DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Lon B. Smith
Acting Associate Chief Counsel
(Financial Institutions and Products)

SUBJECT:

This Field Service Advice responds to your memorandum dated December 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Taxpayer =

State A =

X percent =

Year 1 =

Year 2 =

$AAA =

$BBB =

$CCC =

$xxx =

$yyy =

ISSUE

Whether Taxpayer is required to reduce the amount of its life insurance reserves under § 807(d)(1) of the Internal Revenue Code by ceded reinsurance in cases where the reinsured risks are ceded on a yearly renewable term (YRT) basis and the amount of those life insurance reserves is based on the net surrender values of the reinsured contracts?

CONCLUSIONS

1. Section 807(d)(1) provides generally that the amount of the life insurance reserves with respect to an insurance or annuity contract is the greater of the net surrender value of the contract or the federally prescribed reserve amount determined in accordance with § 807(d)(2). Because YRT reinsurance is used to transfer only the mortality risk or morbidity risk on the reinsured contracts, Taxpayer's YRT reinsurance treaties did not reduce its liability to policyholders for payment of their net surrender values in the event of lapse and surrender.

Accordingly, for purposes of making the net surrender value/federally prescribed reserve comparison under § 807(d)(1), Taxpayer is not required to reduce the net surrender values of the reinsured contracts by ceded reinsurance.

2. Taxpayer's deduction of life insurance reserves under § 807(d)(1) based on the net surrender values of the reinsured contracts, together with the reductions claimed in determining of "premiums" under § 803(a)(1) by the amounts paid or incurred under the YRT reinsurance treaties, does not involve a double deduction of the "same item" within the meaning of § 811(c)(2) or (c)(3).

3. Taxpayer properly characterized the change in method of applying credits for ceded reinsurance when making the net surrender value/federally prescribed reserve comparison under § 807(d)(1) as a "change in basis" subject to the 10–year ratable adjustment rule of § 807(f).

FACTS

Taxpayer is a life insurance company within the meaning of § 816 which is subject to the tax imposed by § 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 yearly renewable term (YRT) basis. Taxpayer enters into these YRT reinsurance treaties for a variety of business reasons, including limiting the amount of its underwriting risk on any individual life or pair of lives, improving the underwriting classification of its prospective insureds, and providing more competitive premium rates for a broad range of policyholders. During the taxable years involved, Taxpayer had in force approximately 20 different YRT reinsurance treaties, which covered approximately X percent of the aggregate face amount of coverage under Taxpayer's individual whole life policies and other permanent insurance plans.

Under a YRT reinsurance treaty, Taxpayer purchases reinsurance with respect to its mortality risk during the following policy year on a particular insurance policy or group of policies. This mortality risk is referred to as the "net amount at risk," and is equal to the excess of the face amount of the policy over Taxpayer's policy reserve at the end of the policy year. Accordingly, if the insured were to die during a policy year for which a YRT treaty was in effect, Taxpayer would be responsible for the portion of the death benefit reflected in the existing policy reserve, and the YRT reinsurer would indemnify Taxpayer for the excess of the face amount of the policy over the policy reserve.

The reinsurance premium that Taxpayer pays to a YRT reinsurer is based on the net amount at risk on the reinsured policies during the following policy year,

and thus is not directly tied to the gross premiums that Taxpayer collects from its policyholders on the underlying plan of insurance. The reinsurance premiums are due as of the first day of each month. Each monthly reinsurance premium represents the annual premium due for the reinsured portion of all policies with an anniversary date during that month. This reinsurance premium is due and payable to the YRT reinsurer regardless of the premium mode of the underlying policy. If a reinsured policy were to terminate at some point during the policy year, the reinsurer is released from liability with respect to the net amount of risk on that policy for the remainder of the policy year. Thus, the unearned portion of the reinsurance premium on that policy is returned to Taxpayer by way of netting this amount against the monthly reinsurance premium otherwise payable to the reinsurer.

