INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Parent	=
Taxpayer	=
State A	=
Date B	=
Date C	=

ISSUE

Whether life insurance reserves based upon the net surrender value of insurance contracts should be reduced by the net value of risks reinsured on a yearly renewable term (YRT) basis.

CONCLUSION

Reserves calculated under section 807(d)(1) of the Internal Revenue Code are to be reduced by the net value of risks reinsured on a YRT basis. This reduction is required even for contracts with net surrender values in excess of the reserves calculated under section 807(d)(2).

FACTS

Taxpayer is a life insurance company within the meaning of section 816 and is subject to the tax imposed by section 801. Taxpayer is organized under the laws of State A and is subject to the regulatory supervision of the State A commissioner of insurance. Among its various life insurance products, Taxpayer issues individual whole life insurance policies and other permanent insurance plans for which it purchases reinsurance on a YRT basis.

Under a YRT reinsurance treaty, Taxpayer purchases reinsurance with respect to some or all of its mortality risk during the following policy year on a particular insurance policy or group of policies. The mortality risk is equal to the excess of the face amount of the policy over Taxpayer's policy reserve at the end of the policy year. If the insured dies during a policy year for which a YRT treaty was in effect, the YRT reinsurer indemnifies Taxpayer for the portion of the mortality risk for which reinsurance was purchased. The YRT reinsurance does not transfer any liability from Taxpayer to the reinsurer for its obligation to pay the net surrender value (as described by section 807(e)(1)(A)) to the policyholder or beneficiary either upon demand or as a portion of the benefit payable upon death.

On its annual statement, Taxpayer shows aggregate reserves for its life insurance contracts and, on a separate schedule, the net value of risks reinsured including those covered by YRT treaties.

On its original returns for Date C, Taxpayer determined the amount of life insurance reserve for each contract by first ascertaining the contract's net surrender value and then calculating, under section 807(d)(2), a Federally prescribed reserve for each contract. Pursuant to section 807(d)(1), Taxpayer treated the larger of the net surrender value or the reserve amount calculated under section 807(d)(2) as the life insurance reserve for the contract, to the extent that the amount did not exceed the annual statement reserve for the contract. Taxpayer then reduced the amount of the life insurance reserve determined under section 807(d)(1) by the net value of risks reinsured on a YRT basis.

On Date B, Taxpayer submitted an informal claim for refund, asserting that its original computation method was incorrect because its obligation with respect to the net surrender value is unchanged by the reinsurance treaty and because the net surrender value is a current liability rather than a reserve. Taxpayer contends that, for contracts with net surrender values in excess of the reserves determined under section 807(d)(2), the amount of life insurance reserves determined under section 807(d)(1) should not have been reduced by the net value of risks reinsured on a YRT basis. Taxpayer proposes to treat the net increase in its life insurance reserves resulting from this modification as a change in basis within the meaning of section 807(f).

The Field argues that total reserves carried by the ceding company and the reinsurer for Federal tax purposes should not be more than the reserves that were held by the ceding company prior to engaging in the YRT treaty because, actuarially, the total obligations under the contract have not changed. They further argue that section 1.801-4(a) of the regulations and section 807 of the Code should be read together to require that section 807(d)(1) life insurance reserves based upon net surrender value be reduced for the net value of risks reinsured on a YRT basis.

You have requested our advice whether tax reserves held by Taxpayer that are based on the net surrender value of certain life insurance contracts should be reduced by the net value of risks reinsured on a YRT basis.

LAW AND ANALYSIS

Section 801(a) imposes a tax on the life insurance company taxable income (LICTI) of every life insurance company. Section 801(b) defines life insurance company taxable income as life insurance gross income, minus life insurance deductions.

Life insurance gross income includes net decreases in life insurance reserves. Sections 803(a)(2) and 807(a). Life insurance deductions include net increases in such reserves. Sections 804(1), 805(a)(2), 807(b).

