

# TAXATION OF LIFE INSURANCE COMPANIES

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## I. General Considerations

A. Types of organizations - Life insurers are chartered under state law as stock or mutual companies.

### B. Economic Functions

1. Underwriting -- Issuance of life insurance, accident and health insurance, and annuity contracts.
2. Investment -- Investing primarily in bonds, stock, mortgages, and real estate.
3. Insurers act as an intermediary spread risk among insureds. With numerous insureds, under the law of large numbers, events become actuarially predictable.

## II. Major Tax Concepts

A. In general, life insurance contracts entail long-term obligations and liabilities. Life insurance reserves reflect the long-term nature of those insurance risks. Life insurance companies are those insurance companies that issue such contracts and hold such reserves.

### B. Life Insurance and Other Types of Contracts

#### 1. Life insurance contracts

Life insurance contracts insure life contingencies. There are different types of life insurance contracts, including whole life and term contracts. Life insurance contracts must satisfy the test set forth in section 7702.

#### 2. Annuity contracts

Annuity contracts provide for a series of payments at fixed intervals.

#### 3. Noncancelable A&H contracts (“noncan A&H”)

A&H contracts pay benefits for sickness or accidental injury or death. To be considered noncancelable, the issuing company must be obligated to renew the contract at a specified premium through the insured’s 60<sup>th</sup> birthday. In addition, the company must hold both an unearned premium reserve and an “additional reserve” for the policy.

#### 4. Guaranteed renewable A&H contracts

To be guaranteed renewable, a contract must not be cancelable by the Company, but the Company may retain the right to adjust premium rates by classes to reflect its experience. In addition, the Company must hold

both an unearned premium reserve and an “additional reserve” for the policy.

C. Life Insurance Company

1. To qualify as a “life insurance company,” a company must be an “insurance company.” An insurance company is a company more than one half of the business of which is issuing insurance or annuity contracts, or reinsuring risks underwritten by other insurance companies. Section 816(a). See Rev. Rul. 83-132, 1983-2 C. B. 270 (an entity need not be organized as a corporation to be taxed as an insurance company).
2. Moreover, the company must be engaged in the business of issuing certain types of insurance contracts (section 816(a)):
  - a. Life insurance contracts
  - b. Annuity contracts
  - c. Noncancelable health and accident contracts (“noncan A&H”)
  - d. Guaranteed renewable health and accident contracts (section 816(e))
3. Finally, more than 50 percent of the company’s “total reserves” must consist of (a) “life insurance reserves,” and (b) unearned premiums and unpaid losses on noncan or guaranteed renewable A&H policies (to the extent not included in life insurance reserves). Section 816(a).
4. “Life insurance reserves” are defined in the Code as amounts (section 816(b)):
  - a. computed or estimated on the basis of recognized tables and assumed rates of interest,
  - b. set aside to liquidate future unaccrued claims arising from life insurance, annuity, and noncan A&H contracts which involve life or A&H contingencies,
  - c. required by law.

D. The Theory of Life Insurance Reserves

1. Under life insurance contracts companies are obligated to pay, in the future, benefits to policyholders. Companies establish reserves in order to reflect their (unaccrued) liability to pay those benefits.

2. Many life insurance policies involve long-term risks. In order to provide for those risks, an insurer must hold reserves greater than the unearned premium reserve.
3. The cost of life insurance increases with age. Level premium whole life insurance policies charge premiums in excess of early year mortality cost. That excess is accumulated for later years, when mortality costs exceed the amounts of premiums paid. Thus, the function of reserves is to balance timing differences between premiums and mortality cost.
4. Under the mean reserve method, the mean life insurance reserve as of the December 31, 1989 valuation date is as follows:

$$\frac{\text{Reserve at 6-30-1989}}{2} + \frac{\text{Reserve at 6-30-1990}}{2} + \frac{\text{Annual Premium}}{2}$$

5. Viewed retrospectively, the total reserve for life insurance policies equals the total of premiums paid, plus interest thereon, less benefits already paid.
6. Viewed prospectively, the total reserve for life policies equals the present value of future benefits less the present value of future premiums.  
See Example #22.
7. All states follow the prospective view, which is embodied in the Standard Valuation Law.

