INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

February 13, 2003

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CASE MIS No.: TAM-156259-02/CC:FIP:B04

Appeals - Large & Mid-Size Business Operating Unit
Attn: Appeals Team Manager
LBSP, Area 4, Team 2

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Parent =

State A =

State B =

Date 1 =

Date 2 =

Date 3 =

Agreement-1 =

Agreement-2 =

X =

Y =

Rate Z =

Amount 1 =

Amount 2 =

ISSUE:

Whether, under the facts described, the accumulated funds held by Taxpayer for certain funding agreements ("Funding Agreements", "Agreements") constitute amounts necessary to satisfy obligations arising under insurance or annuity contracts not involving life contingencies, as described in § 807(c)(3) of the Internal Revenue Code, or a reserve item described in § 807(c)(4).

CONCLUSION:

Taxpayer's Funding Agreements do not constitute insurance or annuity contracts for tax purposes. Accordingly, the accumulated funds held by Taxpayer with respect to the Agreements do not constitute a reserve item under § 807(c)(3), or any other reserve item under § 807(c). Rather, Taxpayer should account for its obligation to credit guaranteed interest under the Funding Agreements through the deduction allowed by §§ 805(a)(8) and 163 for interest paid or accrued within the taxable year on indebtedness.

FACTS:

Taxpayer is a life and health insurance company domiciled in State A which is taxable as a life insurance company under § 816(a). During the taxable years involved, Taxpayer was a wholly-owned subsidiary of Parent, and joined with Parent and other life insurance and non-insurance members of Parent's affiliated group in filing a life/nonlife consolidated return pursuant to § 1504(c)(2)(A) and § 1.1502-47 of the Income Tax Regulations.

As an outgrowth of its pension fund business, Taxpayer also markets funding agreements to

institutional investors such as asset managers, state and local government entities, banks, and other institutional entities. Like its GIC products, Taxpayer's Funding Agreements provide for an accumulation of the initial consideration at a guaranteed rate of interest for a specified period of time. If held to maturity, the Funding Agreements guarantee the return of the initial consideration plus credited interest to the contract holder. The term "Funding Agreement" is used to differentiate these investment products from GICs, which are sold to qualified pension and employee benefit plans and contain benefit-sensitive withdrawal provisions (such as the option to use the accumulated funds to purchase retirement annuities). The terms of Taxpayer's Funding Agreements were individually negotiated, and the rate of interest could be either a fixed or floating rate.

The general provisions of Taxpayer's Funding Agreements may be illustrated by two contracts from the years under examination, copies of which were submitted with the technical advice request. Both of the Agreements were large dollar contracts that were individually negotiated; however, the general terms of these Agreements were representative of Taxpayer's Funding Agreements during the taxable years involved.

Agreement-1 was issued on Date 1 to X, a governmental agency of State B. Under Agreement-1, X was to remit a fixed consideration, Amount 1, which Taxpayer would credit to a Funding Account for X. Agreement-1 specifically provided that at the end of any day, the Funding Account Balance was equal to X's initial consideration plus credited interest, less amounts withdrawn from the Funding Account. Agreement-1 also specified that Taxpayer was to credit interest to the Funding Account at a fixed rate of Rate Z. Interest accrued on a daily basis and was withdrawn and remitted to X on the first day of each month. Agreement-1 also specified a scheduled maturity date, approximately thirty-three months after issue, at which time Taxpayer was required to return the Fund Account Balance plus accrued interest to X. Finally, Agreement-1 contained a credit default provision, so that in the event that Taxpayer's credit rating was downgraded at any time prior to the scheduled maturity date, X could exercise a "put option" and obtain the full amount of the Fund Account Balance plus accrued interest prior to the scheduled maturity date. As X was not a natural person, Agreement-1 did not contain any provisions relating to mortality or morbidity. Moreover, in Agreement-1, Taxpayer did not offer to provide any annuity form of settlement (either for life or a fixed term) and Agreement-1 thus did not contain any annuity purchase guarantees.

