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Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One

By Stephen Baker

Internal Revenue Code (I.R.C.) §§243–246[1] provide that a corporation is allowed a percentage deduction for dividends received from other corporations (the DRD). In addition to the general corporate rules regarding the DRD, if the recipient of a corporate dividend is a life insurance company, I.R.C. §812(a) further allocates the benefit of the DRD between the company's share and the policyholders' share. This allocation methodology is often referred to as proration. Proration has historically involved a complex and at times contentious[2] formulaic process.

Beginning with the present, Section 13518 of Public Law No. 115-97[3] (the Act) simplified proration. The Act amended I.R.C. §812(a), which now states that for tax years beginning after Dec. 31, 2017, the company's share of the DRD is 70 percent and the policyholders' share is 30 percent for both general and separate account dividend income.[4]

PRIOR TO TAX REFORM

Prior to the Act (and thus still applicable to tax years beginning prior to Jan. 1, 2018), proration was a mired process that greatly proliferated long spreadsheets.

The company's share was the percentage equal to the (company's share of net investment income) divided by (total net investment income).[5] The company's share of net investment income was formulaically determined as the excess, if any, of net investment income over the sum of policy interest and the gross investment income's proportional share of policyholder dividends.[6] All three terms in the preceding sentence required further explanation.

- Net investment income was simply 95 percent of gross investment income attributable to assets held in segregated asset accounts under variable products and 90 percent of gross investment income attributable to general account assets.[7]

- Policy interest was defined as the sum of the required interest on I.R.C. §807(c) reserves at the greater of the prevailing

state assumed interest rate (PSAIR) or applicable federal interest rate (AFIR), plus the deductible portion of:

1. excess interest.
2. amounts credited to a deferred annuity contract before the annuity starting date.
3. interest on amounts left on deposit with the company.
4. amounts credited to a policyholder's fund under a pension plan contract for non-retired employees.[8]

- The gross investment income's proportional share of policyholder dividends was also a windy formula.[9] Simply stated . . . it was the sum of the deductions for policyholder dividends, excluding the deductible portions of:

  1. excess interest.
  2. amounts credited to a deferred annuity contract before the annuity starting date.
  3. amounts credited to a policyholder's fund under a pension plan contract for non-retired employees, multiplied by a simple fraction.

  This fraction was gross investment income (reduced by policy interest), divided by life insurance gross income (reduced by the increase, if any, in I.R.C. §807(c) reserves).

As noted above, proration has been controversial at times. In 2007, the Internal Revenue Service issued Revenue Ruling 2007-54[10] requiring a computational method of required interest that virtually assured a zero company share with respect to variable contracts. After quick and intense industry action the Service issued Revenue Ruling 2007-61[11] suspending Revenue Ruling 2007-54.[12] The proper application of short-term capital gains in computing net investment income percentages has been widely discussed (but arguably not settled in writing).

AFTER TAX REFORM

Even a brief review of the prior paragraphs highlights the complexity involved in computing the DRD by life insurance companies prior to the Act. Following the Act, the company's share is now 70 percent for both the general and separate accounts. The impact of this simplification will vary by company and even between the general and separate accounts.

At least the spreadsheets are shorter. ■

Stephen Baker is vice president—Tax at Symetra Life Insurance Company and may be reached at *stephen.baker@symetra.com*.

ENDNOTES

1 All references are to the Internal Revenue Code of 1986, as amended and the Treasury Regulations promulgated thereunder.

2 *See* below.

3 "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," enacted Dec. 22, 2017.

4 It is also of interest to note that Section 13002 of the Act modified I.R.C. §243(a) reducing the general corporate DRD percentage from 70 percent to 50 percent.

5 *See* prior law I.R.C. §812(a).

6 *See* prior law I.R.C. §812(b)(1).

7 *See* prior law I.R.C. §812(c).

8 *See* prior law I.R.C. §812(b)(2).

9 *See* prior law I.R.C. §812(b)(3).

10 Revenue Ruling 2007-54, 2007-38 IRB 604.

11 Revenue Ruling 2007-61, 2007-42 IRB 799. The less controversial portions of Revenue Ruling 2007-54 were restated in Revenue Ruling 2014-7, 2014-9 IRB 539.

12 *See*, for more detail, Gregory L. Stephenson and Stephen Baker, "Separate Account Dividends Received Deduction," *Taxing Times* Vol. 4, Issue 3 (September 2008) at page 21.