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IRS to Rule on the Meaning of Statutory Reserves

by Peter H. Winslow and Samuel A. Mitchell

The Department of Treasury 2007-2008 Priority Guidance Plan dated Aug. 13, 2007 includes the following new topic under the heading "Insurance Companies and Products:"

> "Revenue ruling concerning the meaning of the term 'statutory reserves' under section 807 when the company is subject to different statutory reserve requirements in different states."

The IRS does not usually place issues with clear answers on the priority guidance plan. Therefore, we are surprised the IRS believes taxpayers need priority guidance on this topic because those in the insurance industry who have studied it generally think current law is clear and not subject to debate.

The term "statutory reserves" in I.R.C. § 807 has a well-recognized meaning under current law. "Statutory reserves" are defined in I.R.C. § 807(d)(6) as "the aggregate amount set forth in the annual statement with respect to items described in section 807(c)." The "annual statement" is defined in Treas. Reg. § 1.6012-2T(c)(5) as "the form … which is approved by the National Association of Insurance Commissioners (NAIC), which is filed by an insurance company for the year with the insurance departments of States, Territories, and the District of Columbia."[1] For purposes of determining discounted unpaid loss reserves (*see* I.R.C. § 807(c)), the annual statement is defined in I.R.C. § 846(f)(3) to mean "the annual statement approved by the National Association of Insurance Commissioners which the taxpayer is required to file with insurance regulatory authorities of a State."

When the aggregate amount of statutory reserves reported on the annual statement differs by state, Treas. Reg. § 1.801-5(a) permits the taxpayer to select the applicable annual statement to use for purposes of filing its tax return. The regulation permits the taxpayer to select the annual statement that reflects the highest aggregate reserve in any state or jurisdiction in which it transacts business. This rule has been in the regulations since the Revenue Act of 1921. *See* former Treas. Reg. §§ 39.201-4(d) and 1.803-1(d); *Pan-American Life Ins. Co. v. Commissioner,* 38 B.T.A. 1430 (1938). Treas. Reg. § 1.6012-2T(c)(1) further requires an insurance company to file with its Federal income tax return, a "copy of its annual statement which shows the reserves used by the company in computing the taxable income reported on its return."[2] This regulation suggests, consistent with Treas. Reg. § 1.801-5(a), that the applicable annual statement used for reserves is selected by the company and filed or associated with the tax return. Although the regulations permit the taxpayer to choose the annual statement for tax purposes, the taxpayer cannot pick and choose among annual statements for different purposes. Rather, the taxpayer must use the same annual statement for all reserve purposes in computing taxable income.

By its terms, Treas. Reg. § 1.801-5(a) applies specifically to the reserves taken into account to determine whether a taxpayer satisfies the 50 percent reserve test under I.R.C. § 816 for qualification as a life insurance company. Perhaps the IRS is examining this issue because some of its employees may prefer to confine Treas. Reg. § 1.801-5(a) to life insurance company qualification and desire a rule that would require taxpayers to use smaller annual statement reserves for the increase-in-reserve-deduction under I.R.C. § 807. However, this narrow interpretation of the regulation cannot be supported under current law.

[1] The definition also includes a pro forma annual statement if the insurance company is not required to file the NAIC annual statement.

[2] An insurance company that files its tax return electronically does not transmit its annual statement with the tax return, but associates it with the return in its records for potential inspection by the IRS.

Statutory reserves reported on the annual statement affect an insurance company's taxable income in many ways. Therefore, the question of annual statement selection for purposes of the increase-in-reserves deduction must be analyzed in the broader context of how the annual statement generally is used in determining taxable income.

As stated previously, Treas. Reg. § 1.801-5(a) applies specifically for life insurance company qualification. A taxpayer qualifies as a life insurance company for Federal income tax purposes if its life insurance reserves (plus unearned premium and unpaid losses on noncancellable life, accident and health policies not included in life insurance reserves) comprise more than 50 percent of its total reserves. *See* I.R.C. § 816(a) under current law and former I.R.C. § 801(a) under the 1959 Act. Pub. L. No. 86-69 (1959). The legislative history of the 1984 Act states that I.R.C. § 816(a) adopts the same definitions as in pre-1984 Act law for both life insurance and total reserves. *See* Staff of the Joint Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Deficit Reduction Act* of 1984, 98th Cong., 2d Sess. 583-584 ("1984 Blue Book"). This is consistent with the more general statements in the legislative history to the effect that where the 1984 Act incorporates and carries over provisions from pre-1984 law, Congress intended that the 1984 Act be interpreted in a manner consistent with pre-1984 "regulations, rulings, and case law." *Id.* at 581. Under the 1959 Act, as well as the 1984 Act, life insurance company qualification is determined by statutory reserves. Therefore, there is no question that Treas. Reg. § 1.801-(a) continues to apply for that purpose.

