Section 807.—Rules for Certain Reserves

(Also Part I, § 816.)

Part III – Administrative, Procedural, and Miscellaneous

Notice 2013-19

PURPOSE

This Notice provides guidance on whether, for purposes of applying the limitation set forth in the flush language of § 807(d)(1) (the statutory reserve cap), deficiency reserves are included in the amount taken into account with respect to a life insurance contract in determining statutory reserves under § 807(d)(6).

BACKGROUND

A life insurance company must pay tax on its life insurance company taxable income, which is defined in § 801(b) to mean life insurance gross income less life insurance deductions. Life insurance gross income is defined in § 803(a) to include net decreases in certain reserves under § 807(a). Life insurance deductions include the general deductions provided in § 805 including, under § 805(a)(2), the net increase in certain reserves under § 807(b). The reserves taken into account under § 807(a) and (b) are described in § 807(c), and include “life insurance reserves (as defined in section 816(b)).”

For purposes of determining a life insurance company’s decreases or increases in life insurance reserves under § 807, § 807(d)(1) provides that the amount of the life insurance reserve for any contract is the greater of (A) the contract's net surrender value, or (B) the contract's reserve determined under § 807(d)(2) (the Federally prescribed reserve). The flush language of § 807(d)(1) further provides that in no event may the reserve for a contract exceed the amount that would be taken into account with respect to the contract in determining statutory reserves as defined in § 807(d)(6). Section 807(d)(6) generally defines statutory reserves as “the aggregate amount set forth in the annual statement with respect to items described in section 807(c).”

Section 807(d)(2) provides that the Federally prescribed reserve is determined using the tax reserve method applicable to the contract. Section 807(d)(3) defines the applicable tax reserve method and includes an explicit rule in § 807(d)(3)(C) that denies any increase in the Federally prescribed reserve because the net premium (computed on the basis of assumptions required under § 807(d)) exceeds the actual premiums or other consideration charged for the benefit. The reserve that applies because gross premium is less than the net premium is often referred to as a “deficiency reserve.”

DISCUSSION

The flush language of § 807(d)(1) limits the reserve for a contract to the amount that would be taken into account with respect to the contract in determining statutory reserves. The term “statutory reserves” is defined in § 807(d)(6) to mean the aggregate amount set forth in the annual statement with respect to items described in § 807(c).

When § 807 was enacted, the term “statutory reserves” for purposes of the statutory reserve cap was defined by cross-reference to former § 809(b)(4)(B)(i), which was the predecessor to § 807(d)(6) and defined statutory reserves identically to § 807(d)(6). After § 807 was enacted as part of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, the Joint Committee of Taxation explained that the statutory reserve cap included deficiency reserves:

> For purposes of determining life insurance company taxable income, the [1984] Act provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. 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.

Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Reform Act of 1984, at 598.

When later enacting a subsection of a different provision, Congress affirmed the Joint Committee’s explanation. Specifically, when Congress enacted § 816(h) in 1986 as a technical correction to the Deficit Reduction Act of 1984, Tax Reform Act of 1986, Pub. L. No. 99-514, § 1821(l), the House report stated 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 the reserves.” H. R. Rep. No. 426, 99th Cong., 1st Sess. 956 (1985), 1986-3 C.B. Vol. 2, 956 (House Report). The bill, as ultimately enacted, included § 816(h) from the House bill verbatim.

Moreover, the legislative history of another technical correction to the Deficit Reduction Act of 1984 further demonstrates that both houses of Congress believed the definition of statutory reserves that now appears in § 807(d)(6) includes deficiency reserves. At the same time that § 816(h) was enacted, former § 809(b)(2) was amended to provide that no item could be taken into account more than once in determining the equity base. Both the House Report and the Senate Report noted that former § 809(b)(2) was necessary in part "because deficiency reserves, which are specifically listed in the statute as included in the equity base, could also be included indirectly as part of the excess of statutory policy reserves over tax reserves, which is also specifically included in the equity base." House Report at 948; S. Rep. No. 313, 99th Cong., 2d Sess. 968 (1986), 1986-3 C.B. Vol. 3 968.

SCOPE AND APPLICATION

For purposes of applying the limitation set forth in the statutory reserve cap in § 807(d)(1), deficiency reserves are included in the amount taken into account with respect to a life insurance contract in determining statutory reserves under § 807(d)(6).

DRAFTING INFORMATION

The principal author of this notice is Sharon Y. Horn of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information, contact Ms. Horn at (202) 622-3970 (not a toll-free call).