

CHAPTER 32

THIRTY-TWO

Separate Accounts Generally

32.1 GENERAL

This chapter deals with separate account contracts that qualify under Section 817. These contracts are used to fund variable life insurance, variable annuities, or various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability.¹ Separate accounts may also be used to fund modified guaranteed contracts and other types of products (typically group contracts) that do not qualify for treatment under Section 817. Some of these latter contracts qualify for special tax treatment under Section 817A, as discussed in Chapter 18. Separate account contracts may also be used to accumulate funds to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options. Assets allocated to separate accounts are owned by the insurance company rather than by the policyholder.² Reserves and related liabilities for guaranteed benefits on variable contracts are typically held in the general account.³

All investment income and realized and unrealized capital gains and losses from assets allocated to a separate account, net of related investment expenses, are generally reflected in the separate account, and investment performance is generally not guaranteed by the insurer. Except for assets supporting guaranteed benefits, assets are recorded at their market value on the date of valuation. If there is no readily available market, assets are recorded in accordance with the applicable contract. Assets supporting guaranteed benefits are recorded as if the assets were held in the general account.⁴

Separate accounts, as reported in the statement blank, normally do not develop a gain from operations. There are three reasons for this: (1) gains or losses arising from mortality and expenses are

¹ State statutes generally provide that amounts allocated to a separate account and accumulations on those amounts may be invested and reinvested without regard to any requirements or limitations imposed upon an insurer by the investment statutes that apply to insurers generally. Some statutes provide that, to the extent that the insurer's reserve liability (with regard to benefits guaranteed as to dollar amounts and duration and funds guaranteed as to principal or interest) is maintained in a separate account, a portion of the assets of the account at least equal to the reserve liability with regard to these benefits shall be invested in accordance with the investment statutes of the domiciliary state. Such assets should be reported separately. See, for example, New York Insurance Law, § 4240.

² Under state law, however, the portion of the assets of the separate account equal to the reserves and other contract liabilities of the separate account are typically not chargeable with liabilities arising out of any other business of the insurer.

³ See § 5C of the Variable Life Insurance Model Regulation, which provides that reserves for all fixed incidental insurance benefits and any guarantees shall be maintained in the general account and reserves for all variable aspects of the variable incidental benefits shall be maintained in a separate account, in amounts determined according to actuarial procedures appropriate to the benefit.

⁴ See SSAP No. 56, ¶ 7.

reflected in the general account; (2) investment expenses and taxes are deducted from investment gains and losses; and (3) investment gains and losses after expenses and taxes are absorbed in the increase in reserve liabilities. A gain from operations within the separate account could arise from earnings on seed money maintained in a separate account.

Insurance activities such as sales, underwriting and contract administration, premium collection and payment of premium taxes, claims, and benefits are functions of the insurance company distinct from the separate account and are accounted for as transactions of the general account.⁵ Thus, because the separate account annual statement is concerned primarily with the investment activities and obligations of the separate accounts and with the transfer of funds between the separate account and the general account, the separate account statement reports only the assets, liabilities, and operations of the separate account (i.e., policy and contract reserves and items relating to making investments, including investment expenses and taxes due or accrued). The separate account statement does not include any direct administrative expenses associated with separate account contracts.⁶

Gross premiums and deposits⁷ on separate account contracts are recorded as income in the Summary of Operations of the general account.⁸ These amounts (net of loading charges) are then reflected as part of the transfers to (and from) the separate account in the Summary of Operations of the general account.⁹ The amounts are also reflected in the operations of the separate account.¹⁰ As with premiums, benefits and surrenders on separate account contracts are reflected as expenses in the general account and also as part of the transfers between the separate account and general account.¹¹ The amounts are also reflected in the operations of the separate account.¹² The general account also reflects commissions, and it reflects taxes on gross premiums and considerations.¹³ Income from fees associated with investment management, administration, and contract guarantees incurred on separate account contracts is not included in net transfers to and from separate accounts.¹⁴ Rather, they are recorded as income in the Summary of Operations of the general account.¹⁵

The general account includes the total assets and liabilities, including transfers due or accrued, of any separate accounts business which it maintains and, therefore, the surplus, if any, of its separate accounts business. Transfers to the general account due or accrued are reported on a net basis so that the asset and liability totals of the general account are not overstated. Changes in the surplus of the

⁵ SSAP No. 56, ¶ 4; 2004 Annual Statement Instructions, at 451.

