

IRS Issues Guidance on the Separate Account Dividends Received Deduction

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The Insurance Branch in IRS Chief Counsel's National Office recently issued a Chief Counsel Advice (CCA) memorandum regarding the Dividends Received Deduction (DRD) in the separate account partnership fund context.¹ The CCA provides guidance on a partnership structure that some life insurance companies have adopted for separate accounts in lieu of the more typical Registered Investment Company (RIC) structure. Under the partnership structure, some of the funds in which the separate accounts are invested are taxed as partnerships (instead of RICs) and the life insurance company is a partner.² A few Large Business & International division (LB&I) examiners have raised issues regarding the mechanical application of the company's share/proration calculation as it applies to the partnership structure.

By way of background, the term "proration" generally refers to an allocation of a company's net investment income between the "company's share" and the "policyholders' share." It is based on a fraction that is applied to determine how much of the company's net investment income is credited to policyholders, and how much is not. In this context, the result is applied to the separate account DRD to disallow a portion (representing the policyholders' share) in order to prevent the company from obtaining a double benefit by funding reserve deductions with dividends that have been deducted.

The LB&I examiners, in general, have asserted that in calculating this fraction to be applied to the separate account DRD, the pass-through partnership taxation rules should be disregarded and the proration formula should be calculated as if the partnerships were RIC-like entities. The National Office provided the CCA to an LB&I team in response to a request for advice on three related issues the team raised in an audit of a life insurance company.

In particular, the National Office concluded that the taxpayer under audit by the LB&I team

1. properly determined its gross investment income under section 812(d) without reduction for the investment expenses of the partnership in which the taxpayer invested;



2. properly included in "amount retained" under Treas. Reg. § 1.801-8 the partnership investment fees it paid to an affiliate; and
3. was not precluded from deducting those fees by the section 811(c)(3) prohibition on double deductions.

SEPARATE ACCOUNT DRD BACKGROUND

Some general background might help readers who are not familiar with the separate account DRD understand the CCA's conclusions. Internal Revenue Code section 805(a)(4)(A)³ allows a life insurance company a DRD under sections 243 and 245, but the company must reduce the tax benefit from the deduction under the proration formula (which also applies to tax-exempt interest). In general, the reduction is intended to prevent the company from receiving a double benefit by deducting a portion of the dividends received and also receiving a deduction for reserve increases funded by the dividends.⁴ The reduction is accomplished by allocating, or prorating, net investment income between certain deductible amounts, which generally consist of investment earnings deemed to be credited to policy or contract obligations (the policyholder's share) and amounts not credited (the company's share).

Section 805(a)(4)(A)(ii) permits the DRD only for the "company's share" of the dividends received (other than "100 percent dividends" described in section 805(a)(4)(C)). The company's share is intended to represent the portion of the company's net

investment income on assets that is not considered to be credited to policyholders. The company's share is determined under the proration rules of section 812, and is defined in that section as (1) the taxpayer's net investment income reduced by "policy interest," *i.e.*, interest credited to reserves and similar items, divided by (2) the taxpayer's total net investment income—the result is expressed as a percentage. For the sake of administrative convenience, net investment income is defined for this purpose as a set percentage of gross investment income—90 percent in the case of a company's general account and 95 percent in the case of a separate account.

The determination of the company's share in the separate account context, where each separate account must compute its own company's share,⁵ is significantly more complicated than in the general account context and draws on prior law concepts. As indicated above, "policy interest" for purposes of the proration formula in general is intended to represent the amount of net investment income credited to reserves. Stated differently, policy interest is intended to represent the amount the insurance company has deducted as the interest element in an increase in reserves and it is the share of net investment income allocable to this amount that is intended to be eliminated from the DRD. In the proration formula, the amount credited to reserves is equal to "required interest" plus other items not relevant here.⁶ "Required interest" on reserves for this purpose is determined at the greater of the prevailing state assumed rate (PSAR) or the applicable Federal interest rate (AFR), as required under the reserve deduction rule in section 807(c), or at "another appropriate rate" in a case in which neither the PSAR nor the AFR is used for reserve purposes.⁷ In the case of separate accounts supporting variable products, amounts credited to reserves generally are based on the market value and investment returns of the separate account assets rather than a prescribed interest rate (*i.e.*, rather than the PSAR or AFR). Therefore, in the case of separate accounts, "another appropriate rate" under section 812(b)(2) must be used in order to determine the amount of policyholder interest for proration purposes.