Agreement-2 was issued to Y, an investment management company. Agreement-2 contained terms similar to Agreement-1, so that on Date 2, the Agreement's effective date, Y was required to remit an initial consideration, Amount 2, and Taxpayer was to credit this amount to a Funding Account for Y. Under Agreement-2, interest accrued on the Funding Account Balance at a variable rate equal to one month LIBOR plus 15 basis points for each month that the agreement was in effect. This interest rate was reset fifteen days after the contract effective date, and thereafter

as of the first Wednesday of each succeeding month. Credited interest was withdrawn from the Funding Account Balance and paid to Y on each reset date. Agreement-2 contained a scheduled maturity date of Date 3, at which point Taxpayer was to return the Funding Account Balance plus accrued interest to Y. However, under Agreement-2, either party could terminate the arrangement at any time upon seven days advance written notice. As Y was not a natural person, Agreement-2 also did not contain any provisions relating to mortality or morbidity. Moreover, in Agreement-2, Taxpayer did not offer to provide any annuity forms of settlement (either for life or a fixed term) and Agreement-2 thus did not contain any annuity purchase guarantees.

In many states, however, GICs (including funding agreements) are considered insurance contracts for purposes of regulating the issuers of these contracts. This classification may also be significant for purposes of determining the priority of claims of contract holders of funding agreements viz a viz the insurer's other policyholders in the event of an insolvency proceeding. For example, State A's insurance code defines a GIC as

In filing its annual statement for state regulatory reporting purposes, Taxpayer reported the initial consideration for the Funding Agreements in premiums in line 1A, "Annuity and Other Fund Deposits", and established a corresponding reserve item for "Deposit Funds and Other Liabilities without Life and Disability Contingencies" in Exhibit 10. The change in this reserve flowed through the Summary of Operations. Accordingly, instead of recording a separate expense for interest paid or accrued under the Funding Agreements, Taxpayer accounted for its obligations under these arrangements through an increase in the related reserves established for the contracts.

To calculate the statutory reserve for a Funding Agreement, Taxpayer used a methodology in which the contract holder's Funding Account Balance was first projected out to the stated maturity date using the interest rate guaranteed in the contract, and then discounted back using a prescribed state assumed valuation interest rate. This reserve method was substantially similar to the Commissioners Annuity Reserve Valuation Method, as applied to annuity contracts. Under Taxpayer's reserve method, the statutory reserve for a Funding Agreement that provided a future guaranteed interest rate (such as Agreement-1) could either exceed or be less than the contract holder's Fund Account Balance, depending on whether the guaranteed interest rate was higher or less than the applicable statutory reserve valuation rate. This discrepancy did not occur in Funding Agreements similar to Agreement-2 because those Agreements did not provide a future interest rate guarantee.

For federal income tax purposes, Taxpayer treated the reserves established with respect to its Funding Agreements as deductible § 807(c)(3) reserves, relating to obligations on life and annuity contracts that do not involve life, health, or accident contingencies. For tax purposes, however, Taxpayer adjusted the reserves for all of its Funding Agreements to be equal to the contract holder's Funding Account balance.

The examining agent determined that Taxpayer had overstated its Funding Agreement tax reserves in situations where the Fund Account Balance exceeded the corresponding reserve for the Funding Agreement as shown on Taxpayer's annual statement. The examining agent's position is that as a result of the statutory reserve "cap" under § 807(d)(1), Taxpayer's tax reserves for Funding Agreements cannot exceed the corresponding reserves shown on the annual statement. The statement filed by the appeals office supports the examining agent's position.

Taxpayer argues that the reserves in question are § 807(c)(3) reserves, and not life insurance reserves under § 807(c)(1), and, therefore, that the statutory reserve limitation in § 807(d)(1) does not apply. Alternatively, Taxpayer contends that the Fund Account Balances are equivalent to a net surrender value in the sense that the Fund Account Balance measures the amount of Taxpayer's accrued liability to the contract holder at a given period of time.

After reviewing Taxpayer's Funding Agreements, and considering the legal arguments made by Taxpayer and the appeals office, we have determined that the more basic question before us is whether Taxpayer's Funding Agreements constitute insurance or annuity contracts for which premium consideration and a corresponding reserve item should be recognized under the provisions of Part I of subchapter L.