⁶ SSAP No. 56, ¶¶ 4 and 5. See also 2004 Annual Statement Instructions, at 451.

⁷ Deposit-type contracts, as defined in SSAP No. 52, Deposit-Type Contracts, may be maintained in the general account or transferred to the separate account. Attached to APPM, INT 00-03 is an Exhibit A that is included as an illustration of accounting/reporting of separate account deposit-type contracts in accordance with SSAP Nos. 51, 52, and 56.

⁸ See 2004 Annual Statement Instructions, at 65.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ SSAP No. 56, ¶ 5.

¹⁴ See 2004 Annual Statement Instructions, at 68.

¹⁵ 2004 Annual Statement Instructions, at 66, Line 8.1.

separate accounts business of an insurer, except for changes resulting from the net gain from operations of the separate account, are charged or credited directly to the unassigned funds (surplus) of the general account.¹⁶

Seed money is reported as surplus in the separate account until transferred or repatriated to the general account.¹⁷ Similarly, earnings on seed money is reported as surplus in the separate account until transferred or repatriated to the general account.¹⁸ The transfer of such funds between the separate account and the general account is reported as surplus contributed or withdrawn during the year.¹⁹ For tax purposes, the IRS takes the position that the earnings on seed money are taxed as part of the general account.²⁰

The separate account records premiums, considerations (net of loading for sales charges such as commissions and premium taxes), and receipts (other than for net investment income and realized capital gains and losses) as income transfers from the general account. Net investment income and realized capital gains and losses relating to the investment operations of the separate account are recorded as income in the Summary of Operations of the separate account. Benefits and surrenders, reserve transfers, policy loans, policyholder charges (i.e., investment management, administration, and contract guarantees),²¹ and federal income taxes relating to the separate account²² are recorded as expense transfers to the general account in the Summary of Operations.²³ The net change in aggregate reserves relating to separate account contracts and expenses and taxes associated with the separate account investment operations are reported respectively as increases in reserve and expenses in the Summary of Operations of the separate account.²⁴ Separate account surplus is never permitted to become negative.

If the reserves supporting the variable contracts are less than the fund value of the separate account, surplus is created in the separate account. The separate account treats the surplus as a payable to the general account.²⁵ This amount is treated as a receivable by the general account.²⁶ This results in

¹⁶SSAP No. 56, ¶ 6.

¹⁷SSAP No. 56, ¶ 10.

¹⁸*Id.*

¹⁹See Annual Statement Instructions to Lines 46 and 47, at 70.

²⁰Priv. Ltr. Rul. 9408019; Internal Revenue Service Manual Handbook (5/29/2002), 4.42.5.1.1.(8) and (10).

²¹Charges for these guarantees, and for administrative and investment management expenses, are usually expressed as an annual percentage of account values and may also include an amount per contract. Such charges are deducted from the separate account on a daily, weekly, or monthly basis—generally the same interval at which the separate account is valued. Group contracts with separate account provisions may have similar arrangements.

²²These taxes presumably relate to capital gains taxes imposed prior to the 1984 Act that were subtracted from the amount credited to policyholders. They may also relate to investment taxes such as real estate taxes, licenses, and fees that are paid directly by the separate account.

²³See 2004 Annual Statement Instructions, Line 11, at 459.

²⁴SSAP No. 56, ¶ 16.

²⁵2004 Annual Statement Instructions, at 457.

²⁶SSAP No. 56, ¶ 9; 2004 Annual Statement Instructions, at 457.

income²⁷ as part of the "transfers to or from the separate account" in the general account and maintains the separate account surplus at zero except to the extent of any seed money. The receivable in the general account is held as a contra-liability on the liability page on page 3, line 13, of the statutory annual statement as part of net transfers to or from the separate account.²⁸

32.2 STATUTORY AND TAX TREATMENT

Separate accounts that fund pension plan contracts, variable annuity contracts, and variable life insurance contracts are subject to tax under the special rules in Section 817. Modified guaranteed contracts are taxed under the special rules in Section 817A, discussed more fully in Chapter 18. Other separate account products, such as funding agreements for non-pension plan contracts, are taxed as part of the general account, discussed more fully in Chapter 30. This chapter addresses the rules in Section 817.