Section 812(b)(2), however, does not define "another appropriate rate" to be used for proration purposes; nor does section 812 provide the specific formula for computing the company's share for separate accounts. This leads to the legislative history underlying section 812 and the other Subchapter L provisions that apply to life insurance companies in the Deficit Reduction Act of 1984 (the 1984 Act).⁸ According to the legislative history of the 1984 Act, the current law provisions generally follow the proration rules for computing gain or loss from operations under prior law, which was the Life Insurance Company Income Tax Act of 1959 (the 1959 Act), and accompanying regulations.⁹ The proration regulations that applied to separate accounts under the 1959 Act are at Treas. Reg. § 1.801-8. These regulations relate to former section 801(g), the predecessor of the separate account rules under section 817 today. Under the regulations,

the company's share in the case of dividends received by a separate account is computed under a formula that is significantly affected by the "amount retained" as defined under Treas. Reg. § 1.801-8(e)(1). In general, the "amount retained" is intended to reflect the amount of net investment income that is not credited to variable contracts, and, therefore, is the key component of the company's share of net investment income.

Thus, in accordance with the 1984 legislative history, the required interest in the separate account case is determined under the prior law rules, including use of a slightly modified version of the formula in Treas. Reg. § 1.801-8(e)(1). Under the formula, the required interest on the separate account reserves is based on the current earnings rates for the separate account (determined under former section 805(b)(2)) reduced by a percentage obtained by dividing (1) "the amount retained by the taxpayer from gross investment income" on the separate account assets in excess of the related investment expense deductions (as defined in former section 804(c)) by (2) the mean of the separate account reserves. In very general terms, the formula effectively

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eliminates all net investment income that is deemed to be credited to reserves and allocates what is left over to the company's share. The effect of increasing the "amount retained" by including partnership investment expenses is to increase the proportionate amount of separate account investment income that is considered not credited to contracts and thereby increase the company's share percentage, allowing a larger portion of dividends received to be deducted.¹⁰

One simple reason the partnership structure mathematically can result in a larger company's share, and hence, a larger DRD than a typical RIC structure is that RICs are taxed as separate entities and make their distributions net of the type of investment expenses that are passed through in the partnership structure. Similar investment expenses in a typical RIC structure, therefore, do not end up being included in the "amount retained." The LB&I team that requested advice apparently took the position that partnership expenses paid to an affiliate in the partnership structure must not be included in the "amount retained," similar to what would happen in a RIC structure, because the company does not "retain" the amounts in its general account.

FACTS DESCRIBED IN CCA 201603023

As is common with CCAs, CCA 201603023 sets out the operative facts in short form. According to the CCA, the taxpayer/life insurance company issues variable annuity contracts under which certain charges are assessed, such as mortality and expense (M&E) charges. Such charges are paid to the company by a transfer of funds from the separate accounts supporting the contracts to the company's general account, and the transferred amount is reported as income in the general account. The separate accounts, each of which is organized as a unit investment trust and registered as such under the Investment Company Act of 1940, invest in various funds, some of which are organized as partnerships and are assumed in the CCA to be taxed as partnerships. The CCA states that "[w]ith respect to these funds, Taxpayer pays investment expenses to its nonlife affiliate." The nonlife affiliate presumably functions as an investment adviser for the investment partnerships in return for the fees the company pays to it, although the CCA does not say so.

ANALYSIS AND CONCLUSIONS IN THE CCA

The CCA then addresses three specific issues on which it says the LB&I team requested assistance from the National Office. Before exploring the details, the CCA, like predecessor rulings (both published and private (i.e., non-precedential)) relating to the proration rules, acknowledged that the proration "between life insurance company's share and the policyholder's share of net investment income, as provided in § 812, is intended to eliminate the double tax benefit that would arise if the company were allowed to fund deductible reserve increases with tax exempt or tax preferred income."

