



SOCIETY OF ACTUARIES

Article from:

Taxing Times

September 2006 – Volume 2, No. 2

The Statutory Reserve Cap on Tax Reserves Includes Deficiency Reserves

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With the hiring of Internal Revenue Service (IRS) tax actuaries in recent years, IRS examiners are paying closer attention to life insurance reserves in general. In addition to technical issues pertaining to how the reserves are computed, the agents are raising basic legal questions sometimes casting doubt on settled law. One area of particular attention has been deficiency reserves. In a troubling development, examiners are dredging up an old Field Service Advisory (FSA) from 1993, in which a National Office attorney incorrectly concluded that the statutory reserve cap in Internal Revenue Code section 807(d)(1) excludes deficiency reserves.¹ A deficiency reserve is a reserve in addition to the basic life insurance reserve that is equal to the present value of the excess of future net premiums over future gross premiums to be received on a life insurance contract. Historically, deficiency reserves were not deductible because they were held to be an additional reserve that is not held for future claims (*i.e.*, a type of surplus reserve).² The prohibition on the deduction of deficiency reserves carried over into the

current life insurance reserve taxation rules in section 807(d), enacted as part of the Tax Reform Act of 1984.³ Section 807(d) provides that the deductible reserve for a life insurance contract is the greater of net surrender value or the Federally Prescribed Reserve (FPR) calculated under prescribed interest rate and mortality assumptions, but in no event can the tax reserve exceed “aggregate statutory reserves” (*i.e.*, the statutory cap). The aggregate statutory reserves cap in section 807(d) originally was defined by cross-reference to the differential earnings amount calculations for mutual companies in former section 809.⁴ Section 807(d)(3)(C), in turn, provides that the FPR cannot include deficiency reserves. The issue addressed in the FSA is whether the exclusion of deficiency reserves applies only to the FPR calculated under the assumptions in section 807(d), or also to the aggregate statutory reserve cap.

The most logical place to start the analysis of whether the aggregate statutory reserves cap in section 807(d) includes deficiency reserves is with an explanation of the dual role statutory reserves originally played in the 1984 Act. Under the 1984 Act, aggregate statutory reserves were used not only to cap the tax reserve deduction, but also to measure the increase to a mutual company’s equity base in order to calculate the differential earnings amount for the reduction of the policyholder dividend deduction. The computation of the equity base began with a mutual company’s surplus and capital as reflected on its NAIC annual statement, which was then adjusted for several items. One adjustment was to increase the equity base by the excess of the “aggregate amount [of

¹ See 1993 WL 1609132 (Feb. 26, 1993). An FSA was an advice document provided by National Office attorneys to Field agents without the participation of the taxpayer. The documents are among a number of types of Chief Counsel Advice subject to public disclosure in redacted form under section 6110. At the time the FSA was drafted in 1993, the IRS took the formal position that FSAs were simply the opinion of one Chief Counsel Attorney, and, as such, covered by the governmental deliberative process privilege and thus not be subject to public disclosure. The IRS lost this battle in court, *Tax Analysts v. Internal Revenue Service*, 117 F.3d 607 (D.C. Cir. 1997), and Congress subsequently amended section 6110 to require disclosure of FSAs and other advisory documents known as Chief Counsel Advice. IRS Restructuring and Reform Act of 1998, sec. 3509, Pub. L. No. 105-206 (1998). Ironically, since the IRS lost the *Tax Analysts* FSA case and Congress amended section 6110, agents seem inclined to rely on FSAs to support adjustments, particularly in areas such as life insurance reserves where there is not an abundance of published guidance—this, in spite of the section 6110(k), which provides that Chief Counsel Advice, including FSAs, private letter rulings and the like cannot be cited or relied on as precedent.

² *North American Reassurance Co. v. Commissioner*, 29 BTA 683 (1934).

³ Pub. L. No. 98-369 sec. 211(a) (1984).

