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## **Section 812.—Definition of Company's Share and Policyholders' Share**

**Life insurance companies; computation of required interest.** This ruling provides that a life insurance company calculates “required interest” under section 812(b)(2)(A) of the Code using the mean of the amount of the reserve at the beginning of the taxable year and the amount of the reserve at the end of such year.

### **Rev. Rul. 2003-120**

#### **ISSUE**

What is the amount of reserves used to calculate “required interest” under section 812(b)(2)(A) of the Internal Revenue Code?

#### **FACTS**

IC is a life insurance company subject to tax under Part I of subchapter L of the Internal Revenue Code (§§ 801–818). For purposes of determining its life insurance company taxable income, IC computes the amount of the section 807(c)(1) life insurance reserves under section 807(d)(2), using the greater of the applicable Federal interest rate or the prevailing State assumed rate. For purposes of this revenue ruling,

assume that the applicable Federal interest rate for the contracts is 6.0% and that the applicable Federal interest rate exceeds the prevailing State assumed rate for the contracts.

On January 1, 200x, the opening balance of IC’s life insurance reserves (determined under section 807(d)(2)) equaled \$1,000,000x. On December 31, 200x, the closing balance of IC’s life insurance reserves for the contracts totaled \$1,224,434x.

#### **LAW AND ANALYSIS**

To prevent a life insurance company from realizing a double benefit for tax-preferred investment income (tax-exempt interest and dividends providing a dividends-received deduction) used to fund the company’s liabilities to policyholders, sections 807 and 805 require the company to adjust certain income and deduction items for the policyholders’ share of such tax preferred income.

To determine the increase or decrease in reserves for a taxable year, a life insurance company reduces its end-of-year reserves by the “policyholders’ share” of tax-exempt interest. Section 807(a) and (b). The company’s deduction under section 805(a)(2) for a net increase in reserves, therefore, is reduced by the policyholders’ share of tax exempt interest. Conversely, if there is a net decrease in reserves, the company’s gross income under section 803(a)(2) is increased by the policyholders’ share of tax exempt interest. The adjustments effectively deny the company any exclusion for the policyholders’ share of tax-exempt interest.

Section 805(a)(4) prevents a double benefit with regard to dividends eligible for the dividends-received deduction by limiting a life insurance company's deduction for dividends (other than "100 percent dividends" as defined in section 805(a)(4)(C)) received by the company. The deduction is limited to the "company's share" of the dividends received. See section 805(a)(4)(A)(ii). No dividends-received deduction is allowed for the policyholders' share of dividends received.

Section 812 provides the mechanism to calculate the life insurance company's and policyholders' respective shares of net investment income. For purposes of section 805(a)(4), the company's share is the percentage obtained by dividing (1) the company's share of the net investment income for the taxable year, by (2) the net investment income for the year. Section 812(a)(1). The policyholders' share is the excess of 100 percent over the company's percentage share. Section 812(a)(2).

The first step in applying section 812 is to determine, under section 812(d), the amount of the life insurance company's "gross investment income" for the taxable year. Next, "net investment income" for the taxable year is calculated under section 812(c). Except as otherwise provided in section 812(c)(2) with regard to income attributable to assets held in a segregated asset account for variable contracts, the net investment income for a taxable year equals 90% of gross investment income for the year. Under section 812(b)(1), the life insurance company's share of net investment income is the excess (if any) of the net investment income for the taxable year over the sum of the "policy interest" for the taxable year and the "gross investment income's proportionate share of policyholder dividends" for the taxable year. The policyholders' share of net investment income, therefore, is the portion of net investment income equal to the lesser of (1) the sum of policy interest and gross investment income's proportionate share of policyholder dividends for the taxable year or (2) the total net investment income.

Section 812(b)(2) provides that policy interest equals the sum of—

- (A) required interest (at the greater of the prevailing State assumed rate or the applicable Federal interest rate) on section 807(c) reserves (other than unearned premiums and unpaid losses under section 807(c)(2));
- (B) the deductible portion of excess interest;
- (C) the deductible portion of any amount (whether or not a policyholder dividend) that is not taken into account under section 812(b)(2)(A) or (B) and that is credited either to (i) a policyholder's fund under a pension plan contract for employees (other than retired employees), or (ii) a deferred annuity contract before the annuity stating date; and
- (D) interest on amounts left on deposit with the company.

If neither the prevailing State assumed interest rate nor the applicable Federal interest rate is used in determining the reserve for a contract, required interest is calculated using another appropriate interest rate.

Although required interest is a significant component of policy interest, section 812(b)(2) provides no guidance (other than the interest rates) regarding the method of calculating required interest. The legislative history that accompanied the enactment of section 812 in 1984, however, states that "the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (*i.e.*, by reference to 'required interest')." *See H. Rep. No. 432, Pt. 2, 98<sup>th</sup> Cong., 2d Sess. 1430–31 (1984); S. Prt. 169, Vol. I, 98<sup>th</sup> Cong. 2d Sess. 557–59 (1984).*

Under section 809(a)(2) of pre-1984 law, a life insurance company's required interest for any taxable year equaled the sum of the products obtained by multiplying (i) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c) of pre-1984 law [now section 807(c)], by (ii) the means of the amount of the reserves

computed at that rate at the beginning and the end of the taxable year. *See also* section 1.809–2(d) of the Income Tax Regulations.<sup>1</sup> As the formula in section 812 is based generally on the proration formula used under former section 809(a)(2), required interest under section 812(b)(2)(A) is calculated using mean reserves. Accordingly, required interest under section 812(b)(2)(A) equals the sum of products obtained by multiplying (i) the mean of the beginning-of-year and end-of-year reserves under section 807(c)(1)–(6) (other than section 807(c)(2)) by (ii) the applicable interest rate (the prevailing State assumed interest rate, the applicable Federal interest rate, or another appropriate interest rate).

The opening balance of IC's section 807(c)(1) life insurance reserves is \$1,000,000x and the closing balance of the reserves is \$1,224,434x. The mean of the reserves is \$1,112,217x. Therefore, the required interest on the life insurance reserves is \$66,733x [\$1,112,217x 6% = \$66,733x].

## HOLDING

Required interest under § 812(b)(2)(A) is calculated using the mean of the amount of the reserve at the beginning of the taxable year and the amount of the reserve at the end of such year.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Stephen Hooe of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling, contact Mr. Hooe at (202) 622–7595 (not a toll-free call).

<sup>1</sup> If provisions of pre-1984 law are incorporated into a current life insurance company tax provision, the regulations under the pre-1984 law may serve as an interpretative guide to the provision in the absence of any contrary guidance in the legislative history. *See H. Rep. 432, at 1401; S. Prt. 169, at 524.*