Section 807(d) sets forth the manner of computing life insurance reserves for purposes of measuring life insurance gross income or deductions. Specifically, section 807(d)(1) provides that, other than for purposes of section 816 (relating to qualification as a life insurance company), the amount of the life insurance reserve with respect to any contract is the greater of (i) the net surrender value of the contract, or (ii) the reserve determined under section 807(d)(2) (often referred to as the Federally prescribed reserve). In no event, however, may the reserve for any contract exceed the amount taken into account with respect to that contract as of that time in determining statutory (annual statement) reserves as defined in section 809(b)(4)(B). Section 807(d)(1) (flush language).

Section 807(e)(1) provides that the net surrender value of an insurance or annuity 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 constitutes the amount returnable to the policyholder during the policyholder's lifetime (absent terminal or chronic illness that accelerates the death benefit or market value adjustments). Although the net surrender value will, if based upon a fixed account or the crediting of interest, generally increase over time, the value may fluctuate up and down if all or a portion of the cash value of the policy is based upon the investment return of underlying separate accounts. The terms of the underlying contract determine whether the amount at risk fluctuates in tandem with the changes in net surrender value or remains level. The net surrender value therefore represents a current contractual cash benefit under the policy in contrast to statutory or Federally prescribed reserves which are a present measure of future obligations less future premiums to be paid. See Staff of Jt. Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 599 (Comm. Print 1984) (1984 Blue Book).

Section 807(d)(2) provides that the Federally prescribed reserve for any contract must be determined using (i) the tax reserve method applicable to that type of 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 morbidity or mortality adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

Section 809(b)(4)(B) defines statutory reserves as the aggregate amount set forth in the annual statement with respect to items described in section 807(c), but not including any reserve attributable to deferred and uncollected premiums if establishment of such reserves is not permitted under section 811(c).

Section 1.801-4(a) of the Income Tax Regulations provides, in pertinent part, that reserves held by the insurance company with respect to the net value of risks reinsured in other solvent companies (whether or not authorized) are to be deducted from the company's life insurance reserves. The regulations include an example that specifically involves YRT reinsurance. The example states that, if an ordinary policy with a reserve of $100 is reinsured in another solvent company on a yearly renewable term basis, and the reserve on such yearly renewable term policy is $10, the reinsured company shall include $90 ($100 minus $10) in determining its life insurance reserves.

The regulation interpreted the definition of "life insurance reserves" in former section 801(b), which is now contained in section 816(b). Section 807(c)(1) includes "life insurance reserves, as defined in section 816(b)" among deductible reserve items. In general, where a provision of prior law was carried over to the new Part I of subchapter L, as added by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98th Cong., 2d Sess. (1984), in the absence of contrary guidance, Congress intended the new provision to be interpreted in a manner consistent with the prior law provision to the extent not inconsistent with the new provision. 1984 House Report at 1401; see also 1984 Senate Report at 524 and 1984 Bluebook at 581.

Section 1.801-4(a) clearly requires an insurance company to reduce the amount of its life insurance reserves by the net value of risks reinsured on a YRT basis. There in no indication in section 807, its legislative history, or in the regulations thereunder that the amount of an insurance company's life insurance reserves (as determined under section 807(d)(1)) are not to be adjusted for net value risks reinsured on a YRT basis. Thus, section 1.801-4(a) continues to apply in post-1983 years.

Taxpayer argues that the differences between YRT reinsurance and proportional reinsurance or coinsurance of life insurance policies should be reflected in the calculation of tax reserves. Under a coinsurance treaty, the reinsurance coverage is provided in the same form as that of the direct policy issued to the policyholder. The reinsurer receives a proportionate share of the gross premiums on the underlying policies (net of an annual expense allowance reflecting the ceding company's current administrative expenses on the policies), and assumes a proportionate share of the policy obligations (including the risk of loss due to excessive mortality or morbidity, lapses, cash surrenders, and investment risks inherent in the contract guarantees). See Tiller and Tiller, Life, Health, and Annuity Reinsurance, 62-75, 82-85 (2d ed. 1995). In contrast, YRT treaties affect only the mortality or morbidity risk and none of the obligations inherent in the current liability to pay a contract's net surrender value.