The IRS appears to be focusing on whether Treas. Reg. § 1.801-5(a) has any application for computing the amount of the deduction for life insurance reserves under I.R.C. § 807(d). Statutory reserves enter into the computation of the reserve deduction in several ways. First, life insurance reserves are computed as the higher of the federally prescribed reserve or the net surrender value of the contract, subject to an overall cap based on statutory reserves. Second, although taxpayers generally must compute federally prescribed reserves using CRVM or CARVM as prescribed by the NAIC in effect on the date of the issuance of the contract regardless of statutory reserve methods or assumptions, the legislative history provides that in computing the federally prescribed reserves for assumptions not prescribed by I.R.C. § 807(d) the taxpayer "should begin with its statutory or annual statement reserve, and modify that reserve to take into account [the adjustments prescribed by the Code]." *Id.* at 599. Third, there are several types of life insurance reserves for which statutory reserves are not required to be recomputed at all under I.R.C. § 807(d).

Therefore, as with total reserves, mutual life insurance companies were permitted by Treas. Reg. § 1.801-5(a), but not required, to choose the annual statement that yielded the highest reserve to determine statutory reserves.

As indicated earlier, the amount of life insurance reserves taken into account in the deduction for the increase in reserves is capped at the amount of "statutory reserves." "Statutory reserves" currently are defined for this purpose in exactly the same way as in repealed I.R.C. § 809(b)(4)(B). Prior to its repeal effective for taxable years beginning after 2004, I.R.C. § 809 required mutual life insurance companies to reduce certain deductions based on a "differential earnings amount." In computing the differential earnings amount, the provision required mutual company taxpayers to take into account the excess of their "statutory reserves" over their "tax reserves." For this purpose, former I.R.C. § 809(b)(4)(B) defined "statutory reserves" as "the aggregate amount set forth in the annual statement with respect to the items described in section 807(c)." The items described in I.R.C. § 807(c) are the same items included in total reserves under I.R.C. § 816(a). *E.g.,* Treas. Reg. § 1.810-2(b)(2). Therefore, as with total reserves, mutual life insurance companies were permitted by Treas. Reg. § 1.801-5(a), but not required, to choose the annual statement that yielded the highest reserve to determine statutory reserves.

An example of life insurance reserves that do not have to be recomputed under I.R.C. § 807(d) involves certain reserves for supplemental benefits. I.R.C. § 807(e)(3) provides that the amount of the life insurance reserves for certain enumerated supplemental benefits shall be the reserves taken into account for purposes of the annual statement approved by the NAIC. The legislative history equates these reserves with "statutory reserves," which presumably are the same reserves taken into account for life company qualification purposes under

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I.R.C. § 816. S. Prt. 98-169, 98th Cong., 2d Sess., Vol. I (1984); 1984 Blue Book at 604.

Statutory reserves also come into play for tax reserves other than life insurance reserves. Prior to the 1984 Act, former I.R.C. § 810(c) provided a list of reserves that were taken into account in the deduction for increases in reserves. These reserve items essentially were the same items now included in total insurance reserves required by law under current I.R.C. § 816(a). In the 1984 Act, Congress made changes to only three of the I.R.C. § 810(c) reserve items. The changes were: (1) most life insurance reserves were required to be computed in accordance with I.R.C. § 807(d)(2); (2) I.R.C. § 807(c)(3) items were required to be discounted using the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits;[3] and (3) I.R.C. § 807(c)(6) special contingency reserves were required to be reasonable. For all other reserves, Congress intended pre-1984 Act rules to apply without change (presumably including the definition of statutory reserves used for purposes of "capping" the life insurance reserve deduction under the flush language of I.R.C. § 807(d)(1)). 1984 Blue Book at 598. That is, a life insurance company's reserve deduction for these other reserves is determined on the basis of statutory reserves as reported in the annual statement. In 1986, the Code was amended by adding I.R.C. § 846 to require discounting of unpaid losses. *See* I.R.C. § 807(c). Discounted unpaid losses are defined in I.R.C. § 846(b)(1) to mean "the unpaid losses shown in the annual statement filed by the taxpayer for the year ending with or within the taxable year of the taxpayer."

Thus, it seems clear from the face of the statute and current regulations that the permission to use the annual statement with the highest aggregate reserve granted by Treas. Reg. § 1.801-5(a) applies both for purposes of life insurance company qualification as well as for purposes of determining the deduction for all of these reserves. Under the 1959 Act, for example, former I.R.C. § 810(c), which detailed the items taken into account for the life insurance reserve deduction, cross-referenced the life insurance reserve definition in former I.R.C. § 801 for insurance company qualification. Furthermore, the amount of unpaid losses was the same amount included in total reserves, which, under Treas. Reg. § 1.801-5(a), can be the annual statement that yields the highest deduction. *See* Treas. Reg. § 1.810-2(b)(2). When Congress added I.R.C. § 846 to the Code (with a conforming amendment to I.R.C. § 807(c)) to require discounting of certain unpaid loss reserves, it continued to determine the deduction for I.R.C. § 807(c)(2) reserve items by reference to the annual statement. *See* I.R.C. §§ 846(b)(1) and (f)(3).