A separate account is not treated as a separate entity for federal income tax purposes even though those assets are not subject to the liabilities of the general account.²⁹ Generally, a separate Form 1120-L is prepared for each separate account and for the general account. The bottom line is then aggregated to determine taxable income.³⁰ Where there are numerous separate accounts, taxpayers may combine separate accounts with similar characteristics into a single Form 1120-L.

Prior to the 1984 Tax Act, the special rules now found in Section 817 applied only to pension contracts. The 1984 Act extended the rules that applied to pension plan contracts to all variable annuities and to variable life contracts. When Congress enacted Section 817 in 1984, it considered its actions as merely continuing, with some changes, the rules that existed under the 1959 Act.³¹ The IRS has noted that Regulations Section 1.801-8, which deals with variable contracts, should serve as an interpretive guide to Section 817.³²

²⁷Rationale for allowing the difference between the Commissioners Annuity Reserve Valuation Method (CARVM) reserve and account value to be reflected in the general account is that the income reflected is fairly certain of being earned in the general account via either surrender charges or asset fees. Issue Paper 89, ¶ 36. It has also been noted that the difference between account value and net surrender value thus is akin to the Commissioners Reserve Valuation Method (CRVM) allowance for life insurance. See Report to the NAIC Life and Health Actuarial Task Force at 1992-1 NAIC Proc. 1396; see also 1995-4 NAIC Proc. 35, 48.

²⁸2004 Annual Statement, at 68; 2001 Annual Statement Instructions to Line 10 of the Separate Account, at 412, and to Line 9.2 of the Summary of Operations, at 413.

²⁹See Treas. Reg. § 1.801-8(d)(2) (offsetting of capital gains and losses in the general account with gains and losses in the separate account); Rev. Rul. 74-4 (where general account sold stock at a loss and the separate account sold stock at a gain, the loss on the sale of stock by the general account was disallowed under the wash sales provisions of § 1091); Priv. Ltr. Rul. 8305098 (in computing taxable income for purposes of § 841, the foreign tax credit limitation is computed by combining the general account and the separate account since a segregated account is not considered to be a separate taxable entity).

³⁰Internal Revenue Service Manual Handbook (1999), HB 4.42 5.1.1.(5).

³¹H.R. REP. NO. 432, PART 2, 98TH CONG., 2D SESS. 1419 ("The bill continues to provide the special rules as under present law."); S. PRI. NO. 169, 98TH CONG., 2D SESS., at 545 ("The bill continues to provide special rules for variable annuities and contracts.").

³²Priv. Ltr. Rul. 9807001.

Section 817 applies only to a contract “which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company.”³³ Thus, the Code does not actually refer to a “separate account,” which is a legal term that is relevant to state insurance law and to federal securities laws. The term “segregated asset account” (SAA) is used in various subsections of Section 817, but is not explicitly defined anywhere in Section 817. Sections 817(d)(3)(A), (B), and (C), in defining the term “variable contract,” all make reference to “the investment return and the market value of the segregated asset account.” By virtue of their placement in Section 817(d), these references appear to go back to the phrase used in Section 817(d)(1), that is, “an account which, pursuant to state law or regulation, is segregated from the general asset accounts of the company.” Other references to “segregated asset account” in Section 817 occur in Section 817(b) (which prescribes a basis adjustment for each asset in an SAA), Section 817(f)(1) (which treats the reflection of the investment return and changes in the market value of the SAA as an assumed rate of interest for purposes of the Section 816(b) definition of a life insurance reserve), Section 817(g) (which treats certain variable annuity contracts as annuity contracts for purposes of Part 1 of Subchapter L), and Section 817(h) (which provides diversification requirements for contracts that are based on an SAA).

