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Memorandum

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to: Reid M. Huey
Associate Area Counsel (LB&I)
CC:LB&I:RFTH:STP
Attn: Jack Forsberg, Sr. Counsel

from: Alexis A. MacIvor
Branch Chief, Branch 4
Associate Chief Counsel (Financial Institutions & Products)

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subject: Qualification under § 816(a)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
State =
Contribution Contract =
Amount $A =
Amount $B =
Amount $C =
Amount $D =
Date =
Year 1 =
Year 2 =
Year 3 =
Year 4 =

Amount E =
Amount F =
Amount G =
Amount H =
Amount I =
Amount J =
Amount K =
Amount L =
Amount M =

ISSUE

When applying the reserve ratio test of § 816(a), are the Taxpayer's reserves with respect to certain annuity contracts "life insurance reserves" as defined by § 816(b)? If the reserves for those contracts are not life insurance reserves, are the reserves excluded from "total reserves" by operation of § 816(f)?

CONCLUSION

The developed facts do not establish whether the Taxpayer's reserves for certain annuity contracts are life insurance reserves; advice for further development is provided. If the Taxpayer's reserves for the certain annuity contracts are not life insurance reserves, the reserves are not excluded from "total reserves" by operation of § 816(f).

FACTS

TheTaxpayer

The Taxpayer is an insurance company regulated by State. For recent tax years, the Taxpayer filed a Form 1120-PC, "U.S. Property and Casualty Insurance Company Income Tax Return," determining its taxable income under § 832 as an insurance company other than a life insurance company.

The Taxpayer provides pension products and services for employer-sponsored retirement plans; individual life insurance, annuity, and disability products to retail markets; and group life, disability, dental, and vision insurance products offered to businesses and their employees. The Taxpayer files annual and quarterly National Association of Insurance Commissioners (NAIC) Life and Accident and Health statements as required by regulatory agencies.

The Contracts

Among the products marketed by the Taxpayer is a contract (the "Contribution Contract") that is designed as an investment vehicle for defined contribution plans. The Taxpayer's customers (the "Contractholders") enter into a Contribution Contract to provide investment options, recordkeeping services, and benefit payment options for their employees ("Members") under the Contractholders' plans. Investment options available under the Contribution Contract include guaranteed interest investments with various maturities and a variety of separate account investments.

Contractholders' plans provide that upon a benefit event (i.e., retirement, disability, or termination of employment), a Member may elect to receive benefits under one or more options, one of which may be a life annuity. A Contribution Contract that includes a life annuity option is hereinafter referred to as a "Contract."

If a Contractholder's plan permits selection of a life annuity, the Taxpayer will not issue an annuity unless

a

specified amount. The amount of the annuity payable under the annuity option is to be determined based on:

The Contract provides that:

The "purchase rate" for an annuity is the dollar amount required to purchase a specific level of periodic income payments for life. An annuity purchase rate is calculated based

on a mortality table, an interest rate, the annuitant(s) attained age, and the issuing insurer's loading percentage.[1]

The Contract provides that:

The Contract provides that amendments are binding on Members except that, among other things,

As interpreted and applied by the Taxpayer, the Contract guarantees that the annuity purchase rate in effect when a Contract is purchased will remain unchanged for a minimum of and will apply to all contributions made during the as well as to the earnings thereon, regardless of whether the amounts are used to acquire an annuity during or after the .

The Contract provides that it will continue in force as long as the Taxpayer is holding funds or making annuity payments. Under certain conditions, the Taxpayer may refuse further premium contributions and may begin " " proceedings.

Annual Statement Reporting

[1] Loading is the amount charged by an insurer above the pure risk premium as calculated using the applicable mortality/morbidity table and the assumed rate of interest. It represents the insurer's acquisition costs, overhead, contingencies, and profit margin. *See* Harvey W. Rubin, *Dictionary of Insurance Terms*, (6th Ed. 2013), p. 302 (loading is the "addition to the pure cost of insurance that reflects agent commissions, premium taxes, administrative costs associated with putting business on an insurance company's books, and contingencies").

The Taxpayer reported the Contribution Contract as a deposit-type contract on its Year 4 Annual Statement for Separate Accounts.[2] The statutory accounting principles promulgated by the NAIC define a "deposit contract" as one that does not incorporate insurance risk, that is, one that does not have morbidity or mortality risk. *See* SSAP No. 50, ¶¶ 43 & 44. Per SSAP No. 52, "[a] morbidity or mortality risk is present if, under the terms of the contract, the reporting entity is required to make payments or forego required premiums contingent upon the disability or death (in the case of life and disability insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals." SSAP No. 52, ¶ 2.