For purposes of filing its NAIC annual statement, Taxpayer reduces the aggregate amount of its statutory reserve liabilities by a credit for ceded reinsurance representing the value of the risks that have been reinsured with other insurance companies. For policies which are reinsured on a YRT basis, Taxpayer calculates the credit for ceded reinsurance by first determining the policy reserve that would be required in the absence of YRT reinsurance. Taxpayer then repeats this reserve calculation based on its actual retention after the reinsurance transaction. The difference between these calculated reserves represents the unearned portion of the term insurance benefit based on the premium payment assumptions, reserve method, valuation interest rate, and mortality assumptions used in calculating the statutory reserves. Taxpayer reflects this difference as the credit for ceded reinsurance, which reduces the amount of Taxpayer's statutory reserve liability for the reinsured policies reported on the annual statement.

For purposes of determining the amount of life insurance reserves under § 807(d)(1) taken into account in computing its life insurance taxable income, Taxpayer calculates a credit for ceded reinsurance with respect to policies for which it has ceded risks on a YRT basis using a similar methodology, except that Taxpayer substitutes the valuation assumptions used in calculating the contract's federally prescribed reserve under § 807(d)(2) when comparing the calculated reserves before and after the YRT transaction. Accordingly, the unearned portion of the term insurance benefit which is taken into account as the credit for ceded reinsurance for tax purposes is based on the premium payment assumptions and reserve factors that Taxpayer uses in calculating the federally prescribed reserves for the reinsured policy under § 807(d)(2) (that is, the tax reserve method, the higher of the applicable federal interest rate or the prevailing State assumed interest rate, and the prevailing commissioners standard mortality table) rather than Taxpayer's statutory reserving assumptions.

As a result of this difference in computational assumptions, the credits for ceded reinsurance which Taxpayer applies in determining the amount of its life

insurance reserves under § 807(d)(1) may differ from the corresponding credits for ceded reinsurance reflected on Taxpayer's annual statement. For example, the credit for ceded reinsurance used in calculating Taxpayer's life insurance reserves under § 807(d)(1) may be less than the credit amount shown on Taxpayer's annual statement if Taxpayer has used a mean reserving assumption when calculating its statutory reserves (that is, if Taxpayer assumes that the premiums for a policy are prepaid at the beginning of each policy year when calculating the amount of the policy reserves regardless of the actual payment mode on the underlying policy). This is because, under § 811(c)(1), Taxpayer is precluded from taking deferred and uncollected premium installments into account when computing its federally prescribed reserves under § 807(d)(2) to the extent that its right to receive those unpaid premiums has not accrued under federal tax accrual rules. In addition, the credits for ceded reinsurance may differ because the reserve computation rules of § 807(d)(2) require Taxpayer to use different reserving methods, valuation interest rates, or mortality assumptions when calculating the federally prescribed reserves for a contract than the corresponding assumptions used in calculating the contract's statutory reserves.

During Year 1, Taxpayer reviewed its method of applying credits for ceded reinsurance when determining the amount of its life insurance reserves under § 807(d)(1) for those policies for which Taxpayer had ceded risks on a YRT basis. Taxpayer recognized that its current method of taking credits for ceded reinsurance into account did not differentiate whether the amount of life insurance reserves for a contract were based on the net surrender value or the federally prescribed reserve amount under § 807(d)(2). Taxpayer also recognized that the amounts taken as credits for ceded reinsurance in determining the amount of a contract's statutory reserves (as defined in § 809(b)(4)(B)) for purposes of the "annual statement" cap under § 807(d)(1) were erroneously calculated based on the prescribed reserve assumptions used in determining the contract's federally prescribed reserve under § 807(d)(2), rather than the valuation assumptions actually used in determining the credits for ceded reinsurance shown on Taxpayer's annual statement.

Accordingly, at the end of Year 1, Taxpayer modified its method of taking credits for ceded reinsurance into account for tax purposes. Under the new method, Taxpayer continued to apply a tax-based credit for ceded reinsurance in determining the amount of federally prescribed reserves for a contract under § 807(d)(2); however, Taxpayer made no offset for ceded reinsurance when determining the net surrender values of the contract. Taxpayer also modified its method of applying credits for ceded reinsurance when calculating the amount of statutory reserves for purposes of the "annual statement" cap under § 807(d)(1) so that those credits were calculated consistent with Taxpayer's statutory reserving assumptions (apart from any amounts attributable to deferred and uncollected premiums which were not included in taxable income) rather than the assumptions

used in calculating the federally prescribed reserves for the contract under § 807(d)(2).

