forth at § 807(c)(1), is applicable to "life insurance reserves," as that term is defined in § 816(b).

Section 807(c)(3) provides that, among the items taken into account as reserves under § 807(c) are amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies. The flush language of § 807(c) further provides that, for purposes of reserves taken into account under § 807(c)(3), the appropriate rate of interest is the higher of the prevailing Federal interest rate, the prevailing State assumed interest rate, or the rate of interest assumed by the company in determining the guaranteed benefit. In no case, however, will such reserves be discounted to an amount less than the net surrender value of the underlying contract.

Section 807(c)(4) provides that, among the items taken into account as reserves under § 807(c) are dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.

Section 807(e)(1)(B) sets forth a special rule for computing reserves for pension plan contracts. Specifically, § 807(e)(1)(B) provides that for purposes of § 807, the balance in the "policyholder's fund" shall be treated as the net surrender value of such contract, determined with regard to any penalty or forfeiture which would be imposed upon surrender but without regard to any market value adjustment.

As discussed, the agent in this case argues that Taxpayer must take into account surrender charges in determining its reserves attributable to the group annuities. Although § 807(e)(1)(B) requires that the net surrender value of pension plan contracts be determined with regard to any penalty or forfeiture imposed upon surrender of such contract, the agent also agrees with Taxpayer that the reserves at issue should be taken into account under § 807(c)(4). In contrast to reserves taken into account under § 807(c)(3), the code does not expressly require that reserves taken into account under § 807(c)(4) be determined with reference to net surrender values. Accordingly, it arguably appears that the requirements set forth in § 807(e)(1)(B) apply to reserves taken into account under § 807(c)(3), but not to reserves taken into account under § 807(c)(4).

Nevertheless, we agree with the agent's position that reserves taken into account under § 807(c)(4) are subject to the limitations imposed by § 807(e)(1)(B). As part of the Deficit Reduction Act of 1984 (DRA of 1984), Congress revised the portion of subchapter L applicable to life insurance companies. In an attempt to clarify the tax treatment of reserves with respect to group pension plan contracts which do not contain permanent APR guarantees, Congress in the DRA of 1984 enacted a provision, presently contained in § 816(f), which removes from the numerator and denominator of the life insurance company qualification ratio amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies.[2]

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[2] Under § 816(a), an insurance company qualifies as a life insurance company if its life insurance reserves, plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies (the numerator) comprise more than 50 percent of the company's "total reserves" (the denominator). The legislative history reflects that Congress enacted § 816(f) in order to resolve any question as to how the types of funds described by § 816(f) should be treated for purposes of the qualification fraction. Senate Finance Comm., 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, at 527 (Comm. Print No. 169 (1984)).

In connection with the enactment of § 816(f), the legislative history underlying the DRA of 1984 states that if group pension contracts written by an insurance company have any insurance or APR guarantees (for life or a fixed term), then the premiums for such contracts must be taken into life insurance company gross income under § 803 and the increase in "the fund" is treated as an increase of a reserve item under § 807(c)(3) or (c)(4); if there are no guarantees whatsoever, however, then the insurer need not include premiums as income and no reserves will be treated as increased. See 1 Senate Finance Comm., 98th Cong., 2d Sess., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, at 525, 527 n.7 (Comm. Print No. 169 (1984)); H.R. Rep. No. 98-432, pt. 2, at 1402, 1403 n.7. Although this legislative history does not make specific reference to the special rule in § 807(e)(1)(B), its reference to "the fund" in connection with group pension contracts suggests Congress' intent that the "policyholder's fund" as defined in § 807(e)(1)(B) be used as the basis of determining the reserves attributable to such group pension funds under § 807(c)(3) or (4).