E. Life Insurance Premiums

1. Gross premiums are comprised of the net valuation portion and the loading portion.
2. The net valuation portion is the amount designed to provide all benefits under the contract. In the aggregate, net premiums are sufficient, based on assumed rates of mortality and interest, to pay all death claims as they become due.
3. Upon issuance of a policy, the present value of benefits to be provided must equal the present value of premiums to be paid. The timing of benefit payments is determined by use of a mortality table. Those benefit payments are brought to present value by use of an assumed interest rate. This produces a hypothetical single net premium. Using the same mortality table and interest rate, that single premium is projected into annual net level premiums.
4. The balance of the gross premium, or loading, covers expenses and profit.

F. Valuation Methods

1. There are two basic valuation methods; the net level method and the preliminary term method.
2. Under the net level method, the net premium added to the reserve in each year remains constant.
3. The loading element of the first year premium typically is insufficient to cover expenses (e.g., the first year agent commission). Thus, the required reserve is established out of the company's surplus.
4. To avoid this result, the preliminary term method may be used on the annual statement. Under this method, the first year reserve, and the first year net premium are reduced. Net premiums and reserve additions are increased in later years to make up the difference.

G. Mortality Tables

Mortality tables are used to predict mortality, and are used in reserve and premium calculations.

H. Assumed Rates of Interest

An insurance company must estimate the interest that it can earn on reserves. The higher the rate of interest assumed, the lower the reserves required. Conservative rates of interest are assumed.

- I. Other elements, too complex to be discussed here, also enter into the reserve computations.

III. Taxation Under the 1959 Act: 1958 to 1981 (Historical Background)

A. Overall Framework

1. Under former section 802(b), "life insurance company taxable income" (LICTI) generally equaled:
  - a. The lesser of "taxable investment income" (TII) and "gain from operations" (GFO), plus
  - b. If GFO exceeded TII, 50 percent of that excess.
2. Taxable investment income represented income from investment operations. Any excess of gain from operations over TII represented income from underwriting operations.
3. Under section 802, a life insurance company's income was taxed in three "phases:"
  - a. Phase I - current taxation of investment income (TII),

- b. Phase II - current taxation of one-half of underwriting income (1/2 excess of GFO over TII),
  - c. Phase III - deferred taxation of one-half of underwriting income.
4. The deferred one-half of underwriting income was credited to the “policyholders surplus account” (section 815). In general, amounts in this account were taxed only when distributed to shareholders, such as when a company was acquired and liquidated.

B. Taxable Investment Income

1. Generally, TII was computed as follows:
- a. Gross income from investments,
  - b. Less: investment and similar expenses,
  - c. Exclude: the amount of net investment income credited to reserves, or paid as interest (the policyholders, share of investment yield),
  - d. Plus: long term capital gains,
  - e. Minus: certain specified deductions.
2. Thus, the policyholder’s share of each item of investment yield was excluded from the Phase I tax base.
- a. This accomplished the goal of not taxing the company on the portion of investment income that was, in effect, credited to reserves.
  - b. The “proration” of interest and the dividends received deduction between the company’s share and the policyholders’ share achieved the goal of preventing the funding of reserves with tax-exempt income.

C. Gain (or Loss) from Operations

1. Generally, GFO was computed as follows:
- a. Gross income from all sources, including investment income, premiums, and net capital gains,
  - b. Exclude: the amount of net investment income credited to reserves (the policyholders’ share of investment yield),
  - c. Less: deductions peculiar to the insurance business,

- d. Less: general corporate deductions,
  - e. Less: special insurance deductions, subject to a limitation based on TII.
2. In the computation of gain from operations, a limitation was imposed on three special deductions, the principal one being the deduction for policyholder dividends.
- a. The limitation that was imposed equaled the excess of GFO (computed without the special deductions) over TII, plus \$250,000 (former section 809(f)).
  - b. As a result, most mutual companies were taxed on GFO exactly equal to TII less \$250,000.
  - c. This limitation served two purposes. First, it ensured that companies were taxed, at least, on most of their investment income. Additionally, it reflected the view that some portion of policyholder dividends should be nondeductible and thus taxed at the company level (as are dividends of stock companies).
  - d. Second, the limitation was intended to allocate the insurance industry tax burden between the stock companies and the mutual companies (31% to stock companies and 69% to mutual companies).

