Part I

Section 807.—Rules for certain reserves

(Also § 812)

Rev. Rul. 2007-54

ISSUE(S)

1. What is the amount of the life insurance reserves taken into account under section 807 of the Internal Revenue Code for a variable contract where some or all of the reserves are accounted for as part of a life insurance company's separate account reserves?

2. If the amount of the life insurance reserves for a variable contract is the tax reserve determined under section 807(d)(2), what interest rate is used to calculate required interest on those reserves?

FACTS

Situation 1. IC is a life insurance company as defined in section 816(a) and is the issuer of Contract A. Contract A provides for the payment of variable annuity benefits computed on the basis of a recognized mortality table and the investment experience of IC's segregated asset account (separate account). IC bears the mortality risks with regard to the contingencies involved in the variable annuity benefits. Contract A neither provides any “supplemental benefits” (as defined in section 807(e)(3)(D)) nor involves any “qualified substandard risks” (as defined in section 807(e)(5)(B)).

Contract A is a “variable contract” as defined in section 817(d) and an “annuity contract” under section 817(g). IC’s reserves for Contract A are “life insurance reserves” as defined in section 816(b).

For taxable years 2006 and 2007, the amounts of end-of-year tax reserves determined under section 807(d)(2) for Contract A are $ 8,000 and $10,000, respectively. The applicable Federal interest rate for Contract A is 4.82 percent, and the applicable Federal interest rate exceeds the prevailing State assumed rate for the Contract.

The 2006 and 2007 end-of-year net surrender values determined under section 807(e)(1) for Contract A are $7,840 and $ 9,830, respectively. The amounts taken into account by IC with regard to Contract A in determining its 2006 and 2007 end-of-year statutory reserves within the meaning of section 807(d)(6) are $8,050 and $10,045, respectively. None of IC’s statutory reserves is attributable to any deferred or uncollected premium.

Situation 2. The facts are the same as Situation 1, except that Contract A provides a minimum guaranteed death benefit in addition to variable annuity benefits. IC bears the mortality risks and investment risks with regard to the contingencies involved in the provision of the death benefit.

For taxable years 2006 and 2007, the end-of-year tax reserves determined under section 807(d)(2) for Contract A are $8,155 and $10,165, respectively. The 2006 and 2007 end-of-year net surrender values determined under section 807(e)(1) for Contract A are $8,000 and $10,000, respectively. The amount taken into account by IC with regard to Contract A in determining its 2006 and 2007 end-of-year statutory reserves within the meaning of section 807(d)(6) are $8,210 and $10,215, respectively.

If Contract A had not provided the minimum guaranteed death benefit, the 2006 and 2007 end-of-year tax reserves determined under section 807(d)(2) would have been $8,000 and $10,000, respectively.

LAW AND ANALYSIS

Issue 1. Section 803(a) provides that life insurance company gross income is the sum of (i) premiums, (ii) net decreases in certain reserves under section 807(a), and (iii) other amounts generally included by a taxpayer in gross income. Section 805(a)(2) authorizes a deduction for the net increase in certain reserves under section 807(b). In calculating the change in reserves for a variable contract, the increase or decrease in the reserves due to appreciation and depreciation of separate account assets is removed. *See s*ection 817(a).

Section 807(c) sets forth the items taken into account in determining the net decrease or net increase in reserves under section 807(a) and (b). Among the items taken into account are “life insurance reserves” (as defined in section 816(b)).

For purposes of determining a life insurance company’s income or deduction from a change in reserves, section 807(d)(1) provides that the amount of the life insurance reserves for any contract is the greater of-- (i) the contract's net surrender value, or (ii) the contract's tax reserve determined under section 807(d)(2). However, the life insurance reserves for a contract cannot exceed the "statutory reserves" (as defined in section 807(d)(6)).

Section 807(d)(2) provides that the amount of the tax reserve for any contract is determined using-- (i) the tax reserve method applicable to the contract, (ii) the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, and (iii) the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account. The tax reserves determined under section 807(d)(2) reflect all of the benefits (including the net surrender value) payable under the contract.

Section 807(e)(1) provides generally that the net surrender value of "any contract" is determined with regard to any penalty or charge which would be imposed on surrender, but without regard to any market value adjustment on surrender. The net surrender value represents the current contractual cash benefit payable under a contract.

Except as otherwise provided in special rules under section 807(e)(3) and (5) (relating to qualified supplemental benefits and qualified substandard risks), the comparison of the tax reserve and the net surrender value is made on an aggregate benefit basis. *See* H. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1414 (1984); S. Prt. 169, Vol. I, 98th Cong. 2d Sess. 540 (1984).

Section 807 makes no distinction between a fixed (non-variable) contract and a variable contract. For both fixed and variable contracts, a life insurance company determines its income or deduction from a change in reserves using the amounts of its life insurance reserves determined under section 807. *See also* section 817(a) (referring to "the sum of the items described in section 807(c)”).

Section 817(c) requires a life insurance company to account separately for the income, exclusion, deduction, asset, reserve, and other liability items attributable to variable contracts. If a variable contract contains a guarantee (for example, a minimum death benefit), section 817(d) (flush language) requires an insurance company to account for the excess of obligations under the guarantee over the obligations under the contract without regard to the guarantee as part of the company’s general account, and not as part of the company’s separate account.

In both Situation 1 and Situation 2, the end-of-year tax reserves determined under section 807(d)(2) for Contract A-- (i) exceed the end-of-year net surrender value of the Contract, but (ii) are less than the end-of-year statutory reserves for the Contract. Accordingly, under section 807(d)(1), the amount of the end-of-year life insurance reserves taken into account under section 807 for Contract A in both Situations is the amount of the end-of-year tax reserves determined under section 807(d)(2). In Situation 1, the amounts of the 2006 and 2007 end-of-year life insurance reserves for Contract A are $8,000 and $10,000, respectively. In Situation 2, the amounts of the 2006 and 2007 end-of-year life insurance reserves for Contract A are $8,155 and $10,165, respectively.