The following table illustrates the impact on the amounts taken into account as life insurance reserves under § 807(d)(1) for contracts for which Taxpayer had ceded risks on a YRT basis as a result of Taxpayer's change in method of applying credits for ceded reinsurance.

Reserve basis	**Gross reserve**	**"Old" Reinsurance Offset**	**"New" Reinsurance Offset**
Federally prescribed reserve (section 807(d)(2))	$AAA	$xxx	$xxx
Net surrender value	$BBB	$xxx	0
Statutory reserve	$CCC	$xxx	$yyy
Net reserve deduction under section 807(d)(1)		($BBB-$xxx)	$BBB

In filing its Federal income tax return for Year 1, Taxpayer treated the net increase in its life insurance reserves under § 807(d)(1) resulting from this modification as a change in basis within the meaning of § 807(f). In accordance with § 807(f), the increase in the amount of Taxpayer's life insurance reserves under § 807(d)(1) resulting from this change in basis did not affect Taxpayer's deduction for net increases in reserves during Year 1, but rather was deducted ratably over a 10-year period beginning in Year 2.

You have requested our advice whether in accordance with §1.801-4(a) of the Income Tax Regulations, Taxpayer is required to reduce its life insurance reserves under § 807(d) with respect to contracts for which Taxpayer has ceded risks on a YRT basis by ceded reinsurance regardless of whether those reserves are based on the net surrender values or federally prescribed reserves of the reinsured contracts.

Alternatively, you have requested our advice whether Taxpayer's deduction of life insurance reserves under § 807(d) based on the net surrender values of the reinsured contracts, together with the reductions claimed in determining the amount

of premiums under § 803(a)(1) for the amounts paid or incurred under the YRT reinsurance treaties, represents a prohibited double deduction of the "same item" under § 811(c)(2) or (3).

LAW AND ANALYSIS

Section 803(a) provides that life insurance company gross income is the sum of (i) premiums, (ii) decreases in certain reserves, and (iii) other amounts generally included by a taxpayer in gross income. Under § 803(a)(1), the amount of "premiums" is calculated based on the difference between (A) the gross amount of premiums and other consideration on insurance and annuity contracts during the taxable year, less (B) return premiums, and premiums and other consideration arising out of indemnity reinsurance.

Section 805(a)(2) authorizes a deduction with respect to the net increase in certain reserves required by § 807(c) to be taken into account. Under § 807(c)(1), the reserves to which this treatment applies include "life insurance reserves as defined in § 816(b)."

Section 807(d)(1) provides that, other than for purposes of § 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 § 807(d)(2). In no event may the reserve for any contract exceed the amount taken into account with respect to that contract as of that time in determining the statutory reserves (reduced by any deferred and uncollected premiums taken into account in determining the statutory reserves). Section 807(d)(1) (flush language); see also §§ 809(b)(4)(B) and 811(c).

Section 807(d)(2) provides that the 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 807(e)(1) provides generally 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.

Section 807(f) provides that if the basis for determining any item referred to in § 807(c) as of the close of any taxable year differs from the basis for determining that item as of the close of the preceding taxable year, then so much of the difference between (i) the amount of the item at the close of the taxable year,

computed on the new basis, and (ii) the amount of the item at the close of the taxable year, computed on the old basis, as is attributable to contracts issued before the taxable year, is taken into account ratably over 10 taxable years (either as an increase or decrease in taxable income), beginning with the year following the year of change.

Section 811(a) provides that a life insurance company is required to compute its taxable income using an accrual method of accounting or, to the extent permitted by Treasury regulations, using a combination of an accrual method of accounting with another method of accounting (other than the cash receipts and disbursements method). To the extent not inconsistent with federal income tax accounting rules and other federal tax rules applicable to life insurance companies, all computations, however, are to be made in a manner consistent with the manner required for purposes of the annual statement approved by the NAIC.

Section 811(c)(1) provides that in computing life insurance company taxable income, a reserve for an item is not recognized unless the gross amount of premiums and other consideration attributable to that item are required to be included in gross income. Section 811(c)(2) and (c)(3) further provide that the same item may not be counted more than once for reserve purposes, or deducted (either directly or as an increase in reserves) more than once.