This interpretation is further supported by the provisions of § 807(e)(1)(B). Since § 807(e)(1)(B) applies for purposes of all of § 807, the special rule extends to all of the rules regarding the determination of reserve increases and decreases set forth in § 807. Although the provisions of § 807, as originally enacted, made reference to net surrender values only in the context of the rules for computing increases an decreases in "life insurance reserves" (presently set forth in § 807(d)(1)), the technical corrections title of the Tax Reform Act of 1986 amended the provisions of § 807(c) to provide that, with respect to obligations on insurance and annuity contracts not involving life, accident or health insurance contingencies, the amount to be taken into account as a reserve item under § 807(c)(3) may not be less than the net surrender value of the contract. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1821(a), 100 Stat. 2837-2838 (1986), 1986-3 (Vol. 1) C.B. 754-755. The special rule in § 807(e)(1)(B), therefore, is not merely applicable to "life insurance reserves," but rather, is expressly applicable to the computation of pension plan reserves which are classified as reserve items under § 807(c)(3).

We conclude that since § 807(e)(1)(B) is applicable for purposes of § 807 as a whole, and because § 807(e)(1)(B) is not limited to the determination of "life insurance reserves," the special rule is applicable in computing pension plan reserves which are classified as reserve items under § 807(c)(4).

Issue 2

Taxpayer argues that there are no surrender charges to be taken into account to the extent that the surrender charges are subject to contingencies. In so doing,

Taxpayer argues that § 807(e)(1)(B) applies to amounts that "would be imposed," rather than "may be imposed." We disagree with Taxpayer's position. Taxpayer's interpretation, if accepted, would allow taxpayers to avoid having to take surrender charges into account in determining reserves related to pension contracts by simply subjecting such surrender charges to a contingency. Accordingly, we agree with your conclusion in this regard.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The agent has indicated on p.2 of the Form 886-A, included with your submission, that "most, if not all" of the contracts contain temporary APR guarantees. We cannot tell from the Form 886-A whether the entire proposed adjustment relates to contracts with temporary APRs. Please confirm this.

In addition, we note that since the code does not expressly require that reserves taken into account under § 807(c)(4) be determined with reference to net surrender values, but does expressly make that provision for reserves taken into account under § 807(c)(3), [redacted].[3] One distinction between reserves taken into account under § 807(c)(3) and (c)(4) is that reserves under § 807(c)(3) appear to contemplate future obligations "discounted at the appropriate rate of interest," whereas § 807(c)(4) reserves, by not referring to discounting, seem to contemplate amounts held "at interest" with no future obligation owing to the owner of the underlying contract. In this regard, included with your submission was a letter from [redacted] In that letter, Mr. [redacted] explains that the reserves were determined in accordance with CRVM, and suggests that life contingencies are not involved in the computation of the reserves in issue. Since CRVM calculations typically involve an accumulated amount which is then discounted by the amount of the statutory interest rate, it appears that the reserves in question are more consistent with the definition of § 807(c)(3) reserves than § 807(c)(4) reserves, particularly to the extent that Taxpayer has guaranteed particular rates of interest under the contracts.

[3] [redacted]

[redacted][4] If so, the reserves must be computed with reference to surrender charges, regardless of whether the reserves also meet the definition of § 807(c)(4) reserves. In so doing, we see no reason why Congress would have required surrender charges to be taken into account in calculating pension plan reserves contemplated by § 807(c)(3) without also requiring surrender charges to be taken into account in calculating reserves contemplated by § 807(c)(4).

Please call if you have any further questions.

Deborah A. Butler
Assistant Chief Counsel

By: _____
JOEL E. HELKE
Chief
Financial Institutions and Products Branch

[4] We also note that § 811(c) prevents a taxpayer from "double counting" a reserve item, thereby suggesting that a reserve could be fall into more than one of the six categories of reserves described in § 807(c). In this regard, § 811(c) is the successor to the flush language contained at the end of former § 810(c) in effect prior to enactment of the DRA of 1984. The double counting rule reflected in the flush language of former § 810(c) immediately follows the enumeration of the six categories of reserves presently set forth in § 807(c).