In analyzing the meaning of the term statutory reserves, the IRS also must consider how its ruling will affect other types of insurance companies. Under I.R.C. §§ 832 and 846, non-life insurance companies must compute their gross income and loss reserve deductions on the basis of the underwriting and investment exhibits of the annual statement approved by the NAIC. Treas. Reg. §§ 1.832-4 and 1.846-1. Aspects of the alternative tax on small non-life companies also are determined by reference to the annual statement. *E.g.*, I.R.C. §§ 834(c)(2), (d)(2) and (e)(2). The case law under the 1959 Act and earlier law made it clear that the rule of Treas. Reg. § 1.801-5(a) applies to all types of reserve deductions and for all types of insurance companies. *Central National Life Ins. Co. v. United States,* 574 F.2d 1067 (Ct. Cl. 1978); *Pan-American Life Ins. Co., supra; Lamana, Panno, Fallo v. Commissioner,* BTA Memo 1938-182; *see* also PLR 8951001 (Aug. 29, 1989). In fact, the IRS has ruled that the annual statement with the highest aggregate reserve is required to be used for purposes of determining minimum effectively connected net investment income of a foreign insurance company carrying on an insurance business in the United States. *See* Notice 89-96, sec. II.A.(1)(c), 1989-2 C.B. 417.

The court in *Continental Ins. Co. v. United States,* 474 F.2d 661 (Ct. Cl. 1973), explained the rationale for why the rule permitting the taxpayer to select the annual statement with the highest aggregate reserve applies to all types of insurance companies. State insurance departments are concerned with ensuring solvency and this necessarily requires an examination of the company's operations in all states. The court in *Continental* noted that the reserve provisions for life insurance companies in what is now Treas. Reg. § 1.801-5(a), and the reserve provisions for property/casualty-type unpaid losses, are "quite similar." The court noted: "Both affect the measure of income, both rely on state law, both refer to the

[3] I.R.C. § 807(c) was later amended to require discounting using the applicable Federal interest rate, if it is higher than the other two rates.

requirements of 'any state' in which the company does business, and both look to the most conservative state rule." *Id.* at 669.

At a recent tax conference, IRS representatives stated that Treas. Reg. § 1.801-5(a) may no longer be applicable under the 1984 Act because permitting the taxpayer to select the annual statement with the highest aggregate tax reserves would be incompatible with Congress' desire in the 1984 Act to limit tax reserves deductions. But, this reflects a misreading of Congressional intent. The legislative history of the 1984 Act indicates that the federally prescribed reserve computation in I.R.C. § 807 is designed generally to allow a tax reserve at the minimum amount a majority of states would require to be set aside. 1984 Blue Book at 599. Thus, the calculation of the federally prescribed reserve keys off CRVM and CARVM, which specify the minimum reserve for a contract under the Standard Valuation Law. But, contrary to the IRS representatives' assumption, the primary goal of Congress in enacting I.R.C. § 807 was to convert tax reserves from net level reserves as under the 1959 Act to preliminary term reserves (CRVM) and, in doing so, place all companies on a level playing field with respect to the calculation of their federally prescribed reserves. It was not Congress' intent to require companies to compute tax reserves using the smallest possible reserve amounts. In fact, it was not until 1987 that Congress required tax reserves to be recomputed by using the applicable Federal interest rate. Pub. L. No. 100-203, Sec. 10241(a). To avoid state-by-state variation, I.R.C. § 807(d) requires reserve computations "based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of states." 1984 Blue Book at 599. The standard is driven by the minimum amount that "most states" would require. However, some companies may operate in states where the statutory reserves exceed the federally prescribed reserves and others in states where the minimum reserve is less than the federally prescribed reserve. This provides a "level playing field" for all companies because those companies in states where the minimum statutory reserve is less than the NAIC standard can, if they are willing to bear the economic effect on their surplus, obtain the same tax treatment as others by increasing their statutory reserves. Otherwise, they are limited by the statutory reserve cap in section I.R.C. § 807(d)(1)(B).

It was not Congress' intent to require companies to compute tax reserve using the smallest possible reserve.

The federally prescribed reserve must be distinguished from the determination of the statutory reserve cap. The statutory reserve cap is in place to ensure that an insurance company does not take a deduction for a federally prescribed reserve unless it actually holds that reserve for statutory purposes. The 1984 Blue Book explains that "the amount of the deduction allowable or income includible in any tax year [by changes in reserves] is prescribed [by the federally prescribed reserve] regardless of the method employed in computing State statutory reserves." 1984 Blue Book at 598. The latter method, the statutory reserve method, merely defines a cap on the federally prescribed reserve so that companies are not allowed deductions for reserve amounts not reflected on their financial statements. The rule that permits the taxpayer to select the annual statement with the highest aggregate reserve appropriately implements the legislative purpose because it permits all insurance companies the same CRVM or CARVM reserve deduction unless their statutory surplus is not impacted by the reserves.

In summary, it appears that current law already answers the question posed in the Treasury Priority Guidance Plan. Statutory reserves should be those reserves reported on the annual statement selected by the company. We will have to wait and see whether the IRS agrees.

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com.*

Samuel A. Mitchell is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *smitchell@scribnerhall.com.*