LAW AND ANALYSIS:

The taxation of insurance and annuity contracts under Part I of subchapter L differs from the treatment of investment products offered by other financial intermediaries. Under § 803(a)(1), a life insurance company includes the gross amount of premiums and other consideration received with respect to an insurance or annuity as an item of the company's gross income. For this purpose, the gross amount of premiums and other consideration includes, under § 803(b), advance premiums, deposits, fees, assessments, consideration in respect of assuming liabilities under contracts not issued by the taxpayer, and the amount of policyholder dividends reimbursable to the taxpayer by a reinsurer in respect of reinsured policies.

To compensate for the inclusion of the full amount of consideration for insurance and annuity contracts in gross income, a life insurance company is allowed deductions for the increase in the related reserves held with respect to its obligations under such contracts. The computation of reserve deductions for tax purposes with respect to insurance and annuity contracts is governed by the rules of §§ 807 and 811. Section

807(a) provides that net decreases in § 807(c) reserves during the taxable year are included in gross income under § 803(a)(2), while § 807(b) provides that net increases in § 807(c) reserves during the taxable year are taken into account as a deduction under § 805(a)(2).

Under § 807(d)(1), the amount of the life insurance reserves (as defined by § 816(b)) for any contract that is taken into account for purposes of the deduction for net increases in reserves authorized by §§ 807(b) and 805(a)(2) is the greater of: (1) the net surrender value of the contract, or (2) the reserve determined under § 807(d)(2). In no event, however, may the reserve for the contract exceed the amount taken into account with respect to that contract as of that time in determining the statutory reserves. Section 807(d)(1) (flush language); see also, § 809(b)(4)(B). The term "life insurance reserves" is defined in § 816(b)(1) as those amounts that are (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance contracts involving, at the time with respect to which the reserve is computed, life, health, or accident contingencies. Section 816(b)(2) generally provides that, in order to qualify as such for tax purposes, life insurance reserves must be those required by law.

Section 807(c)(3) provides that, among the reserve and similar items taken into account under § 807(c), are amounts necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made) life, accident, or health contingencies.

Section 807(c)(4) provides that, among the reserve and similar items taken into account under § 807(c), are dividend accumulations, and other amounts held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

Section 805(a)(8) provides that subject to certain modifications described in § 805(b), a life insurance company is allowed all of the deductions otherwise provided under Subtitle A for purposes of computing taxable income. Under § 805(b)(1), however, in applying § 163 (relating to the deduction for interest), no deduction is allowed for interest in respect of a reserve or similar item described in § 807(c).

Whether an insurance company is taxed under § 801 as a life insurance company is determined using the statutory requirements of § 816(a). This section requires that a company's life insurance reserves (as defined in § 816(b)), plus unearned premiums and unpaid losses on noncancellable life, accident, and health insurance contracts not included in life insurance reserves be compared to its total

reserves (as defined in § 816(c)).[1] The comparison mandated by § 816(a) is referred to as the qualification fraction. An insurance company is a life insurance company if the sum of the life insurance reserves and unearned premiums and unpaid losses (whether or not ascertained) on noncancellable life, accident, or health policies not included in life insurance reserves comprise more than 50% of total reserves.

Section 816(f) provides that for purposes of the qualification fraction, amounts set aside and held at interest to satisfy obligations under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves under § 816(c)(1) or in all other insurance reserves required by law under § 816(c)(3). This section was added to the Code in the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984). The Senate Report concerning this section explains its effect as follows:

> ... [F]or purposes of determining whether an insurance company is a life insurance company, amounts set aside and held at interest to satisfy obligations under contracts under contracts which do not contain permanent guarantees with respect to life, accident, or health contingencies shall not be included in life insurance reserves or in total reserves. Thus, these amounts are not included in either the numerator or the denominator of the qualification fraction when determining whether a company's life insurance reserves and unearned premiums and unpaid losses on noncancellable accident and health insurance contracts comprise more than half its total reserves. This provision resolves for future years a question under present law as to how certain pension funds that do not contain permanent annuity purchase rate guarantees should be treated. The Internal Revenue Service has ruled that a reserve for a benefit is not a life insurance reserve unless a life benefit is permanently guaranteed under the contract (Rev. Rul. 77-286, 1977-2 C.B. 228). The provision of the bill substantially adopts this position and extends it to total reserves also, but only for purposes of the qualification fraction.

