SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2014 – Volume 10, Issue 2

IRS APPLIES SECTION 817(a) AND (b) TO A NONLIFE COMPANY: WHAT DOES IT MEAN?

By Chuck Miller and Mark S. Smith

Chuck Miller, FSA, MAAA, is a vice president and actuary with MetLife in Bridgewater, N.J. He may be reached at *cmiller@metlife.com.*

Mark S. Smith, Esq., CPA, is a managing director, Washington National Tax Services with Pricewaterhouse-Coopers LLP, and may be reached at *mark.s.smith@us.pwc.com.*

One principle that frequently guides tax policy—and the interpretation of the Internal Revenue Code (the "Code")—is that similarly situated taxpayers should be taxed similarly on transactions that are economically alike. Congress is thus generally explicit when it intends different rules to apply to similar transactions based solely on the identity or status of a taxpayer. For example, insurance companies are permitted to compute taxable income or loss using reserve methods of accounting for income or loss on insurance contracts, notwithstanding the "all events" test and "economic performance" requirements that govern the timing for deductions of other business taxpayers. And, corporations that elect to be taxed as regulated investment companies, real estate investment trusts and S corporations are subject to provisions that do not apply to corporate taxpayers more generally.

Within Subchapter L of the Code, specific rules apply under Part I (sections 801–818) to life insurance companies, under Part II (sections 831–835) to nonlife insurance companies, and under Part III (sections 841–848) to all insurance companies, regardless of whether they are life insurance or nonlife insurance companies. For some items, Parts I and II prescribe different accounting rules for life and nonlife companies. For example, Part I (section 808) permits a life insurance company to deduct "policyholder dividends paid or accrued during the taxable year," whereas Part II (section 832(c)(11)) permits a nonlife company to deduct "dividends and similar distributions paid or declared to policyholders in their capacity as such." For other items, such as the annual accounting period, measurement of discounted unpaid losses, and policy acquisition expenses (DAC), Part III prescribes rules that apply explicitly to both life and nonlife companies.

In a 2013 Chief Counsel Advice (CCA) memorandum, the insurance branch applied provisions of Part I of Subchapter L—which applies to life insurance companies—to a nonlife company taxed under Part II. CCA 201341033 (May 16, 2013, released Oct. 11, 2013) addresses a nonlife insurance company that issued variable annuities and maintained corresponding separate accounts. For purposes of computing its insurance company taxable income, the company claimed a deduction for reserve increases resulting from both realized and unrealized appreciation in the separate account assets supporting the annuities. The company reported only realized capital gains on those assets, however. According to the company, unrealized gains did not have to be included in insurance company taxable income because the rules governing the adjustments to basis and the increase in reserves that generally apply under section 817(a) and (b) do not apply to a nonlife insurance company. According to the company, this limitation to realized gains and losses does not extend to the reserve increases and decreases, because those amounts were included in reserves for NAIC annual statement purposes and represented amounts owed to policyholders.

The operative rule for computing the taxable income of a nonlife insurance company under Part II of Subchapter L cross-references the rule in section 807 for computing life insurance reserves of a life company under Part I. In general, section 831 imposes a tax on a nonlife insurance company's taxable income, including gross amounts earned from investment income and underwriting income as provided by the Code and computed on the basis of the annual statement underwriting and investment exhibit. The calculation of underwriting income accounts for both earned and unearned premiums. In particular, an increase in unearned premiums decreases taxable income, and a decrease in unearned premiums increases taxable income. Section 831(b)(4) explains that "unearned premiums shall include life insurance reserves, as defined in section 816(b) but determined as provided in section 807." The question thus arises whether the cross-reference to section 807 in turn means that other provisions of Part I should apply to a nonlife company.

In CCA 201341033, the insurance branch concluded that the cross-reference to the rules for computing life insurance reserves of a life insurance company incorporates the rules of section 817 for accounting for gains and losses on separate account assets that support variable contracts. Section 817(a) adjusts the income or deduction that otherwise would result from a reserve increase or decrease by reason of appreciation

or depreciation of separate account assets. Section 817(b) correspondingly adjusts the basis of the separate account assets for the amounts to the extent appreciation and depreciation are from time to time reflected in reserves. Together, sections 817(a) and (b) permanently exclude capital gains on separate account assets at the company level to the extent such assets support variable contracts. Other than the cross-reference to section 807 (and, by extension, section 817's cross-reference to section 807), Part II contains no indication of the appropriate accounting for gains and losses on separate account assets.

Much of the analysis in the CCA relies on the legislative history of section 817, which was added to the Code by the Deficit Reduction Act of 1984 ("DEFRA"). That legislative history confirmed the operation of section 817(a) and (b) and its application to all variable contracts:[1]

> [T]he company's basis in the assets underlying all variable contracts will be adjusted for appreciation or depreciation, to the extent the reserves are so adjusted. Thus, the corporate level capital gains tax is eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under present law.