The Taxpayer established reserves for all contractual obligations arising out of the Contribution Contract pursuant to SSAP No. 56, ¶ 25, which requires the reserve to be "generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums" using the methodologies prescribed in the applicable portion of SSAP Appendices A and C (actuarial guidelines). For reserving purposes, State law requires that the reserve be established pursuant to the requirements of the standard valuation law in accordance with actuarial procedures that recognize the variable nature of the benefits, and the Taxpayer is required to provide an actuarial opinion that the reserves were computed appropriately, based on appropriate assumptions. Here, the Taxpayer's appointed actuary attested that, among other things, the reserves 1) "are computed in accordance with presently accepted actuarial standards consistently applied and are fairly stated in accordance with sound actuarial principles;" 2) "are based on actuarial assumptions that produce reserves at least as great as those called for by law as to reserve basis and method, and are in accordance with all other contract provisions;" and 3) "include provision for all actuarial reserves and related annual statement items that ought to be established."

In response to the exam team's request for the actuarial reserving methodology used to calculate the amount attributable to the Separate Accounts portion of the Contracts, the Taxpayer stated that "[t]he tax reserve for the Separate Accounts is equal to the underlying market value of the assets in the Separate Accounts. The reserves are not calculated using mortality and morbidity tables and assumed rates of interest."

Qualification Fraction

In the course of the audit of tax Year 4, the exam team requested the Taxpayer's detailed calculation of what is commonly referred to as the qualification fraction.[3] The

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[2] The Contribution Contract was included on the Taxpayer's Year 4 Annual Statement for Separate Accounts both on page 3 (as "Liability for Deposit-Type Contracts" on Line 2 of Liabilities and Surplus) and on page 10 (as "Guaranteed Interest Contracts" in column 2 of Exhibit 4 – Deposit-Type Contracts).

[3] The qualification fraction determines whether an insurance company is a life insurance company for Federal income tax purposes. A taxpayer qualifies as a life insurance company for

Taxpayer provided the exam team a high-level spreadsheet showing the calculation of both the numerator and denominator of the fraction and a more detailed spreadsheet for the calculation of the denominator. The Taxpayer included in the denominator of the qualification ratio, but not the numerator, Amount $A representing amounts the Taxpayer treated as reserves for contracts with permanent purchase rate guarantees (in total, not just with respect to Contracts). This amount included Amount $B held for the Contribution Contracts discussed above. Amount $B consists of Amount $C (relating to guaranteed interest investments) held in the general account and Amount $D (relating to separate account investments) held in separate accounts.

If Amount $B is a life insurance reserve, the Taxpayer's qualification fraction percentages for Year 1 through Year 4, are well above 50%. In such case, the Taxpayer was a life insurance company in Year 1 through Year 4. If a portion of Amount $B held for the Contracts is a life insurance reserve, additional computations need to be done to determine Taxpayer's qualification fraction percentages. If Amount $B is not a life insurance reserve but is included in total reserves, the qualification ratio percentages for Year 1, Year 2, Year 3, and Year 4, would be Amount F%, Amount G%, Amount H%, and Amount I%, respectively. In such case, the Taxpayer was not a life insurance company in Year 1 through Year 4.

If all of Amount $B is excluded from both the numerator and the denominator of the qualification fraction, the Taxpayer's qualification fraction percentages for Year 1, Year 2, Year 3, and Year 4, are Amount J%, Amount K%, Amount L%, and Amount M%, respectively. In such case, the Taxpayer was a life insurance company for Year 1 through Year 4.

LAW AND ANALYSIS

At issue is the application of the § 816(a) qualification fraction test. More specifically, the issue is whether the Taxpayer's reserves under the Contracts are "life insurance reserves" as defined by § 816(b). If the Taxpayer's reserves under the Contracts are not life insurance reserves, the issue is whether the amounts are excluded from total reserves by operation of § 816(f).

The Taxpayer's position is that the reserves under the Contracts are not life insurance reserves but are included in total reserves. Hence the result of the qualification fraction test would be that the Taxpayer is not a life insurance company.

Assuming the reserves are not life insurance reserves, Exam questions whether the Contracts involve a permanent purchase rate guarantee. If the Contracts do not involve a permanent purchase rate guarantee, pursuant to the rule of § 816(f), the reserves

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Federal income tax purposes if its life insurance reserves plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50 percent of its total reserves. Section 816(a).

under the Contracts are not included in total reserves, and, thus, the result of the qualification fraction test would be that the Taxpayer is a life insurance company.