Section 1.801-4(a) of the Income Tax Regulations provides guidance with respect to the effect of reinsurance transactions on the amounts taken into account by an insurance company as "life insurance reserves" for purposes of the definition in former § 801(b). Section 1.801-4(a) 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. For example, 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.

Section 1.801-4(a) interpreted the definition of "life insurance reserves" in former § 801(b), which is now contained in § 816(b). 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). Congress intended the new provision to be interpreted in a manner consistent with the prior law provision. See H. Rep. No. 432, Pt. 2, 98th Cong. 2d Sess. 1402 (1984); S. Prt. No. 169, Part I, 98th Cong., 2d Sess. 524 (1984). Although the 1984 Act carries over the historical definition of "life insurance reserves," as set forth in former § 801(b), it substantially changed the impact of this definition on the amounts taken into account in computing life insurance company taxable income. Prior to the

1984 Act, the amount of life insurance reserves for which increases and decreases were recognized in computing taxable income was based on the amount of the reserve liabilities reported on the insurance company's annual statement for State regulatory reporting purposes.

While § 807(c)(1) still includes "life insurance reserves, as defined in § 816(b)" among the deductible reserve items, the legislative committee reports indicate that this cross-reference was intended merely to identify the type of reserve for which increases and decreases were taken into account, and was not intended to superimpose the requirement of proper computation of State law reserves for allowing increases in these reserves to be recognized. See S. Prt. No. 169, Part I, at 540 (1984); see also, Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 598 (1984). Rather, under the 1984 Act, the amount of the life reserves for which increases and decreases are recognized for tax purposes is prescribed regardless of the method employed by the insurance company in its computation statutory reserves for purposes of the NAIC annual statement. According to the legislative committee reports, the prescribed rules for computing life insurance reserves were intended to allow insurance companies to recognize at least the minimum reserve that most states would require to be set aside for the contract, but no more unless the net surrender value for the contract was a greater amount. H. Rep. No. 432, at 1414 (1984); S. Prt. No. 169, at 540 (1984).

The rules for determining the amount of life insurance reserves under § 807(d)(1) require the insurance company to make a comparison between the net surrender value of the contract, the federally prescribed reserve for the contract, and the statutory reserves for the contract (with an adjustment reserves attributable to deferred and uncollected premiums). One effect of this comparison is that the net surrender value of the contract effectively functions as a "floor" on the amount of the insurance company's life insurance reserve deduction. Conversely, the amount of the annual statement reserves for a contract effectively serves as a "ceiling" on the amount of the insurance company's permitted reserve deduction.

When risks are ceded on a YRT basis, the primary insurer purchases reinsurance on its net amount of risk on a particular policy or group of policies during the following policy year (hence the name "yearly renewable term"). This plan of reinsurance covers only the mortality or morbidity risk associated with the reinsured policy. That is, the ceding company retains its liability to policyholders in respect of their cash surrender values, and thus continues to bear any lapse risk or investment risk associated with those cash values. In this respect, the YRT plan of reinsurance is different from a proportional reinsurance arrangement, or coinsurance of life insurance policies. Under a coinsurance treaty, the reinsurance coverage is provided in the same form as that of the direct policy issued to the policyholder. Thus, 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 view of the nature of the reinsured risks covered by a YRT treaty, we believe the proper way to take ceded reinsurance into account in determining Taxpayer's life insurance reserves under § 807(d)(1) is to reduce the amounts taken into account as the federally prescribed reserves and the statutory reserves to the extent the mortality risks have been ceded to the reinsurers; however, no reduction should apply with respect to the determination of the net surrender values because, as noted above, the YRT treaty does not reduce the ceding company's liability to policyholders for payment of their cash surrender values in the event of lapse or surrender. Accordingly, if a contract's net surrender value is greater than the federally prescribed reserve amount (reduced by the value of the mortality risks ceded to the reinsurer), Taxpayer is allowed under § 807(d)(1) to take into account the net surrender value as the life insurance reserves for the contract (subject to the rule in § 807(d)(1) that this reserve may not exceed the corresponding statutory reserve for the contract reduced by any reserves attributable to deferred and uncollected premiums).