D. Problems Under the 1959 Act

- 1. In the early 1980s, Congress determined that the 1959 Act had failed to respond to changes in the economic environment (inflation, rising interest rates, and new types of insurance products) and that, as a result, companies were resorting to newly developed tax-avoidance techniques (in particular, the use by mutuals of modified coinsurance).
- 2. Modified coinsurance (MODCO) was a type of reinsurance whereby risks, assets and reserves were deemed transferred to the reinsurers and premium income was deemed received by the reinsurers. Under these arrangements, the reinsured did not receive investment income (taxable in TII), but rather experience refunds (taxable in GFO).

IV. Taxation During the EFRA Stopgap: 1982 And 1983 (Historical Background)

- A. In TEFRA, Congress enacted temporary measures, effective for the years 1982 and 1983 -- the so-called "stop-gap period."
- B. Former section 820, governing MODCO, was permanently repealed. However, MODCO contracts for years before 1982 were grandfathered.

- C. The former section 809(f) limitation on special deductions was made more liberal. The prior \$250,000 figure was increased to \$1 million. In addition, an alternative limitation was provided, allowing mutuals to deduct 77-1/2 percent of their policyholder dividends.
- D. TEFRA made other significant changes as well.
- E. As a result of TEFRA, many mutual companies changed from Phase I to Phase II (Negative) taxpayers. Thus, for these years, audits and controversies in respect of mutual companies shifted from the TII arena to the GFO arena.

V. Taxation Under the 1984 Act: 1984 and on

- A. In drafting the 1984 Act, Congress stated that it had two motives: to create a statutory scheme better adapted to current economic conditions, and to create a simplified taxing structure.
- B. In General
  - 1. Structure of the 1984 Act
    - a. The 1984 Act imposes a “single phase” tax base, based on a stock company model.
    - b. The 1984 Act was designed to impose a certain aggregate tax burden on the life insurance industry and, for 1984, to allocate that tax burden between the mutual segment (55%) and the stock segment (45%) of the industry.
  - 2. Many concepts and elements are carried over from the 1959 Act to the 1984 Act. For example, the requirements for qualification as a life insurance company, while revised, are basically the same.
- C. Tax is Imposed on LICTI
  - 1. Section 801(a)(1) imposes a tax on LICTI. Section 801(a)(2) imposes an alternative tax for companies with net capital gain.
  - 2. LICTI is defined as “life insurance gross income” reduced by “life insurance deductions.” Section 801(b).
  - 3. In addition, in some cases, a tax will be imposed with respect to distributions from the pre-1984 Phase III account. Section 801(c) and 815. The Seventh Circuit recently decided a case involving a distribution from a company’s policyholders surplus account, and held that the fair market value (and not the adjusted basis) of real property distributed is the amount subject to the “Phase III” tax. Bankers Life & Casualty Co. v.

U.S., 98-1 U.S.T.C. ¶50,346 (7th Cir. 1998). The 2004 Jobs Act suspended the Phase III tax for tax years 2005 and 2006.

D. Life Insurance Gross Income

1. Under the 1984 Act, all of a company's gross income is included in its tax base. Section 803.
2. Premiums are included in income, less return premiums and indemnity reinsurance premiums paid. Section 803(a)(1). See Rev. Rul. 94-45, 1994-2 C.B. 39 (the reinsurance of policies from parent to subsidiary is a section 351 transaction, so that a transfer of assets is not taxable as premium income).
  - a. Under minimum premium plans, a supplemental premium is due if and when the plan terminates. Must the supplemental premium be accrued prior to plan termination? Massachusetts Mutual Life Ins. Co. v. U.S., 2005-2 U.S.T.C. ¶50,553 (Fed. Cl. 2005).
3. Decreases in reserves are included in income. Section 803(a)(2) and 807(a).
  - a. In the computation of GFO under prior law -- former section 809(a) and 810(a) -- the amount of the decrease in reserves did not reflect the policyholders' share of investment income. The reason was that the policyholders' share was excluded from gross income.
  - b. Under the 1984 Act, the full amount of investment income, including the policyholders' share of investment income, is included in income. Thus, the full decrease in reserves is reflected in income.
  - c. As will be described later, the amount of the decrease in reserves is increased by the policyholders' share of tax-exempt interest, and may be increased by a "section 809" amount for tax years beginning before 2001. Section 807(a)(2)(B), 809, and 812. (Section 205 of the Pension Equity Funding Act of 2004, Pub. L. No. 108-218, permanently repealed section 809 effective beginning in 2005).
4. Gross income includes all other amounts, including the total amount of investment income (but not tax-exempt interest). Section 803(a)(3).