In Situation 2, IC is required under section 817(d) to account for the excess of its obligations under Contract A with the minimum death benefit over its obligations under the Contract without the death benefit as part of the company's general account reserves. Pursuant to section 817(c), IC accounts for its remaining obligations under the Contract A as part of the company's separate account reserves. Accordingly, for end-of-year 2006, IC accounts for the $155 excess of its obligations under Contract A with the minimum death benefit ($8,155) over its obligations under the Contract without the death benefit ($8,000) as part of the company's general account reserves. IC accounts for the remaining $8,000 as part of its separate account reserves. For end-of-year 2007, IC accounts for the $165 excess of its obligations under Contract A with the minimum death benefit ($10,165) over its obligations under Contract A without the death benefit ($10,000) as part of the company's general account reserves. IC accounts for the remaining $10,000 as part of its separate account reserves.

The allocation of obligations between general account reserves and separate account reserves has no effect on the determination of the amount of IC's life insurance reserves for Contract A under section 807(d).

Issue 2. To prevent a life insurance company from realizing a double benefit for tax-preferred investment income (tax-exempt interest and dividends qualifying for the dividends received deduction) used to fund the company's obligations to policyholders, sections 807 and 805 require the company to adjust certain income and deduction items for the policyholders' share of such tax preferred income. *See* section 807(a) and (b), section 805(a)(4).

Section 812 provides the mechanism to calculate the life insurance company's and policyholders' respective shares of net investment income. Under section 812(b)(1), a life insurance company's share of net investment income is the excess (if any) of "net investment income" (determined under section 812(c)) for the taxable year over the sum of (i) "policy interest" (determined under section 812(b)(2)) for the taxable year, and (ii) the "gross investment income's proportionate share of policyholder dividends" (determined under section 812(b)(3)) for the taxable year.

Policy interest includes "required interest" on reserves. Section 812(b)(2)(A). Required interest on a contract's reserves is calculated using the mean of the contract's beginning-of-year and end-of-year reserves and the interest rate used in determining the contract's reserves. For example, if the life insurance reserves for a contract are determined using the greater of the applicable Federal interest rate or the prevailing State assumed interest rate for the contract, then required interest on those reserves is calculated by multiplying (i) the mean of the reserves by (ii) the interest rate used in calculating the reserves (*i.e.,* the greater of the applicable Federal interest rate or the prevailing State assumed interest rate for the contract). If neither the prevailing State assumed interest rate nor the applicable Federal interest rate is used in determining a contract's life insurance reserves, then required interest is calculated using another appropriate rate. Section 812(b)(2); Rev. Rul. 2003-120, 2003-2 C.B. 1154.

In both Situation 1 and Situation 2, the amount of the life insurance reserves taken into account under section 807 for Contract A is the amount of tax reserve determined under section 807(d)(2), which is determined using the applicable Federal interest rate for the Contract. As the applicable Federal interest rate is used to determine the amount of the life insurance reserves for Contract A, the required interest on the Contract's life insurance reserves is calculated by multiplying the mean of those reserves by the applicable Federal interest rate for the Contract. Rev. Rul. 2003-120.

In Situation 1, the mean of the 2007 beginning-of-year and end-of-year life insurance reserves for Contract A is $9,000 ([$8,000 + $10,000] ÷ 2 = $9,000) and the applicable Federal interest rate for Contract A is 4.82 percent. For taxable year 2007, the required interest on Contract A's life insurance reserves A is $433.80 ($9,000 × 4.82% = $433.80).

In Situation 2, the mean of the 2007 beginning-of-year and end-of-year life insurance reserves for Contract A is $9,160 ([$8,155 + $10,165] ÷ 2 = $9,160). The applicable Federal interest rate for Contract A is 4.82 percent. For taxable year 2007, the required interest on Contract A's life insurance reserves is $441.51 ($9,160 × 4.82% = $441.51). Consistent with the allocation of Contract A's life insurance reserves between IC's general account reserves and separate account reserves, $7.71 of the required interest ($441.51 × $160 / $9,160 = $7.71) is taken into account under section 812 as required interest on IC's general account reserves. The remaining $433.80 ($441.51 × $9,000 / $9,160 = $433.80) of the required interest is taken into account under section 812 as required interest on IC's separate account reserves.

HOLDING(S)

1. Under section 807(d)(1), the amounts of the end-of-year life insurance reserves for Contract A in both Situation 1 and Situation 2 are the amounts of the tax

reserve determined under section 807(d)(2). Thus, in Situation 1, the amounts of the 2006 and 2007 end-of-year life insurance reserves for Contract A are $8,000 and $10,000, respectively. In Situation 2, the amounts of the 2006 and 2007 end-of-year life insurance reserves for Contract A are $8,155 and $10,165, respectively.

2. In both Situation 1 and Situation 2, the required interest on Contract A's life insurance reserves is calculated by multiplying the mean of the Contract's beginning-of-year and end-of-year reserves by the applicable Federal interest rate for the Contract. In Situation 1, the 2007 required interest on Contract A's life insurance reserves A is $433.80. In Situation 2, the 2007 required interest on Contract A's life insurance reserves is $441.51. Of this amount, $7.71 is required interest on IC's general account reserves for Contract A, and the remaining $433.80 is required interest on IC's separate account reserves for Contract A.

DRAFTING INFORMATION

The principal author of this revenue ruling is Stephen D. Hooe of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Stephen D. Hooe at (202) 622-3900 (not a toll-free call).