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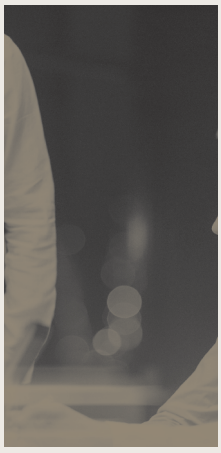

DOES THE TAX LAW REQUIRE THAT STATUTORY RESERVES BE BACKED BY ASSETS?

By Brion D. Graber

On Aug. 29, 2014, the Internal Revenue Service (IRS) released Private Letter Ruling 201435011 (May 16, 2014), which addresses the computation of "losses incurred" under Section 832(b)(5) and the statutory cap on discounted unpaid losses under Section 846(a)(3).[1] Although the letter ruling involves a nonlife insurance company in rehabilitation, life insurers may find it useful in determining the statutory reserve cap under Section 807(d). In particular, the letter ruling supports the position that the computation of an insurer's statutory reserve cap does not depend on the nature or quality of assets, or even whether there are assets, supporting reserves accepted by a life insurer's regulator on the annual statement.

Stated Facts

The taxpayer in the letter ruling wrote insurance policies with respect to a particular business and ultimately incurred significant losses on certain of those policies. After those losses were incurred, the taxpayer voluntarily stopped writing new policies. The taxpayer's regulator then issued an order suspending further payment on any policy claims and prohibiting the taxpayer from writing any new policies.

The taxpayer's parent commenced a bankruptcy proceeding. The bankruptcy court ordered the appointment of a rehabilitator for the taxpayer and began a court-supervised rehabilitation proceeding. A rehabilitation plan was ultimately approved that provided that when a policyholder makes a valid claim under a policy, the claim will be divided into a portion that will be paid currently and a portion that may be paid in the future. More specifically, the taxpayer will pay promptly a portion of the claim in cash based on the cash payment percentage in effect at the time; the remaining portion of the claim will be deferred, and may become payable in the future depending on the taxpayer's financial performance and condition. In accordance with the rehabilitation plan and the regulator's guidelines under that plan, the taxpayer will adjust its statutory accounting treatment of the restructured policies to establish and maintain a "minimum surplus amount" that will be reflected on its annual statement. The letter ruling does not describe the reason for the maintenance of this amount, but presumably the taxpayer lacked sufficient assets to cover all of its losses and the regulator wanted to ensure it maintained a certain level of surplus. In any case, the reporting of the minimum surplus amount ultimately decreases the amount of undiscounted unpaid losses reported on the taxpayer's annual statement.

Relevant Law

Taxable income for nonlife insurance companies includes "the combined gross amount earned during the taxable year, from investment income and from underwriting income … computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners."[2] Underwriting income equals the premiums earned on insurance contracts during the taxable year less losses and expenses incurred.[3] Losses incurred include the increase or decrease during the year in discounted unpaid losses (as defined in Section 846),[4] which are determined by discounting the unpaid losses shown on the insurer's annual statement.[5] In no event, however, may the amount of discounted unpaid losses exceed the amount of unpaid losses included on the annual statement (i.e., the statutory cap on discounted unpaid losses).[6]

IRS Conclusions

In Private Letter Ruling 201435011, the IRS ruled without much discussion that the taxpayer can take into account in computing "losses incurred" under Section 832(b)(5), both the portion of the claim the taxpayer will pay promptly in cash and the deferred portion of the claim that is not currently payable, but may become payable in the future.[7] Citing Treas. Reg. § 1.832-4, the IRS stated that (1) the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them, and (2) the losses must

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be stated in amounts that represent a fair and reasonable estimate, based on the facts and the taxpayer's experience, of the amount the taxpayer will owe to the policyholder.

Also with little discussion, the IRS ruled that the statutory cap on the taxpayer's discounted unpaid losses under Section 846(a)(3) shall be determined without any adjustment related to unpaid losses as a result of the guidelines the taxpayer's regulator issued under the rehabilitation plan. Those guidelines required the taxpayer to establish and maintain a minimum surplus amount, which ultimately decreases the amount of undiscounted unpaid losses reported on the annual statement.

Relevance for Life Insurers

Our law firm has sometimes been asked whether the statutory reserve cap under Section 807(d) is determined without regard to the nature of the assets the taxpayer holds, or even whether the taxpayer holds assets, to support its reserves as reported on the annual statement. Although Private Letter Ruling 201435011 involves a nonlife insurer under a rehabilitation plan, not a life insurer, it nevertheless appears to offer support for that position.

The Section 846 statutory cap is generally modeled on the Section 807(d) statutory cap. Section 846(a)(3) provides that "[i]n no event shall the amount of discounted unpaid losses with respect to any line of business attributable to any accident year exceed the aggregate amount of unpaid losses with respect to such line of business for such accident year included on the annual statement filed by the taxpayer for the year ending with or within the taxable year." Section 807(d)(1) similarly provides that "[i]n no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves." Section 807(d)(6) provides that, for this purpose, statutory reserves "means the aggregate amount set forth in the annual statement with respect to items described in section 807(c)."

In Private Letter Ruling 201435011, the IRS concluded that the taxpayer should compute its losses incurred and the statutory cap on discounted unpaid losses without regard to the adjustment for the minimum surplus amount the taxpayer was required to report on its annual statement, even though reporting of that amount decreases the amount of undiscounted unpaid losses reported on the annual statement. If it is appropriate to ignore the minimum surplus amount in that context, it follows that the existence, nature, or quality of assets supporting a life insurer's reserves should not be a factor in the determination of the insurer's Section 807(d) statutory reserve cap. ◂

END NOTES

1 Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended.

2 Section 832(a), (b)(1)(A).

3 Section 832(b)(3).

4 Section 832(b)(5).

5 Section 846(a), (b)(1).

6 Section 846(a)(3). This cap could come into play, for example, when reserves that are already discounted on the annual statement are grossed up before being discounted for tax purposes. See Section 846(b)(2).

7 In an earlier letter ruling involving a different taxpayer with similarly restructured policies, the IRS reached the same conclusion, and included the same discussion, regarding the computation of "losses incurred" under Section 832(b)(5). PLR 201429007 (March 12, 2014).

TO CLONE OR NOT TO CLONE: THE IRS ANSWERS AN INVESTOR CONTROL QUESTION

By John T. Adney and Bryan W. Keene

Since the late 1970s, the Internal Revenue Service (IRS) has repeatedly said that excessive control over the separate account investments underlying a variable annuity or life insurance contract by the owner of that contract will forfeit the customary income tax treatment of the contract's owner. Instead of benefitting from non-taxation of the contract's cash value buildup—the "inside buildup"—prior to any distributions from the contract, the owner will be taxed on the earnings of the investments underlying the contract where that owner is found to possess "investor control" over those investments.[1] Congress waded into this fray in 1984, providing the IRS with a statutory tool—specifically, IRC section 817(h)—to enforce its 1981 ruling that a variable contract based on a single mutual fund available for purchase by the public apart from the contract was a prima facie case of investor control.[2]

While the "doctrine" of investor control is thus embedded in the tax landscape for variable contracts, there is less clarity on exactly what constitutes impermissible control by a contract owner. The IRS has said that an owner may allocate and reallocate cash values among a limited number of investment options available under a contract without invoking the doctrine and its unfortunate consequences, provided that none of those options represent funds available for public purchase. Not