Issue 1. The first issue dealt with in the CCA involved whether the section 812 proration calculation required the life insurance company to compute the gross investment income of its separate accounts invested in partnership funds net of investment expenses. While not spelled out in the CCA, the investment expenses in question appear to be those of the investment partnerships that were paid to the company's nonlife affiliate.

According to the CCA, the company determined its gross investment income from the separate account's partnership investments under section 812(d) without reducing the amounts by the related investment expenses. On audit the LB&I team apparently contended that the partnership structure should be disregarded and that such gross investment income should be determined net of the investment expenses as it would be in the more typical RIC structure. In a RIC structure the gross investment income determined under subchapter M would consist of the RIC ordinary dividends, net of expenses. The CCA does not detail the LB&I rationale for disregarding the partnership structure but instead points to the general partnership taxation rules under Subchapter K. The CCA notes that "[p]artnerships distribute

The partnership investment fees, regardless of whether they are paid to an affiliate or third party, are not credited to the reserves.

gross investment income to their partners and the partners receive their distributive share of the corporate dividends and a flow-through of their share of partnership investment expenses," citing to section 702(a)(5). Accordingly, the CCA concludes that a "partner that is a life insurance company includes its distributive share of the partnership gross investment income in its gross investment income under § 812(d)," unreduced by investment expenses. The CCA's conclusion, in other words, is that "gross" means "gross," based on the plain language of section 812(d) working in combination with the partnership tax rules.

It is important to understand that the first ruling, standing alone, may not have resulted in a different company's share of the DRD if the expenses were not in turn also included in the "amount retained," which is the subject of issue number two discussed immediately below. The important aspect of the first ruling is that the National Office recognized and respected the flow-through nature of the partnership structure which, ultimately, can result in a higher company's share by inclusion of the partnership expenses in the "amount retained"—i.e., the amount of net investment income that is not credited to the variable contracts.

Issue 2. The CCA next turned to whether including the partnership investment fees in the "amount retained" from interest credited to policyholders was consistent with Treas. Reg. § 1.801-8(e), which the LB&I team contended was not the case. The life insurance company had included these fees, which were paid to its nonlife affiliate, in calculating the amount retained within the meaning of the regulation for purposes of calculating the required interest element of the numerator of the company's share fraction. The CCA concluded that the company was correct in doing so, reasoning that LB&I was incorrect in its effort to exclude from the amount retained calculation the fees paid to the affiliate. (LB&I was willing, according to the CCA, to accept the inclusion of the M&E charges and like amounts transferred from the separate account to the general account in determining the amount retained, but balked at doing so to the extent amounts were paid to the nonlife affiliate.)

The LB&I team apparently contended that amounts paid to an affiliate could not be amounts "retained" by the insurance com-

pany because the amounts did not end up in the general account. This assertion represents a misunderstanding of the purpose underlying the “amount retained” that the CCA helps to clarify although it does not directly explain. As explained above, the objective of the required interest calculation of which the “amount retained” is a part is to determine the amount of the deduction for separate account reserves reflecting amounts credited to policyholders. The partnership investment fees, regardless of whether they are paid to an affiliate or third party, are not credited to the reserves. Stated differently, the “amount retained” is not limited to amounts transferred to the insurance company’s general account, but includes any amount of gross investment income that is not credited to the reserves. Otherwise, under the regulation’s formula, the partnership expenses effectively would be treated as credited to policyholders—clearly not establishing “another appropriate rate” for computing required interest or the policyholder’s share of DRD to be disallowed. Viewed differently, the partnership structure yields a result that is equivalent to the separate account directly owning the underlying assets. The formula recognizes that the fees associated with owning the assets do not belong in the policyholders’ share.

The conclusion that expenses such as investment fees must be included in the “amount retained” becomes even clearer when examining the history of the 1959 Act. The initial 1959 Act provisions with respect to variable annuities were temporary in nature. As first enacted, prior-law section 801(g)(3) contained a special rule for computing required interest under prior-law section 809(a)(2) for reserves based on segregated accounts. The original language provided that the assumed rate of interest for variable annuities was the company’s current earnings rate for variable contracts (determined under prior-law section 805(b)(2)) reduced by a percentage obtained by dividing the amount of the “actuarial margin charge” for all variable annuities by the mean of the reserves. Legislative history defined actuarial margin charges as “general operating charges and other amounts retained by the issuing company pursuant to the terms of the contract to cover actuarial contingencies and to increase surplus.”¹¹ In 1962, the 1959 Act provisions with respect to variable annuities were amended and made permanent.¹² The assumed interest provision mentioned in prior-law section 801(g)(3) was replaced by prior-law section 801(g)(5), and the term “actuarial margin charge” was replaced by the broader concept of “any amount retained ... from gross investment income ...,” to include any investment expenses charged to the separate account in addition to an actuarial margin charge. The regulations were promulgated after the 1962 amendment and picked up this broader “any amount retained” concept.

