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SUBCHAPTER L: CAN YOU BELIEVE IT? DEDUCTIBLE TAX RESERVES MIGHT BE GREATER FOR LIFE INSURANCE CONTRACTS THAT FLUNK I.R.C. § 7702 THAN FOR THOSE THAT DO NOT

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In my column in the last issue of *Taxing Times*, I pointed out that, despite contrary authority in Rev. Rul. 91-17,[1] the Internal Revenue Code[2] imposes no withholding and reporting obligations on the issuer of a failed contract that does not satisfy the definition of a life insurance contract under I.R.C. § 7702 even though the inside build-up on the contract in an amount specified in I.R.C. § 7702(g) is currently taxable to the policyholder. This column will now turn to the taxation of the issuer with respect to a failed contract. It may seem counterintuitive, but it is possible for a life insurance company to have a more favorable tax result if a contract flunks I.R.C. § 7702, *i.e.*, it may get a higher tax reserve deduction than if the contract qualified.

Statutory reserves for life insurance contracts generally are required to be recomputed for tax purposes. The recomputation of life insurance reserves under I.R.C. § 807(d) involves a three-step approach. An actuarial reserve is first computed on a contract-by-contract basis, and second, this reserve is compared to the net surrender value of the contract. The larger amount is the tax reserve, except—the third step—in no event can the amount of the tax reserve exceed the amount of the statutory reserves. "Statutory reserves" for this purpose generally refers to the aggregate amount of reserves for the contract which are set forth in the company's annual statement.[3]

To compute the actuarial reserve—the "federally prescribed reserve"—a company begins with its statutory reserve and modifies that reserve to take into account six adjustments: (1) the tax reserve method applicable to such contract; (2) the prevailing state assumed interest rate or the applicable federal interest rate (AFIR), whichever is larger; (3) the prevailing Commissioners standard tables for mortality or morbidity; (4) the elimination of any portion of the reserve attributable to net deferred and uncollected premiums; (5) the elimination of any portion of the reserve attributable to excess interest guaranteed beyond the end of the taxable year; and (6) the elimination of any deficiency reserves. Except for the federally prescribed adjustments, the methods and assumptions employed in computing the tax reserve should be consistent with those employed in computing the company's statutory reserve.[4] These adjustments to federally prescribed reserves, particularly the requirement to use the AFIR discount rate, frequently result in the amount of deductible tax reserves being less than statutory reserves.

What happens when the contract fails to qualify under I.R.C. § 7702? The starting place in the analysis is that the tax reserve computation rules of I.R.C. § 807(d) do not apply. By its terms, I.R.C. § 807(d) only applies to life insurance reserves, which, in turn, only are held with respect to life insurance, annuity or noncancellable accident and health insurance contracts.[5] Because I.R.C. § 7702(a) provides that a life insurance contract under applicable law is a life insurance contract "[f]or purposes of this title" only if it satisfies the cash value accumulation test or guideline premium requirements, reserves held for failed contracts cannot be life insurance reserves subject to recomputation under I.R.C. § 807(d); I.R.C. § 807(d) is in the same title as I.R.C. § 7702—Title 26 of the United States Code.

If I.R.C. § 807(d) does not apply, what does? Section 7702, together with the legislative history, offer some guidance. Section 7702(g)(3) provides that if a failed life insurance contract is a life insurance contract under "applicable law," *i.e.*, state or foreign insurance law, then the contract is nevertheless treated as an insurance contract—again, "for purposes of this title." This means that the premiums are included in gross income under I.R.C. § 803(a)(1) and reserve items listed in I.R.C. § 807(c) are deductible. The legislative history explains that "[t]he investment portion of any life insurance contract which fails to meet the definition of a life insurance contract under section 7702 is treated as a reserve under section 807(c)(4)."[6] This reserve category includes amounts held at interest in connection with insurance contracts. Presumably, this means that a reserve equal to the contractual account value to which interest is added would be the reserve for the investment portion, *i.e.*, the cash value or account value whichever is applicable.

The legislative history is incomplete, however. The reference is only to the reserve for the investment portion of the failed contract; it is silent with respect to the reserve for the net amount at risk—the insurance element. It seems that the portion of statutory reserves allocable to the insurance portion of the contract (*i.e.*, not the investment portion) should be treated just like any other pre-claim incidence nonlife insurance reserves and be classified as an unearned premium reserve taken into account under I.R.C. § 807(c)(2) and subject to a 20 percent "haircut" reduction under I.R.C. § 807(e)(7).

This being the case, deductible tax reserves for failed life contracts might exceed what I.R.C. § 807(d) would otherwise permit for life insurance reserves. This would be so if the sum of the reserve for the investment portion of the contract (the I.R.C. § 807(c)(4) reserve) plus 80 percent of the statutory reserve for the net amount at risk (the I.R.C. § 807(c)(2) reserve) exceeds the amount of the statutory reserves adjusted for the six federally prescribed items described above that otherwise would apply. ■

END NOTES

1 1991-1 C.B. 190, superseded in part, Rev. Proc. 2008-40, 2008-2 C.B. 151.

2 I.R.C. § 6047(d), § 3405.

3 I.R.C. § 807(d)(6).

4 Joint Comm. on Taxation, JC5-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 599 (1984).

5 I.R.C. § 807(c)(1), § 816(b).

6 H.R. Rep. No. 98-432, pt. 2, at 1413 n.128 (1984).

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