E. Life Insurance Deductions

1. Section 804 provides that life insurance deductions include:

- a. The “small life insurance company deduction,” provided by section 806, and the
  - b. “General deductions,” specified in section 805.
2. As originally enacted, section 804 also provided for a “special life insurance company deduction,” which was computed under section 806.
    - a. The “special” deduction was equal to 20 percent of the excess of tentative LICTI over the “small company” deduction. It was intended to provide relief from the increased tax burden imposed by the 1984 Act.
    - b. In the 1986 Act, Congress determined that this relief was no longer necessary, and repealed the deduction.

F. Small Life Insurance Company Deduction

1. The small company deduction is equal to 60 percent of tentative LICTI up to \$3,000,000. Section 806.
  - a. The deduction phases out by 15 percent of tentative LICTI over \$3,000,000. Thus, for companies with tentative LICTI over \$15,000,000 the deduction is zero.
  - b. The deduction is not allowed to any company with assets over \$500 million.
2. “Tentative LICTI” is defined as LICTI determined without the small company deduction, and excluding all items attributable to a “noninsurance business.” Thus, the small company deduction is allowable only against insurance income.

G. General Deductions

1. The general deductions are specified in section 805. These deductions are somewhat similar to the deductions in former section 809(d).
2. Claims and benefits accrued, and losses incurred, are deductible. Section 805(a)(1).
3. The increase in reserves is deductible. Section 805(a)(2) and 807(b).
  - a. The full amount of the increase, without any reduction for the policyholders’ share of investment income, is reflected.
  - b. Under prior law, a portion of tax-exempt interest was excluded from income as the policyholders’ share of investment income. In

theory, a portion of the interest credited to reserves was deemed to be tax-exempt interest.

- c. Under the 1984 Act, the same result is accomplished by a different method. The amount of the increase in reserves deductible from income is reduced by the policyholders' share of tax-exempt interest. Section 807(b)(1)(B) and 812.
4. Policyholder dividends are deductible. Section 805(a)(3) and 808.
    - a. The definition of policyholder dividends
      - (1) Under the 1959 Act, the deduction for policyholder dividends was limited, while the deduction of return premiums and interest paid was not. Problems arose regarding experience rated refunds and excess interest.
      - (2) The 1984 Act broadly defines policyholder dividends to include all such amounts. Section 808(b).
    - b. The timing of the dividends deduction
      - (1) Under the 1959 Act, dividends were accounted for on a reserve basis (a deduction was allowed for liability to pay dividends, even if unaccrued).
      - (2) Under the 1984 Act, dividends are deductible only to the extent "paid or accrued." Section 808(c)(1).
        - (a) In New York Life Insurance Co. v. U.S., 2011-1 U.S.T.C. ¶ 50373 (S.D.N.Y. 2011), the court held that the Taxpayer may not accrue and deduct in the taxable year either (a) annual dividends on an insurance policy that accrue in the taxable year and, under the terms of the policy, become payable during the first month of the succeeding taxable year, or (b) the lessor of the termination dividend or the annual dividend. The court reasoned that the all events test was not satisfied.
        - (b) In TAM 200948042, the IRS held that a Taxpayer may not accrue and deduct in the taxable year annual dividends on an insurance policy that, under the terms of the policy, become payable during the first month of the succeeding taxable year.
        - (c) Also in TAM 200948042, the IRS held that a Taxpayer may not accrue and deduct in the taxable

year the lesser of (1) the termination dividend that will be payable in the succeeding taxable year if the policy is terminated, or (2) the annual dividend that will be payable in the succeeding taxable year if the policy is not terminated.

- (3) Normally, this change from the reserve to the accrual method would be a change in method of accounting, and section 481 would apply. However, the 1984 Act gives the dividend reserves a “fresh start.” Thus, no section 481 adjustment must be made.
  - (4) A question exists regarding the amount of the “fresh start” that applies to companies that have accrued policyholder dividends. See LTR 9224001 (Feb. 12, 1992).
    - (a) In National Life Ins. Co. v. Comm’r, the Tax Court and the Second Circuit held that such a company must create a year-end 1983 accrual balance. 103 T.C. No. 615 (1994), aff’d, 103 F.3d 5 (2d Cir. 1996).
    - (b) As a result, companies with accrued dividends receive less “fresh start” than other companies.
  - (5) The “fresh start” is taken away to the extent that a company changes its policyholder dividend practices in order to “accelerate” its dividend deductions. Section 808(f).
    - c. When a mutual company demutualizes, it may distribute cash and stock to policyholders. It has been held that such distributions are not policyholder dividends. UNUM Life Ins. Co. v. U.S., 929 F. Supp. 15 (D. Me. 1996), aff’d, 130 F.3d 501 (1st Cir. 1997). The court held that the term “dividend” does not include a distribution to an equity owner in exchange for the equity ownership.
    - d. In certain cases, the policyholder dividend deduction of mutual companies will be reduced for tax years beginning before 2001. Section 808(c)(2). This will be discussed, infra.
5. A deduction is allowed for dividends received from other corporations. Section 805(a)(4).
  - a. Generally, only the “company’s share” of the dividends received deduction is allowed. Sections 805(a)(4)(A)(ii) and 812.