Section 817(a) provides that, with respect to any variable contract, reserves are adjusted (1) by subtracting an amount equal to the sum of the amounts added from time to time (for the taxable year) to the reserves separately accounted for by reason of appreciation in value of assets (whether or not the assets have been disposed of) and (2) by adding thereto an amount equal to the sum of the amounts subtracted from time to time (for the taxable year) from such reserves by reason of depreciation in value of assets. Reserves in separate accounts are included in the qualification ratio of Section 816.³⁴

For qualification ratio purposes, the end-of-year reserves used in the calculation are before any Section 817 adjustment for such appreciation or depreciation. Section 817(b) further provides that “the basis of each asset in a segregated asset account is (1) increased by the amount of any appreciation in value and (2) decreased by the amount of any depreciation in value, to the extent such appreciation and depreciation are from time to time reflected in the increases and decreases in reserves.” These rules apply to both long-term capital gains and short-term capital gains.³⁵ Mutual funds often make distributions out of short-term and long-term capital gains. However, distributions out of short-term capital gains are treated as ordinary income distributions, i.e., treated identically to distributions made out of interest earned in the mutual fund, and are not treated as capital gains. Only distributions made by mutual funds out of long-term capital gains are afforded capital gains treatment. The adjustment applies only to the extent of appreciation or depreciation in assets and not to the related increase or decrease in benefits. For example, if under a variable life contract appreciation in assets of \$250 results in increased death benefits of \$1,000, the amount of the adjustment is \$250.³⁶

³³I.R.C. § 817(d)(1).

³⁴See Treas. Reg. § 1.801-8(b), which provides that a company issuing contracts with reserves based on segregated asset accounts will qualify as a life insurance company if it satisfies the definition of a life insurance company. See also Priv. Ltr. Rul. 6701259510A. Refer to Chapter 3, Section 3.2, for a discussion of the qualification ratio.

³⁵Rev. Rul. 77-219 and Tech. Adv. Mem. 200330002.

³⁶S. PRT. NO. 169, 98TH CONG., 2D SESS., at 546 (1984), n. 15; H.R. REP. NO. 98-432 (PART 2), 98TH CONG., 2D SESS., at 1419 (1984), n. 18. See also the discussion under § 32.4.

Section 817(c) provides that for purposes of Sections 801 through 818,³⁷ a life insurance company that issues variable contracts must separately account for the various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such variable contracts. For such items as are not accounted for directly, separate accounting is made in accordance with the method regularly employed by such company, if such method is reasonable. Section 817(f)(2) further provides that the IRS may issue regulations to require "such additional separate computations with respect to the items separately accounted for in accordance with subsection (c)," but no such regulations have been issued.

The flush language in Section 817(d) provides that "obligations under such guarantee which exceed obligations under the contract without regard to such guarantee shall be accounted for as part of the company's general account." Thus, benefits such as minimum guaranteed death benefits or investments in accounts that pay a fixed rate of interest are taxed as part of the general account.

Under these rules, taxable income in a separate account always equals zero (excluding any dividends-received deduction) when reserves are equal to fund values. For example, assume that a premium of \$100 is paid on December 31, 1998, and that a reserve is held equal to \$100. The separate account reflects \$100 premium income and \$100 reserve increase. During 1999, assume the \$100 asset appreciates in value by \$5 and also earns investment income of \$5. Statutory and tax reserves at the end of the year are \$110. Before any Section 817(a) adjustment, there is a \$10 reserve increase. Section 817(a)(1) requires the \$10 reserve increase to be reduced by the \$5 of unrealized appreciation. Therefore, the deduction for the reserve increase under Section 807 is only \$5. Investment income is \$5, and taxable income is zero. Under Section 817(b), the basis in the asset is increased by \$5 to reflect the \$5 appreciation in value that reduced the reserve increase under Section 817(a). In 2000, assume that on January 1, the asset is sold for \$105 and that on January 1 the contract is surrendered for \$110. There is a reserve decrease of \$110 (income) offset by a deduction under Section 805(a)(1) for the claims paid of \$110. Similarly, since the basis in the asset is now \$105, there is no tax gain on the asset sale.

³⁷Section 817(c) provides specifically, "for purposes of this part" and this part refers to §§ 801-818. Prior to the repeal of § 809, § 817(c) excluded § 809 from its application.