As described below, the developed facts do not establish whether the reserves for the Contracts are life insurance reserves; advice for further development is provided. If the reserves are life insurance reserves, the Taxpayer is a life insurance company. If the reserves are not life insurance reserves, and the reserves are included in total reserves (i.e., are not excluded by § 816(f)), the Taxpayer is not a life insurance company.

Life Insurance Reserves

A life insurance company is an insurance company[4] that is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable contracts of health and accident insurance, if (1) its life insurance reserves (as defined in § 816(b)), plus (2) unearned premiums and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of its total reserves (as defined in § 816(c)). This computation is sometimes referred to as the "qualification fraction" or "qualification ratio" test.

Life insurance reserves are defined as amounts that meet the following three elements:

(1) They are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;
(2) They are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies; and
(3) They are required by law.

Section 816(b). Regulation § 1.801-4(d) presents examples of reserves that qualify as life insurance reserves provided, among other things, they meet the requirements of § 801(b) (now § 816(b)). Among these examples are "reserves held by a life insurance company on both the active and retired lives under deposit administration contracts."

The issue is whether the reserves for the Contracts meet the three elements in § 816(b) to qualify as life insurance reserves. The reserves meet the third element because they are required by State law.

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[4] An insurance company is defined as any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 816(a).

With respect to the second element, the issue is whether the Contracts are within the scope of § 816(b). Section 816(b) includes contracts that are life insurance, annuity, or noncancellable accident and health insurance contracts (including a combination). The Contracts are not life insurance contract as defined by § 7702 and the Contracts do not provide any accident and health insurance benefits; therefore, the Contracts are within § 816(b) only if the Contracts are annuity contracts.

A contract may be an annuity if it provides a permanent right to purchase an annuity at a guaranteed purchase rate (a permanent purchase guarantee). In Revenue Ruling 77-286, 1977-2 C.B. 228, the Service considered an arrangement involving a "deposit administration contract" which contained a limited annuity purchase rate guarantee lasting for an initial period. The Service ruled that because the contract did not provide for *permanent* purchase rate guarantees, it did not constitute an annuity contract during its accumulation phase, and, accordingly, the funds held under the contract were not life insurance reserves. The corollary is that if such deposit administration contracts provided for permanent purchase rate guarantees, the contracts would be annuity contracts.

For purposes of § 816(a), § 816(f) provides that amounts set aside and held at interest to satisfy obligations under contracts that do not contain permanent guarantees with respect to life, accident, or health contingencies are not included in the life insurance reserve or the total reserve. Consequently, reserves for contracts that do provide for permanent purchase rate guarantees may be included in the life insurance reserves (provided other requirements are met).

The legislative history to §816(f) reports that Congress adopted the Service's position in Rev. Rul. 77-286 that a purchase rate guarantee must be permanent for the reserves with respect to such guarantee to be deemed life insurance reserves.

> In general, the bill adopts the [the 1959 Act] definition of total reserves. However, the bill also provides that, for purposes of determining whether an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent purchase rate guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves. Thus, these amounts are not included in either the numerator or the denominator of the qualification fraction when determining whether a company's life insurance reserves and unearned premiums and unpaid losses on noncancellable accident and health insurance contracts comprise more than half its total reserves. The Internal Revenue Service has ruled that a reserve for a benefit is not a life insurance reserve unless a life benefit is permanently guaranteed under the contract

> (Rev. Rul. 77-286, 1977-2 C.B. 228). The provision of the bill substantially adopts this position and extends it to total reserves also, but only for purposes of the qualification fraction.

S.Prt. 98-169 (Vol. I) at 527; *see also*, H.R. Rep. 98-432 (Part 2) at 1403-04.

In *UNUM Life Ins. Co. v. United States*, 897 F.2d 599 (1st Cir. 1990), the issue was whether certain amounts maintained to safeguard the payment of obligations under "deposit administration contracts" qualified as "pension plan reserves" (the answer was dispositive of the amount of deduction allowed under then-applicable law). Attached to UNUM's contracts in question was a table that lists the price of a one-dollar monthly annuity for a person, depending on age. UNUM guaranteed these prices with respect to any annuity bought with money deposited by the employer during the first five years of the contract's life, regardless of when the annuity was actually bought. For money deposited after the initial five-year period, UNUM did not guarantee a price for an annuity. The court noted that "[b]ecause the employer can take advantage of the Contract's guaranteed annuity purchase rates at any time, even long after the five year period for depositing money (to which the rates apply) has passed, the parties call the annuity price guarantees 'permanent.'" 897 F.2d at 603.