⁴ Repealed by Pub. L. No. 108-218(2004).

reserves] set forth in the annual statement” over the amount of tax reserves.⁵ Because this adjustment resulted in a larger reduction of the policyholder dividend deduction, the Joint Committee on Taxation’s Staff Report (1984 Bluebook) makes it clear that Congress wanted to make sure that statutory reserves for this purpose included deficiency reserves.⁶ The 1984 Bluebook also makes it clear that the statutory reserve cap, like the section 809 differential earnings amount determination, includes deficiency reserves. With regard to the cap, the 1984 Bluebook specifically states:

In no event will the amount of the tax reserves at any time exceed the amount of statutory reserves, which (given the general definition thereof in new sec. 809(b)(4)(B)(i)), include also any deficiency reserves relating to the liabilities.⁷

This quote clearly indicates that Congress intended the statutory reserve cap, by cross-reference to the section 809(b)(4)(B)(i) definition, to include deficiency reserves. This conclusion reflects settled law and is endorsed in the Internal Revenue Manual instructions for calculating the section 807(d) tax reserve, which provide as follows:

However, in the comparison to the statutory reserve, any deficiency reserve included in the contract’s statutory reserve is allowed to be included for purposes of the maximum FPR limitation.⁸

In the 1993 FSA, however, the National Office attorney relied on a wrinkle in legislative history of the 1986 Technical Corrections to the 1984 Act that affected section 816 and former section 809 to conclude that Congress intended to exclude deficiency reserves from the statutory cap. A brief explanation of the technical corrections is necessary to understand the FSA’s position, and why it is incorrect. Contrary to the FSA’s conclusion, the technical corrections actually reconfirm Congress’ intent to include deficiency reserves in the cap. In the 1986 Act, Congress made technical corrections to the 1984 Act to ensure that deficiency reserves would be excluded from the life insurance company

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qualification test under section 816 and to clarify that deficiency reserves should not be double counted in determining the equity base under former section 809. The change to section 816 added subsection (h), which specifically provides that deficiency reserves are excluded from life insurance reserves “for purposes of this section [the life insurance company qualification test] and section 842(b)(2)(B)(i) [the definition of United States surplus of a foreign company insurance doing business in the United States].” The obvious negative inference from section 816(h)’s limited application to the life insurance qualification and foreign company surplus provisions is that deficiency reserves are included for other purposes, such as the statutory reserve cap under section 807(d) and the calculations underlying the policyholder dividend deduction offset for mutual companies under former section 809.

The negative inference from the limited scope of section 816(h) becomes more obvious on consideration of the changes to former section 809. The original version of section 809 created a potential problem of double counting. Deficiency reserves were included in the adjustment to a mutual company’s equity base for aggregate statutory reserves in former section 809(b)(4)(A)(i) and then added a second time by former section 809(b)(5). To correct this problem, Congress amended former section 809(b)(2) to provide that no item shall be taken into account more than once in adjusting the equity base. The Joint Committee on Taxation’s Staff Report on the technical changes explains that this change was designed to avoid the double counting of deficiency reserves, which, the report specifically notes, are included in aggregate

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⁵ Former section 809(b)(4)(B)(i).

⁶ Staff of the Jt. Comm. on Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984, 615-616 (Comm. Print 1985) (1984 Bluebook).

⁷ 1984 Bluebook at 598.

⁸ IRM sec. 4.42.4.6.3(6)(d)(Revised May 2002).



statutory reserves in section 809(b)(4)(A)(i).⁹ Because the statutory reserve cap in section 807(d) originally was defined by cross reference to the definition of “statutory reserves” in former section 809(b)(4)(A)(i), the unmistakable conclusion from the double-counting correction is that deficiency reserves are included for purposes not only of section 809, but also for the statutory reserve cap in section 807(d). The technical correction adding section 816(h), which is specifically limited to the life insurance qualification and foreign company United States surplus determinations, should not be read to cast doubt on this conclusion.

The FSA, however, relied on a deletion in the Senate Finance Committee report regarding the new subsection 816(h), to conclude that the subsection, in spite of its self-limiting language, also applied to the statutory reserve cap in section 807. The House Committee Report underlying the technical correction that added section 816(h) contains a definitive statement that deficiency reserves are included in statutory reserves for purposes of the statutory reserve cap comparison.

Likewise, this change does not affect the fact that deficiency reserves are included in statutory reserves for purposes of comparing the tax reserve to statutory reserves in determining the amount of¹⁰ any increase or decrease in life insurance reserves.