- b. However, “100 percent dividends” (for example, from a wholly-owned subsidiary) are deductible in full, except to the extent distributed out of tax-exempt income of the subsidiary or the increase in policy cash values of life insurance, annuity, or endowment contracts owned by the distributing corporation to which section 264(f) applies.
6. All other deductions allowed under the Code, subject to some modifications, are allowable to life insurance companies. Section 805(a) and (b).

H. Proration under the 1984 Act

- 1. Under the 1959 Act, the policyholders’ share of investment income was excluded from both the Phase I and Phase II tax bases. Then, only the company’s share of tax-exempt interest and the dividends received deduction were deducted.
- 2. As discussed above, the 1984 Act prorates these items differently:
  - a. Tax-exempt interest is totally excluded from a company’s gross income. However, the policyholders’ share of tax-exempt interest then reduces the deduction for reserve increases (or increases the income from reserve decreases).
  - b. As discussed above, a company may deduct only the company’s share of the dividends received deduction.
  - c. See Example #. 24
- 3. The 1984 Act’s proration formula, which is stated in section 812, is similar to the prior law’s Phase II proration formula (required interest over investment yield).
  - a. The “company’s share” is (1) the company’s share of net investment income over (2) net investment income. Section 812(a)(1).
  - b. Gross investment income, defined in section 812(d), is similar to the old law’s Phase I definition.
  - c. Net investment income is 90 percent of gross investment income. Section 812(c).
  - d. The company’s share of net investment income is the excess of net investment income over the sum of:

- (1) Policy interest, consisting of required interest, and portions of excess interest and other interest, and
- (2) A portion of policyholder dividends.

4. See Example #25

I. Reserves under the 1984 Act

1. Under the 1959 Act, reserves were utilized in both Phase I and Phase II. In Phase I, they entered into the formula for excluding the policyholders' share of investment income. In Phase II, they played a similar role, and they also determined the amount of expense (or income) due to the increase (or decrease) in reserves allocable to premium income.
2. Under the 1984 Act, reserve increases (or decreases) allocable to both premiums and investment income constitute an expense (or income). As noted above, closing reserve balances are reduced by the policyholders' share of tax-exempt interest.
3. As under the 1959 Act, the "items taken into account" for these purposes include not only "life insurance reserves," but also unearned premiums, unpaid losses, etc. Section 807(c).
4. Under the 1959 Act, life insurance reserves were the amounts reflected on a company's NAIC annual statement. However, preliminary term reserves could be revalued on the net level basis for tax purposes. Former section 818(c).
5. For purposes of qualification as a life insurance company under section 816, annual statement reserve amounts are still utilized. Section 807(d)(1).
6. However, for purposes of computing LICTI, two changes are made:
  - a. Section 818(c) revaluations are no longer available, and
  - b. Specially computed tax reserves, rather than annual statement reserve amounts, must be used to compute LICTI.
7. In computing LICTI, the amount of life insurance reserves for a contract is the greater of (1) net surrender value, and (2) the federally prescribed reserve. Section 807(d)(1).
8. However, the amount of the reserves so determined cannot exceed the amount of the annual statement statutory reserves. This is referred to as the annual statement "cap."