In rejecting LB&I’s objection, the CCA did not discuss much of the history of the “amount retained,” but focused on the post-1962-amendment regulations that incorporate the broader concept. The CCA observed that the wording of Treas. Reg. § 1.801-8(e) as well as examples appearing in that regulation (which the

CCA summarized in simplified form) showed that inclusion of the investment fees paid to the affiliate in the amount retained was consistent with the regulation. Also, apparently adding support for this conclusion, the CCA’s footnote 16 observed that “[h]istorically, amount retained was the amount the life insurance company held from the gross investment income on all segregated asset accounts to cover general expenses in excess of the expenses provided for in the charges made against premiums to cover actuarial contingencies and increase surplus,” citing to the Senate report on the 1959 Act. The conclusion reached in the CCA is consistent with TAM 200339049, in which the National Office agreed that including a variety of variable contract charges (M&E charges, annual contract maintenance fees, administrative fees, and premium tax charges) in the amount retained was appropriate.

It warrants mention that both LB&I, in stating its objection to the company’s approach, and the National Office in CCA 201603023 accepted the role played by Treas. Reg. § 1.801-8(e) in determining the required interest element of the proration calculation. The use of the modified formula in that regulation, however, has been the subject of considerable controversy in IRS audits of life insurance companies and in published rulings and non-precedential advice issued by the National Office dating at least as far back as TAM 200038008. In 2007, the IRS caused a huge stir in the industry when it issued Rev. Rul. 2007-54, 2007-2 C.B. 604, backing off the holding in TAM 200038008 by concluding in holding number two that life insurance companies must use the applicable federal interest rate rather than “another appropriate rate” in calculating separate account reserves. This holding had a dramatically negative effect on the separate account DRD and surprised the industry. The IRS then issued Rev. Rul. 2007-61, 2007-2 I.R.B. 799, which suspended Rev. Rul. 2007-54 for further study of the issue. After some intense audit controversy over the next three years, LB&I relented in the form of an Industry Directive instructing examiners not to challenge taxpayers who calculated required interest consistently with the TAM.¹³ Then, in 2014, the National Office republished Rev. Rul. 2007-54 in the form of Rev. Rul. 2014-7, 2014-9 I.R.B. 539 (Feb. 4, 2014), in which it officially eliminated holding number two regarding required interest.¹⁴ In footnote 15, the CCA states that it does not express an opinion about the “another appropriate rate” issue, but its analysis and conclusions effectively reject the holding in Rev. Rul. 2007-54.

Issue 3. The rules of part I of Subchapter L (the life insurance company tax provisions) are complex, even apart from the section 812 proration rules described in the first two rulings of the CCA. Reflecting this is the presence of a series of “no double counting” rules in section 811(c). In particular, section 811(c)(3) states that nothing in part I of Subchapter L may be construed to permit “any item to be deducted (either directly or as an increase in reserves) more than once.” LB&I teams have asserted that a

life insurance company taxpayer, by deducting its distributable share of partnership expenses while at the same time including those expenses in the retained amount in the proration formula, is taking a double deduction in violation of section 811(c). The LB&I team that asked for advice made the same assertion.

The CCA rejected the LB&I team’s assertion that the double counting rule applied in the partnership fund context. The CCA explained that while section 811(c)(3) disallows a double deduction for the same item, the dividend for which the company received a DRD is an income item whereas the investment expenses it deducted constitute a general deduction under section 805(a)(8)—hence the two are not the same item. The CCA also noted that LB&I’s contention was inconsistent with proration, since once a life insurance company determined the company’s share of the DRD, “it can use the resulting dividend income to pay deductible expenses or fund its reserves just as it could with any other income.”