The branch could have agreed, but did not agree, with the taxpayer that for a nonlife company, there is no requirement that reserves and asset basis be adjusted for unrealized appreciation in separate account assets, even though that same unrealized appreciation is appropriately accounted for in computing reserves with regard to the contracts the assets supported. Not only is section 817 a part of Part I of Subchapter L, which applies only to life insurance companies; section 817(a) itself applies "for purposes of subsections (a) and (b) of section 807." A nonlife insurance company, however, accounts for income or deduction by reason of changes in reserves under section 832(b), not under section 807(a) or (b). Such an approach, however, would have condoned a mismatch, because unrealized gains and losses would have been accounted for in computing deductions but not in computing the related income. That mismatch could not be corrected otherwise, such as by changing the clear instruction that life insurance reserves be computed as provided in section 807(d).

This is not the first time that the Internal Revenue Service (the "Service") has opted for policy considerations over a

mechanical reading of section 817. In PLR 201038008, the Service was asked to determine whether a separate account held by a foreign insurance company that elected to be taxed as a U.S. domestic insurer pursuant to section 953(d) was a segregated asset account as described in section 817(d). If so, contracts based on that account were variable contracts and subject to diversification requirements of that section. Section 817(d) states that an account is a segregated asset account if it is segregated from the general asset accounts of the company "pursuant to State law or regulation." The term "State" is defined, in section 7701(a), to mean one of the 50 states of the United States or the District of Columbia "where not otherwise distinctly expressed or manifestly incompatible with the intent of [federal tax law]." Even though the account was segregated pursuant to foreign law, the Service ruled that the account was a segregated asset account, in order to preserve equal treatment of the company's variable products with those sold by U.S. domestic carriers. The restrictive use of the term "State" would have been manifestly incompatible with the intent of U.S. tax law.

Much of the analysis in the CCA relies on the legislative history of section 817.

Another arguable ambiguity can be found in the Code itself. In the case of a U.S.-owned foreign insurer, section 954(i)(3) contains specific guidance in regard to "any contract which

CONTINUED ON **PAGE 18**

is a separate account-type contract (including any variable contract not meeting the requirements of section 817)." Since section 817 defines the term "variable contract," the parenthetical expression in section 954(i)(3) could be read as a contradiction. That said, it achieves the "policy" goal of ensuring that economically similar contracts are covered.

The taxpayer that is the subject of the CCA clearly preferred to treat its variable annuities as not subject to section 817(a) and (b). The CCA doesn't go into the reasons for this, but it is likely that the timing of reserve deductions relative to the income that created them is part of the story. In an equity market that generally rises over time, reserves will rise with unrealized appreciation. Absent section 817 (or section 817A if this were a modified guaranteed contract), those increases in reserves would be deductible, but the offsetting unrealized income would not be included in income until realized.

Of course, such "good timing" comes at a price; in this case, volatility of taxable income. In addition, the tax method could have unintended consequences for statutory accounting purposes. In order to establish the statutory deferred tax asset (DTA) under SSAP 101, the taxpayer must determine the amount of any temporary differences between statutory reporting amounts and the comparable tax reporting amounts. Such a temporary difference will be created for any unrealized losses taken through statutory income, but not through taxable income. The taxpayer must determine how much of the temporary difference will reverse in three years (assuming the company's risk-based capital [RBC] ratio exceeds 300 percent)[2], since that is the amount that can be included in the taxpayer's gross admitted statutory DTA. Also, for statutory filers without taxes paid in prior years, with admitted DTAs capped at 15 percent of adjusted surplus, or with statutory valuation allowances, the further risk is that the statutory DTA will drop in the presence of future unrealized gains, but cannot rise beyond the cap and other SSAP 101 limitations in the presence of future unrealized losses. This may add to the volatility of statutory surplus and could also impact the taxpayer's risk-based capital (RBC) ratio.

Assuming a nonlife company were not in compliance with the position in the CCA, how would it actually adopt this guidance? It seems clear that some recognition would need to be given to the fact that this represents a change in timing. In implementing such a change, a number of things would need to be addressed, including the magnitude and nature of the changed elements.◂

END NOTES

1 H.R. Conf. Rep. No. 98-861, 98th Cong., 2d Sess. 1054 (1984).

2 This limitation in SSAP 101 is based generally on the ratio of capital and surplus to the Authorized Control Level RBC. Most companies measure against the Company Action Level RBC; 300 percent of the Authorized Control Level is equivalent to 150 percent of the Company Action Level.