Here, the original purchase rate applies for the duration of a Contract, albeit only to contributions made during its effective period (which is the greater of five years or when the rate is amended) and the account value accumulated thereon. Amended purchase rates, if any, apply to subsequent contributions and the account value accumulated thereon. A "guarantee" is generally defined to be "the assurance that a contract or legal act will be duly carried out". *Black's Law Dictionary* (10th ed. 2014). In the context of the qualification fraction, the concept of a "guarantee" is whether there is a legally cognizable promise to perform in the future. Here, the Taxpayer has a legally cognizable promise to perform in the future; hence there is guarantee that is permanent for the life of a Contract. Accordingly, the second element of the definition of a life insurance reserve for purposes of the qualification fraction is satisfied.

The remaining element, element one, is the requirement that reserves be computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest. The Taxpayer asserts that the reserve was not so computed or estimated and that the account value was used as the reserve amount. However, the Taxpayer's actuary attested that the reserve was determined in accordance with presently accepted actuarial standards consistently applied based on actuarial assumptions that produce reserves at least as great as those called for by law as to reserve basis and method. The Taxpayer does not explain the connection between the use of the account value and the actuarial standards. Thus, it is not clear how the amount of the reserve was actually determined. Further factual development will be needed to conclude whether the first element of the definition of a life insurance reserve for purposes of the Qualification Fraction is satisfied. As a consequence, no conclusion can be reached

with respect to the issue of whether the reserves for the Contracts are life insurance reserves as defined by § 816(b).

Total Reserves

Section 816(c) defines total reserves for purposes of the qualification fraction test to be (1) life insurance reserves, (2) unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law.

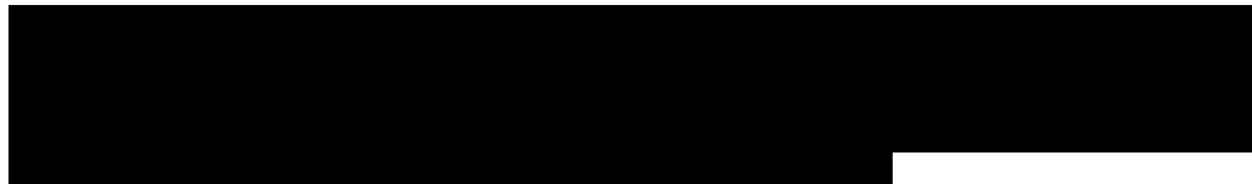
Section 1.801-5(b) provides that the term “reserves required by law” means reserves which are required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, and which are reported in the annual statement of the company and accepted by state regulatory authorities as held for the fulfillment of the claims of policyholders or beneficiaries.

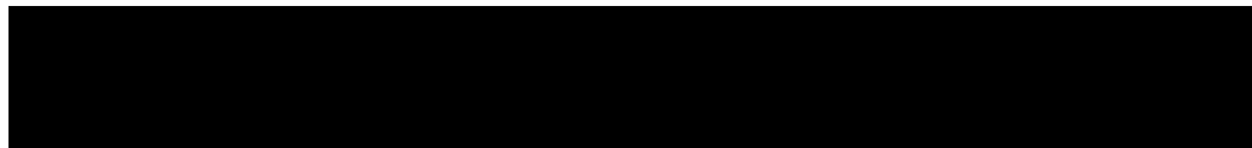
Here, if the Contracts’ reserves are life insurance reserves, they are included in total reserves for purposes of the qualification fraction. Section 816(c)(1). If the Contracts’ reserves are not life insurance reserves, the reserves are required by law as that term is defined by § 1.801-5(b). Because the Contracts involves a permanent purchase rate guarantee, the reserves are not excluded from total reserves under § 816(f). Thus, the reserves are included in total reserves. If there were no permanent purchase rate guarantee, the reserves would be excluded from both the numerator (life insurance reserves) and the denominator (total reserves) of the qualification fraction.

Other Considerations

The Contracts are used to support pension plans. Consideration could be given to whether any Contract fails to meet the requirements of § 72(s)(5). If any Contract does not provide for distribution as required by § 72(s)(5), the Contract is not an annuity for federal tax purposes and the reserves on the contracts are not life insurance reserves.

<u>CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS</u>





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