CONCLUDING OBSERVATIONS

The conclusions reached in CCA 201603023 constituted a victory of some significance for the taxpayer involved. While these conclusions do not constitute precedent on which other taxpayers can rely, the CCA set out the National Office’s reasons for rejecting the LB&I contentions in a clear and straightforward, albeit succinct, manner. The explanations thus provided for the conclusions should benefit other life insurance companies in comparable situations.

As explained above, the conclusion the CCA reached on issue 1 (inclusion of the gross partnership income in the section 812(d) gross investment income unreduced by the partnership investment expenses) is an important ruling because it respects the flow-through nature of partnership expenses for purposes of the separate account DRD calculation.

The conclusion the CCA reached on issue 2 (inclusion of the partnership investment fees in the amount retained) is the key holding in the CCA for the taxpayer involved, and it makes perfect sense in the context of proration and the supporting background in the 1959 Act and its regulations. The partnership fees were in fact not credited to the policyholders under the variable contracts. Even though they were paid to an affiliate of the company, they clearly did not belong to the policyholders or their share of the earnings. The CCA’s conclusion also was consistent with the view previously taken by the National Office in TAM 200339049, as noted above. As to the conclusion on issue 3 (involving the section 811(c)(3) ban on double deductions), the reasoning of the CCA speaks for itself. Had the theory of LB&I prevailed, the very purpose of the dividends received deduction—mitigation of double taxation of corporate earnings—would have been thwarted. ■

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ENDNOTES

- ¹ CCA 201603023 (July 17, 2015) (Released to the public on Jan. 15, 2016).
- ² A typical partnership fund structure is described in PLR 201527039 (March 19, 2015). Under the structure described in the PLR, a business trust was formed under state law that consisted of a series of segregated portfolios of assets, which were taxed as partnerships. The trust issued shares of each portfolio to support separate accounts and were available only to life insurance companies, either directly or through separate accounts.
- ³ References to “section” refer to the Internal Revenue Code of 1986 unless otherwise indicated.
- ⁴ See generally TAM 9246001 (Oct. 30, 1991), discussing legislative history.
- ⁵ See section 805(a)(4)(D)(iii), (iv) and section 817(c).
- ⁶ See section 812(b)(2). The other items are the deductible portion of excess interest and the deductible amounts credited to policyholder funds under pension plans other than for retired employees, deferred annuities before the deferred annuity starting date, and amounts left on deposit.
- ⁷ See section 812(b)(2)(A), cross-referencing section 807(c), and the flush language at the end of section 812(b)(2).
- ⁸ See TAM 200038008 (June 13, 2000) (discussing legislative history); TAM 200339049 (Aug. 20, 2002) (discussing legislative history).
- ⁹ See H.R. Rep. No. 98-432, pt. 2, at 1430 (1984); S. Prt. No. 98-169, vol. I, at 557 (1984). See also Staff of Jt. Comm. on Tax’n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 623 (1984).
- ¹⁰ The leading tax-actuarial treatise expresses the modified formula for determining the company share in simplified form as follows:

$$\text{Company's Share} = \left[1 - \frac{\text{Mean of Reserves}}{\text{Mean of Assets}} \right] + \left[\frac{\text{Amount Retained}}{\text{Net Investment Income}} \right]$$

Where Net Investment Income is equal to 95% of Gross Investment Income

Edward Robbins and Richard Bush, *Tax Basis of Assets and Liabilities of U.S. Life Insurers*, 215 (ACTEX Publications 2014); see also *id.* at 211, Table 8.1, for a more detailed representation of the formula. The reader can see graphically that this formula effectively allocates amounts not deemed to be credited to reserves to the company’s share.

- ¹¹ S. Rep. No. 86-291, at 43 (1959).
- ¹² Pub. L. No. 87-858, § 3(a) (Oct. 23, 1962).
- ¹³ *Examination of Dividends Received Deduction on Separate Accounts of Life Insurance Companies*, LMSB-4-0510-015 (May 20, 2010).
- ¹⁴ See Susan J. Hotine, “Do We Finally Have Guidance on Separate Account DRD?” *TAXING TIMES*, Vol. 10, Issue 2, at 28 (May 2014).