- a. What rules, if any, govern how reserves on the annual statement must be computed in order to qualify as “statutory reserves”?
9. Net surrender value is determined with regard to surrender charges, but without regard to policy loans. Section 807(e)(1).
10. Annuity reserves are determined under CARVM, which determines the future value of guaranteed benefits at future year ends. If surrender charges are waived at each year end, those charges are not taken into account and do not reduce reserves. LTR 9452001 (Aug. 26, 1994).
11. Under pension deposit contracts, the reserve is the policyholders’ fund reduced by surrender charges. LTR 9452001 (Aug. 26, 1994).
12. Federally prescribed reserves are computed using (section 807(d)(2)):
  - a. A specified reserve method (Various preliminary term methods are specified. E.g., for life insurance, CRVM must be used).
  - b. The greater of a prevailing State assumed interest rate and an AFR rate,
  - c. Prevailing State mortality or morbidity tables.
13. See Treas. Reg. § 1.807-1 for a list of “prevailing” rates and tables. See also Rev. Rul. 92-19, 1992-1 C. B. 227, which has been supplemented by multiple revenue rulings, including Rev. Rul. 2008-19.
  - a. Section 807 requires that taxpayers use CARVM prescribed by the NAIC as of the date of issuance. If the NAIC is silent on the CARVM issue, taxpayers must use the prevailing state practice. LTR 200448046 (Aug. 30, 2004).
14. A company may elect to recompute reserves every five years using the then-current interest rate. Once the election is made, the company must continue it. Section 807(d)(4)(A)(ii).
15. These new rules, which generally will result in smaller reserves, must be used in 1984 and subsequent years. Closing 1983 reserves will be computed under old law, and closing 1984 reserves under new law. Thus, in 1984 a large decrease in reserves could result. To prevent recognition of a section 481 income adjustment, the 1984 Act gives reserves a “fresh start.”
16. Certain special reserves for supplemental benefits are excluded from these rules. Section 807(e)(3).
  - a. For these reserves, annual statement amounts are allowable.

- b. If the reserve is for a “qualified” supplemental benefit, the reserve is computed as if the benefit were provided under a separate contract. LTR 9620001 (Jan. 23, 1996).
  - c. To be “qualified,” there must be a separately identified premium or charge for the benefit. LTR 9442001 (June 7, 1994).
- 17. Certain special reserves for substandard risks also are excluded from the generally applicable reserve rules. Section 807(e)(5).
- 18. A question exists regarding the extent to which the new rules prescribed in section 807 apply not only to life insurance reserves, but also to other section 807(c) reserve items.
- 19. Under the case law, reserves that are not actuarially computed do not qualify as “life insurance reserves” for tax purposes. Companies, by varying their methods of computing reserves, could choose to be taxed as a P&C or as a life company. Prop. Treas. Reg. § 1.801-4(g) permits the IRS to recompute reserves on an actuarial basis and have them qualify as life insurance reserves.
- 20. If a company changes its method of computing reserves, the change may qualify as a “change in basis.” Section 807(f). The IRS’ consent is not required and the resulting change in reserves is taken into account ratably over 10 years. Rev. Rul. 94-74, 1994-2 C.B. 157, which distinguishes between a change in basis and the correction of an error, takes the position that most changes are changes in basis and that a change only rarely should be treated as the correction of an error. See also, Rev. Rul. 2002-6, 2002-6 I.R.B. 460 (concluding that a change in reserve computations to conform to NAIC guidelines was a change in basis for purposes of section 807(f)).
- 21. Questions will arise as insurance regulators require that reserves be computed in ways that are different from the way that section 807 requires reserve computations. These new methods produce what are called “principles-based reserves.” See Notice 2008-18.

J. The Section 809 Add-on Tax

- 1. Congress has always believed that some portion of the policyholder dividends paid by mutual companies represents a distribution of earnings. Such a distribution ordinarily is not deductible.
- 2. In the 1959 Act, section 809(f) imposed a limitation on the deduction of policyholder dividends.
- 3. The 1984 Act imposed the section 809 add-on tax to accomplish two goals:

