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Insurance: CCA addresses qualification under section 816(a)

The IRS publicly released a Chief Counsel Advice (CCA) memorandum* that addresses the issue of—when applying the qualification fraction test of section 816(a)—whether reserves with respect to certain annuity contracts are "life insurance reserves" as defined by section 816(b). In addition, if the reserves for those contracts are not life insurance reserves, the IRS also addressed the issue as to if the reserves are excluded from "total reserves" by operation of section 816(f). CCA 201733012 (release date August 18, 2017, and dated May 10, 2017).

In the CCA, the IRS found that the facts as developed did not establish whether the taxpayer's reserves for certain annuity contracts were life insurance reserves and requested further factual development. In addition, the IRS concluded that if the taxpayer's reserves for the annuity contracts were not life insurance reserves, the reserves were included in "total reserves" by operation of section 816(f).

Read **CCA 201733012** [PDF 87 KB]

*Chief Counsel Advice (CCA) documents are legal advice, signed by executives in the National Office of the IRS Office of Chief Counsel and issued to IRS personnel who are national program executives and managers. The documents are issued to assist IRS personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues. However, they are not to be used or cited as precedent.

Background

The taxpayer is a U.S. insurance company. 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 section 832 as an insurance company other than a life insurance company.

The taxpayer markets a contract (the "Contribution Contract" or "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.

The taxpayer reported the Contribution Contract as a deposit-type contract on its Year 4 Annual Statement for Separate Accounts. 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.

For regulatory purposes, state law requires that the insurance 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.

CCA—overview

At issue is the application of the section 816(a) qualification fraction test[1] to the Contribution Contracts. More specifically, the issue is whether the taxpayer's reserves under the Contracts were "life insurance reserves" as defined by section 816(b). If the taxpayer's reserves under the Contracts were not life insurance reserves, the issue is whether the amounts are excluded from total reserves by operation of section 816(f).

The characterization of the Contribution Contracts as life insurance reserves or insurance reserve affects whether the taxpayer qualifies as a life insurance company or as a nonlife insurance company under subchapter L.

Qualification fraction

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

- They are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest;
- They are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance,

[1] 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 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% of its total reserves. Section 816(a).

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

- They are required by law.

The issue is whether the reserves for the Contracts meet the three elements in section 816(b) to qualify as life insurance reserves.

The reserves satisfied the third element automatically because they are required by state law.

To determine whether the Contribution Contracts satisfied the second element of the qualification fraction, the IRS focused on whether the contracts qualified as annuity contracts. Specifically, the IRS analyzed whether the Contracts contained a permanent purchase rate guarantee.

The IRS discussed *UNUM Life Ins. Co. v. United States*, 897 F.2d 599 (1st Cir. 1990), where the issue was whether certain amounts maintained to safeguard the payment of obligations under "deposit administration contracts" qualified as "pension plan reserves." Attached to UNUM's contracts in question was a table that listed 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.

In the taxpayer's circumstance in the CCA, the original annuity purchase price applies for the duration of the contract with respect to contributions made during the Contracts effective period. Amended purchase rates apply to subsequent contributions and earnings. The IRS concluded that the taxpayer had a legally cognizable promise to perform in the future; hence, there was guarantee that is permanent for the life of a Contract. Accordingly, the IRS determined that the Contracts qualified as annuity contracts and that the second element of the definition of a life insurance reserve was satisfied.

The remaining element, the first 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 asserted 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 did not explain the connection between the use of the account value and the actuarial standards.

Ultimately the IRS concluded that it was not clear how the amount of the reserve was actually determined and that further factual development was needed to decide whether the first element of the definition of a life insurance reserve for purposes of the Qualification Fraction was satisfied. As a consequence, no conclusion was reached as to whether the Contracts would be included in the numerator of the qualification fraction.

Because the Contracts included a permanent purchase rate guarantee, the IRS concluded that the Contracts' reserves were to be included in the denominator of the qualification fraction.

KPMG observation

A taxpayer's characterization as a life or nonlife insurance company under subchapter L could substantially affect the taxpayer's taxable income calculation. For example, the proration calculations for tax-exempt interest and the dividends received deduction differ significantly for life and nonlife insurance companies.

It is the opinion of tax professionals that the CCA and IRS position neglect existing case law. The product features described in this CCA appear to align with the *UNUM* product features. Note that the IRS issued a technical advice memorandum—TAM 200427024 (March 5, 2004)—that did not follow the *UNUM* decision.

In the instant CCA, it is hard to see how the taxpayer's reserve computation could use mortality and morbidity assumptions for a permanent purchase rate guarantee. Once the IRS has completed its audit of the reserve method, tax professionals have expressed a hope that the IRS would follow *UNUM* and conclude that these contracts are not life insurance contracts for purposes of section 816. In any case, as the IRS did not reach a conclusion in this CCA and requested additional factual development, taxpayers need to use caution in relying on this memorandum.

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