Nonetheless, the applicable regulation explicitly requires the reduction of all life insurance reserves for the net value of risks reinsured on a YRT basis. When promulgated, the regulation responded in part to concerns that reinsurance offsets should not be dependent upon whether the reinsurer was authorized.

The regulation is consistent with the general tax principle incorporated in section 811(c) (the "no double counting" rule) that

> Nothing in this part shall permit—
> . . .
> (2) the same item to be counted more than once for reserve purposes, or
> (3) any item to be deducted (either directly or as an increase in reserves) more than once.

The addition of net surrender value to the computation of federal tax reserves in section 807 does not void the regulatory requirement that the net value of risks reinsured on a YRT basis be taken into account in the computation of deductible life insurance reserves.

The regulation is also consistent with the reformulated computational rules for determining the allowable reserve deduction. Section 807(d)(1) provides that the amount of the life insurance reserve with respect to any contract is the greater of (i) the net surrender value of the contract, or (ii) the reserve determined under section 807(d)(2), subject to the annual statement cap. Because a comparison must be made to determine which is greater – the net surrender value or the Federally prescribed reserves – the net surrender value is, for this purpose, treated as a component of reserves. Following Taxpayer's logic to an extreme, any time the section 807(d)(1) amount is equal to the net surrender value, the reserves would not be life insurance reserves because they would not be based on mortality or morbidity tables. Section 807(d)(1) determines the amount of the "life insurance reserves" for a contract, regardless of the role of net surrender value in that determination. Accordingly, the regulation continues to require reduction of life insurance reserves, even if those reserves are based on the net surrender value of the contract.

Taxpayer also argues that section 807(f) lends support to its position that net surrender value is not a life insurance reserve, and therefore not required to be reduced by the net value of risks reinsured on a YRT basis. Section 807(f) mandates a 10-year spread if any change in basis of computing reserves causes an increase or decrease in a company's life insurance reserves. The 1984 Blue Book at 603-604 states that

> Changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

Regardless of whether a particular change in net surrender value constitutes a change in basis under section 807(f), section 807(d)(1) (as stated above) specifically characterizes the net surrender value as a component of the calculation of life insurance reserves. Life insurance reserves based upon net surrender value are still life insurance reserves and, as such, are still required by the regulation to be reduced by the net value of risks reinsured on a YRT basis.

Taxpayer contends in the alternative that the increase in total reserves caused by permitting a deduction for unreduced life insurance reserves plus the credit for YRT reinsurance is no different from the additional deduction available when a company offers qualified supplemental benefits. If a taxpayer elects to state the charges for such benefits separately, section 807(e)(3) explicitly allows an additional reserve for those benefits without regard to the possibility that total reserves may be increased. Taxpayer makes two arguments: (1) that supplemental benefits, if not separately charged, are an element of net surrender value so that total reserves are increased by making them "qualified" and (2) that an additional reserve for qualified supplemental benefits has been specifically allowed despite possible double counting. Taxpayer's argument is self-defeating as a specific statutory provision allows a reserve for qualified supplemental benefits. Adopting Taxpayer's position that life insurance reserves based upon net surrender value should not be adjusted would produce a significant increase in total life insurance reserves, yet neither the statute nor the underlying regulations carve out a special rule with respect to the net value of reinsured risks under this fact pattern.

Finally, Taxpayer argues, because the annual statement begins with an inclusion of the full net surrender value, that Taxpayer should be allowed (for Federal tax purposes) to deduct, at a minimum, its current contractual liabilities for the contract. This assumes the desired answer and disregards the entirety of the annual statement and statutory accounting. Statement of Statutory Accounting Principles (SSAP) No. 51 – Life Contracts mandates that a company hold, for annual statement purposes, minimum reserves equal to cash surrender values even if the mortality risk is reinsured under a YRT treaty. This gross amount is indeed stated on a company's annual statement. However, credits for reinsurance (including those under YRT treaties) are also set forth on the annual statement in a separate schedule.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.