Senate Committee on Finance, 98th Cong., 2d Sess., Deficit Reduction Action of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, p. 527 (1984). [footnotes omitted]

The ruling referred to in the Senate Report, Rev. Rul. 77-286, involves a deposit administration contract issued by a life insurance company and held by an employer for its employees. The life insurance company receives the employer's contributions and accumulates these funds at interest. The contract contains annuity purchase rates

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[1] Section 816(c) defines "total reserves" as (1) life insurance reserves, (2) unearned premiums and unpaid losses (whether or not ascertained), not included in life insurance reserves, and (3) all other insurance reserves required by law.

guarantees but the guarantees are not permanent during the employees' active lives. Rev. Rul. 77-286 holds that since the deposit administration contracts do not provide permanent purchase rate guarantees, the subject pension funding contract does not constitute an annuity contract during its accumulation phase and, accordingly, the funds held for the contract do not qualify as life insurance reserves under former § 801(b).

Although § 816(f) does not address the treatment of contracts that lack permanent guarantees with respect to life, accident, and health contingencies for purposes other than qualification ratio, the Senate Report states:

> If these contracts have any insurance or annuity purchase guarantees (for life or a fixed term), then the premiums will be taken into income and the increase in the fund will be treated as increases in a reserve item under section 807(c)(3) or (4). If there are no guarantees whatsoever, then no income will be taken into account and no reserves will be treated as increased for purposes of the reserve deduction.
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> The fact that such funds are not treated as insurance reserves for purposes of the qualification fraction is not intended to have any effect on the characterization of the contracts or the company issuing the contracts. Rather, whether a contract with less than a permanent guarantee should be considered an insurance or annuity contract would depend on the terms of the contract. That is, it will depend on whether the company has assumed a significant insurance risk or has made an annuity guarantee (for life or a fixed period). Generally, the assumption of solely an investment risk would not give rise to an insurance liability.

Senate Committee on Finance, 98th Cong., 2d Sess., Deficit Reduction Action of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, p. 527 (1984).

For purposes of the federal tax law, risk shifting is an indispensable characteristic of insurance. Helvering v. LeGierse, 312 U.S. 531 (1941), 1941-1 C.B. 430. A similar standard has been used both for exemption from federal antitrust laws, see Group Health Life Insurance Co. v. Royal Drug Co., 440 U.S. 205, 211 (1979) ("The primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk."), and for federal securities laws, see Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202 (1967); Securities and Exchange Commissioner v. Variable Annuity Life Insurance Co., 359 U.S. 65 (1959). Moreover, the opinions in United Benefit Life, 387 U.S. at 211, and in Le Gierse, 312 U.S. at 542, indicate that the transfer of an investment risk cannot by itself create insurance.

In the present case, a review of Taxpayer's Funding Agreements indicates that these Agreements do not contain any provisions with respect to life, health, or accident contingencies. Moreover, although the Funding Agreements contain an interest guarantee and guarantee the return of the contract holder's principal on a stated maturity date, the Agreements do not provide any annuity forms of settlement (either for life or a period certain). Although the interest guarantee and credit default provisions created certain risks for Taxpayer, these risk are investment risks and are not insurance risks. Specifically, the risks assumed by Taxpayer under the Funding Agreements are that it will not earn through the reinvestment of the contract holder's funds to cover the interest rate guarantee, or that Taxpayer will become illiquid as a result of poor asset management and a credit downgrade, causing contract holder's to withdraw funds prior to the Agreements' stated maturity dates. When tested against the federal tax definition of insurance, Taxpayer's assumption of these investment risks is insufficient to create an insurance contract for tax purposes.

Accordingly, we conclude that Taxpayer's Funding Agreements do not constitute insurance contracts for tax purposes for which a reserve item under § 807(c)(3) or (c)(4) would be recognized. Rather, we believe that the Taxpayer's Funding Agreements are a form of indebtedness for tax purposes inasmuch as the Taxpayer agrees to return the contract holder's initial consideration with interest on a stated maturity date. Thus, the accumulated funds with respect to the funding agreements are neither § 807(c)(3) reserves nor any other type of § 807(c) item. The Taxpayer should account for its obligation to credit guaranteed interest under the agreements through the deduction allowed by §§ 805(a)(8) and 163 for interest paid or accrued within the taxable year on indebtedness.

CAVEATS:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.