- a. To tax to mutual companies the amount of income deemed to be distributed to policyholders as earnings. The amount of such earnings is estimated on the basis of a hypothetical return on equity. The rate of return is determined by reference to the earnings rates of stock companies.
  - b. To achieve “segment balance” between stock and mutual life insurance companies. The initial earnings rate was set to allocate 55 percent of the 1984 industry tax burden to mutuals.
4. Section 611(a) of the Job Creation and Worker Assistance Act of 2002, P.L. No. 107-147, suspended the operation of section 809 for tax years beginning in 2001, 2002, and 2003. Section 809(j). See Notice 2002-33, 2002-21 I.R.B. 989 (announcing that life insurance companies are not obligated to file Form 8390 in 2002 or 2003). Section 205 of the Pension Funding Equity Act of 2004, Pub. L. No. 108-218, repealed section 809 for tax years beginning on or after January 1, 2005.
5. The amount of income “added on” to the taxable income of mutuals is termed the “differential earnings amount” (DEA). Section 809(a).
  - a. First, the DEA reduces the policyholder dividends deduction. Sections 808(c) and 809(a)(1).
  - b. If there is any excess DEA, it reduces the closing balance of reserves. Sections 807(a) and (b) and 809(a)(2).
6. The DEA is the product of a company’s “average equity base” times the industry’s “differential earnings rate.” Section 809(a)(3).
7. A company’s average equity base is the mean of its opening and closing equity base for the year.
  - a. A company’s equity base is its surplus and capital per its annual statement, increased by various amounts, such as:
    - (1) Nonadmitted financial assets,
    - (2) the excess of annual statement reserves over tax reserves,
    - (3) certain other reserves (e.g., voluntary reserves, and the mandatory security valuation reserve),
    - (4) 50 percent of the provision for policyholder dividends.
  - b. The mandatory security valuation reserve no longer appears on the annual statement -- it was replaced by two reserves, the asset valuation reserve (AVR) and the interest maintenance reserve

(IMR). Treas. Reg. § 1.809-10 provides that the AVR and the IMR must be included in the equity base.

- c. If a company reduces its equity base, it reduces its DEA and its add-on tax.
8. The differential earnings rate (DER) is the excess of an “imputed earnings rate” over an “average mutual earnings rate.”
  9. The imputed earnings rate is a stock company earnings rate determined as the numerical average of the earnings rates of the 50 largest stock companies.
    - a. For 1984, Congress set the imputed earnings rate at 16.5 percent in order to achieve a segment balance imposing 55 percent of the industry tax burden on mutual companies.
    - b. In subsequent years, changes in the imputed earnings rate, which reflect current stock earnings rates, are indexed to the 16.5 percent rate.
  10. The average mutual earnings rate is the weighted average of mutual company earnings to their average equity bases.
  11. The average mutual earnings rate applied to compute the DEA is the rate for the second preceding year. In the following year, the DEA is recomputed using a recomputed average mutual earnings rate. Section 809(f).
    - a. Any increase or decrease in the DEA is taken into account as income or as a deduction in the recomputation year.
    - b. This process is referred to as a “true-up” or a “true-down.”
  12. The appropriateness of allowing a “negative” differential earnings rate was advocated by taxpayers and contested by the IRS. See IRS Notice 88-106, 1988-2 C.B. 444; Rev. Rul. 89-106, 1989-2 C. B. 108.
    - a. American Mutual Life Ins. Co. v. U.S. held that the negative RDER is not allowed. 43 F.3d 1172 (8th Cir. 1994), cert. denied, 516 U.S. 930 (1995).
    - b. In Indianapolis Life Ins. Co. v. U.S., 115 F.3d 430 (7th Cir. 1997), the Seventh Circuit upheld the validity of the same Treasury regulation that was at issue in American Mutual. See also, CUNA Mutual Life Ins. Co. v. U.S., 97-2 U.S.T.C. ¶50,904 (Fed. Cl. 1997).

- c. In John Hancock Financial Services, Inc. v. U.S., 2003-2 U.S.T.C. ¶150,595 (Fed. Cl.), aff'd, 378 F.3d 1302 (Fed. Cir. 2004), the Court rejected the taxpayer's argument, which was based on the tax benefit rule, that it should not be required to reduce its policyholder dividends deduction for 1988 and 1989.
13. The section 809 add-on mechanism has several unusual consequences:
- a. It attempts to allocate a total industry tax burden between stock and mutual companies (segment balance).
  - b. It determines the tax burden imposed on mutuals as a group by reference to the earnings rates of stocks (coupling).
  - c. It determines the tax imposed on each mutual company by reference to the earnings of other mutuals (socialization).
14. Most mutuals considered and/or implemented alternatives that enabled them to avoid section 809 add-on taxes prospectively.
- a. One way to avoid section 809 was to demutualize, i.e., to become a stock company.
  - b. It was also possible to rearrange under a mutual holding company provision, such that the mutual company becomes a stock company. See LTR 9745013 (Aug. 7, 1997)(conversion of mutual life insurance company to stock life insurance company using a mutual holding company form is a tax-free reorganization under §§ 351 and 368(a)(1)(E)).
  - c. A life insurance company that was organized in stock form but later underwent a "mutualization" under state law, filed suit claiming that it is not a mutual company, but a stock or nonmutual company not subject to section 809. The basis of the company's claim was that it issues a significant amount of non-participating insurance and thus lacks the "mutuality" necessary to be a mutual. The court held that the company was a mutual life insurance company, because it had no stockholders and was owned by the policyholders during the years at issue in the case. Pan American Life Ins. Co. v. U.S., 97-2 U.S.T.C. ¶150,655 (E.D. La. 1997).