The Senate Finance Committee report discussion of the new section 816(h), however, omits the “likewise”

sentence regarding the statutory reserve cap in section 807(d).¹¹ The 1993 FSA noted that a Joint Committee Staff Report pertaining to section 807(d) also contained the sentence quoted above that deficiency reserves are to be included in the statutory cap. Nevertheless, the FSA discounted the Joint Committee Staff report and concluded that the omission in the Senate Finance Committee Report created a negative inference that Congress changed its mind and intended to omit deficiency reserves from the statutory cap.

There are a number of reasons why the 1993 FSA is incorrect, in addition to the fact that it contradicts the current IRS position as stated in the Internal Revenue Manual. Most fundamentally, as mentioned above, statutory reserves for purposes of the cap in section 807(d)(1) were originally defined in former section 809. The 1984 Act legislative history directly on point is unequivocal that statutory reserves include deficiency reserves for this purpose. The 1986 Act technical corrections to section 816 did nothing to change the treatment of deficiency reserves in sections 807 and 809 (other than to reconfirm that deficiency reserves are included in statutory reserves under section 809). Instead, the plain language of section 816(h), added by the technical correction in the 1986 Act, is that the new exclusion of deficiency reserves is solely for purposes of sections 816 and 842. There is no ambiguity in the statute that would give rise to the need to look at legislative history in the first place. The FSA improperly relied on a perceived ambiguity in the legislative history pertaining to section 816(h) to contradict not only the plain language of section 816(h), but also a clear statement in earlier legislative history of section 807(d).

The second problem with the FSA’s analysis is just as fundamental—the FSA’s survey of legislative history is incomplete. As noted above, the House Committee Report for the technical correction contains a clear statement the “this change does not affect the fact that deficiency reserves are included in statutory reserves for purposes of comparing the tax reserve to statutory reserves in determining the amount of any increase or decrease in

⁹ Staff of the Jt. Comm. on Tax’n, 100th Cong., 1st Sess. Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation 85 (Comm. Print 1987).

¹⁰ H.R. Rep. No. 99-426, 99th Cong. 1st Sess. 956 (1985) (1985 House Report).

¹¹ S. Rep. No. 99-313, 99th Cong., 2d Sess. 975 (1986) (1986 Senate Report).

life insurance reserves.”¹² The Conference Report regarding the technical corrections specifically states that the enacted law follows the House bill and the Senate amendment with respect to common provisions, of which this is one.¹³ Thus, the inference the FSA draws from the Senate Finance Committee report was erroneous. Congress adopted the House bill, and its committee report, not the Senate Report.

The FSA’s conclusion is wrong for a third reason—it is inconsistent with the related technical correction to section 809. It is precisely because Congress understood the meaning of statutory reserves under section 809 (and section 807) to include deficiency reserves that it became necessary to include the correction to prohibit double counting in the equity base determination under section 809, and both the House Report and the Senate Report on which the FSA relies specifically acknowledge this point.¹⁴

The FSA also reflected a misunderstanding of why the technical correction adding section 816(h) was necessary. Congress recognized that changes in the NAIC Standard Valuation Law in 1976 made it clear that deficiency reserves are part of life insurance reserves defined in section 816(b). The 1976 amendment to the Standard Valuation Law incorporated deficiency reserves within the prescribed CRVM method. Thus, the case law that had held that deficiency reserves were additional reserves not held for future claims was no longer controlling. This is why section 807(d)(3)(C) was added to the Code to exclude deficiency reserves from the FPR and why a technical correction was needed to exclude deficiency reserves in section 816(h). Thus, Congress correctly understood that deficiency reserves are included in the statutory cap because, without a statutory exclusion, they satisfy the general definition of life insurance reserves as in section 816(b). Thus, the enactment of the technical correction to section 816(h) in 1986 Act served to reconfirm conclusively that deficiency reserves are included in the statutory cap.

Perhaps the Senate Finance Report deleted the reference in the section 816(h) explanation to the section 807(d) statutory cap simply because the existing law was not ambiguous and the sentence was not germane to the technical correction, which did not relate to section 807. The deletion, however, cannot reasonably lead to a conclusion that deficiency reserves are excluded from the statutory cap.

This is one instance where a conclusion in an FSA is simply wrong and does not represent current IRS position. Hopefully, it will no longer be relied upon by IRS examiners to propose adjustments on audit. ◀

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¹² *Supra*.

¹³ Conf. Rep. 99-841, 99th Cong., 2d Sess. 841, Vol. II (1986).

¹⁴ 1985 House Report at 948; 1986 Senate Report at 968.