We have also considered whether Taxpayer's new method of taking ceded reinsurance into account might be challenged as a "double deduction" under the prohibitions set forth in § 811(c)(2) or (c)(3). Your concern is that Taxpayer has taken the amounts paid or incurred under the YRT treaties into account as a reduction of its premiums under § 803(a)(1), without sustaining a corresponding reduction in the amount of its life insurance reserves under § 807(d)(1) for the reinsured contracts. You have asked our advice whether the "no double counting" provisions of § 811(c)(2) or (3) may be applied to limit Taxpayer's life insurance reserve deductions in this situation.

We have examined the "no double counting" provisions of § 811(c)(2) and (c)(3) in light of your concerns, but have concluded that these provisions do not apply in the current situation. These rules are intended to prevent a situation (such as a manipulation of the definition of the reserve items in § 807(c)) that would allow the taxpayer to obtain a double deduction with respect to the same risks. Under these particular facts, we do not believe that Taxpayer's reduction of its premiums under § 803(a)(1) by the amounts paid or incurred under its YRT treaties, together with the deduction of life insurance reserves under § 807(d)(1) based on the net surrender values of the reinsured contracts, represents a double deduction of the same risks. The nature of the YRT reinsurance plan is that the ceding company has shifted its mortality risk during the following policy year, but retains any lapse

risk or investment risk associated with the cash surrender values of the contracts. Accordingly, Taxpayer retains the full liability to policyholders for payment of their net surrender values in the event of lapse or surrender of the reinsured contract. Similarly, if the insured were to die during the policy year for which the YRT reinsurance treaty was in effect, Taxpayer would be required to fund that portion of the death benefit attributable to the existing policy reserve. Thus, the amounts that Taxpayer takes into account as the life insurance reserves for the contracts under § 807(d)(1) do not reflect the same risks as those ceded to the reinsurers under the YRT treaties. Stated differently, Taxpayer's life insurance reserves under § 807(d)(1) reflect its potential liability to policyholders with respect to death benefits and cash surrender benefits, whereas Taxpayer's payments to the YRT reinsurers represent the amounts that must be paid as consideration for other insurance companies assuming the mortality risk during the following policy year.

Finally, we agree with Taxpayer's treatment of its change in method of applying credits for ceded reinsurance as a change in basis subject to the 10-year ratable adjustment rule of § 807(f). Rev. Rul. 94-74, 1994-2 C.B. 157, provides generally that any change in manner of computing a life insurance reserve under § 807(d) is subject to the change in basis rules of § 807(f). Thus, for example, Rev. Rul. 94-74 indicates that a change in method of determining the life insurance reserves for a contract to correct for an erroneous application of the prescribed computational rules of § 807(d)(2) is subject to the 10-year ratable adjustment rule of § 807(f). In accordance with the rule set forth in § 1.806-4(a) of the regulations as regards the statutory predecessor of § 807(f), there is no requirement under § 446(e) to obtain the Commissioner's advance consent to make the change. The only adjustments to an insurance company's reserve computations that Rev. Rul. 94-74 excludes from the change in basis rules are those required to correct mathematical or posting errors in prior year reserve computations.

The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 ("Blue Book"), prepared by the Staff of the Joint Committee on Taxation, contains the following statement, which is not included in the legislative committee reports underlying the 1984 Act's revisions to the life insurance reserve computational rules: "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 is not a reserve but a current liability." Staff of Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 604. Taken in isolation, this statement from the Blue Book might imply that Taxpayer's revised computation of the net surrender values of those contracts for which risks had been ceded on a YRT basis might have been treated as the correction of a mathematical error, rather than a change in basis under § 807(f). Prior to Year 1, however, Taxpayer had established a consistent computational method of applying

credits for ceded reinsurance for purposes of determining the amount of its life insurance reserves under § 807(d). Moreover, the change did not involve simply the correction of a mathematical or posting error, but rather represented a refinement of the measure of Taxpayer's portion of the insured risks when determining the value of each of the reserve-type items referred to in § 807(d)(1). Accordingly, we believe that Taxpayer correctly treated the change in method of applying credits for ceded reinsurance when making the net surrender value/federally prescribed reserve comparison under § 807(d)(1) as a change in basis subject to the 10-year ratable adjustment rule of § 807(f).