K. Deferred Acquisition Costs (DAC)

- 1. The 1990 Act enacted Code section 848, which provides for the capitalization and amortization of "specified policy acquisition expenses."

2. Congress declined to measure actual acquisition costs. Instead, section 848(c)(1) uses specified percentages of “net premiums” as a proxy in the computation of specified policy acquisition expenses.
  - a. The DAC rules substitute for the ordinary capitalization rules, which therefore do not apply. LTR 200334005 (April 16, 2003).
3. Net Premiums
  - a. Only premiums on “specified insurance contracts” are subject to DAC. Treas. Reg. § 1.848-1(b).
    - (1) Included are life insurance, annuity, and noncancelable or guaranteed renewable A&H contracts.
    - (2) Certain insurance contracts are excluded, such as pension plan contracts, flight insurance, and medical savings account contracts.
  - b. Net premiums are calculated as gross premiums received, less return premiums and reinsurance premiums paid.
  - c. Section 848(d)(3) excludes various phantom premiums from net premiums.
  - d. If a policy is exchanged for another policy, the value of the policy may be included in net premiums. Certain internal exchanges of insurance policies are excluded from this treatment. Treas. Reg. § 1.848-2; LTR 9623005 (Feb 22, 1996).
4. The percentage applied to net premiums varies depending on the type of specified insurance contract.
  - a. The percentage for annuities is 1.75%.
  - b. The percentage for group life insurance contracts is 2.05%. To narrow the contracts eligible for this category, the regulations strictly define what is a “group” contract. Treas. Reg. § 1.848-1(h).
  - c. The percentage for all other specified insurance contracts is 7.7%.
  - d. Under combination contracts (providing more than one type of coverage), separately stated premiums are allocated between the coverages provided. If not separately stated, the highest capitalization percentage applies. Treas. Reg. § 1.848-1(g).

5. In general, section 848(a)(2) provides for ratable amortization over a 120 month period. Section 848(b) provides a special rule (60 months) for small companies. Section 848(j) provides a transitional rule for the year 1990.
6. The case law had established that ceding commissions paid by the reinsurer on reinsurance contracts must be capitalized and amortized over the life of the reinsured policies. Section 848(g) provides that such ceding commissions are no longer subject to that case law, but must be amortized under the rules specified in section 848.
7. In the case of reinsurance, section 848(d)(4) prohibits the deduction of reinsurance premiums in computing net premiums if the reinsurance premiums are paid to a reinsurer not subject to U.S. taxation. A special mechanism is provided so that such a foreign reinsurance transaction can be treated separately and thus not subjected to a double DAC tax. Treas. Reg. § 1.848-2(h)(3).
8. In a reinsurance transaction, net premiums are determined by aggregating all amounts of consideration passed between the parties to the reinsurance agreement. Treas. Reg. § 1.848-2(f).
9. Expenditures incurred for the development of new insurance products, including expenditures for overhead, actuarial services, product registration, legal and professional expenses, educational/training expenses, are not subject to capitalization under section 263, because application of section 848 generally trumps section 263. LTR 200334005 (April 16, 2003).
10. See Example #26.

L. Reallocation of Reinsurance Transactions

1. The IRS can propose adjustments to tax items attributable to a reinsurance agreement between related parties if the IRS determines that the reallocation is necessary to reflect the proper amount, source or character of taxable income. Section 845(a) (as amended by section 803 of the 2004 Jobs Act).
2. The IRS also can propose adjustments to tax items attributable to a reinsurance agreement between unrelated parties, but only if necessary to correct a “significant tax avoidance effect.” Section 845(b).
3. In Trans City Life Ins. Co. v. Comm’r, the Tax Court held that two unrelated parties had substantial business purposes for their reinsurance agreement and that there was no substantial tax avoidance effect. 106 T.C. 274 (1996), nonacq., 1998-1 I.R.B. 5.