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# CHAPTER 2 TWO

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## *Tax-Basis Reserves Generally*

### 2.1 GENERAL

As discussed in Chapter 1, a life insurance company generally uses the accrual method of accounting to compute its taxable income.<sup>1</sup> Under the accrual method of accounting, a deduction is generally not allowed for a liability until the all-events test is met. The all-events test “is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.”<sup>2</sup> This rule, however, does not apply to reserves for life insurance companies.<sup>3</sup>

Instead, Internal Revenue Code Sections 803(a)(2) and 807(a) require any net decrease in reserves to be included in gross income. Sections 804(1) and 805(a)(2), together with Section 807(b), allow a deduction for any net increase in reserves. As noted in Chapter 1, reserves for tax purposes are computed using the tax rules set out in Sections 807, 811, 817, 817A, and 846. A company has the burden of proving its deduction for reserves is allowable, even if the government’s disallowance of the deduction is arbitrary and unreasonable.<sup>4</sup>

Section 807(c) defines six categories of deductible reserves. Each category of reserves is separately stated on Schedule F of the Form 1120-L.<sup>5</sup> The six categories are as follows.

*Section 807(c)(1).* Life insurance reserves as defined in Section 816(b). Generally, these are reserves established for mortality or morbidity risks. Reserves on life insurance contracts are generally (but not always) considered life insurance reserves for tax purposes. Reserves on individual deferred fixed and variable annuities are also life insurance reserves, as long as permanent annuity purchase rate guarantees (i.e., such guarantees that last for the life of the contract) for life contingent annuity payments exist under those contracts. Additionally, active life reserves and the present value of claim amounts not yet due on health insurance contracts that meet the definition in the regulations<sup>6</sup> of

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<sup>1</sup> I.R.C. § 811(a)(1) (2004).

<sup>2</sup> See *id.* § 461(h)(4).

<sup>3</sup> HOUSE WAYS AND MEANS COMMITTEE, H.R. REP. NO. 98-432, pt. 2 at 1256 (1983); SENATE COMMITTEE ON FINANCE, DEFICIT REDUCTION ACT OF 1984, S. PRT. NO. 169, at p. 268 (1983). Also, I.R.C. § 461(h)(5) provides that the economic performance rules do not apply to any item for which a deduction is allowable under a provision that specifically provides for a deduction for a reserve for estimated expenses.

<sup>4</sup> See *Time Insurance Co. v. Comm’r*, 86 T.C. 298 (1986).

<sup>5</sup> This is the form that a life insurance company uses to file its tax return.

<sup>6</sup> Treas. Reg. § 1.801-3 (1972).

"guaranteed renewable" or "noncancellable" are also considered life insurance reserves. In general, life insurance reserves are the most important of the six categories of reserves in most companies that are characterized as life insurance companies under Section 816(a).

*Section 807(c)(2).* Unearned premiums and unpaid losses. For reserves that are not life insurance reserves, statutory-basis unearned premiums fall into this category. Eighty percent of the gross unearned premium in this category is deductible if the amount is with respect to contracts that are neither life insurance contracts nor noncancellable accident and health.<sup>7</sup> "Unpaid losses" are the liabilities that the company sets aside for claims payable (other than those included in life insurance reserves, above) on claims that have occurred, based on prescribed methods of calculation for tax purposes. Property/casualty loss reserves generally fall into this category, as do claim reserves and claim liabilities for accident and health contracts that are not guaranteed renewable.

*Section 807(c)(3).* Amounts (discounted at the appropriate rate of interest) 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. For the life insurance practitioner, a major item in this category consists of supplementary contracts not involving life contingencies (SCNIs), which are non-life-contingent settlement options elected by the policyholder or beneficiary. Pension plan deposit-administration funds and non-life-contingent structured settlements often fall into this category.

*Section 807(c)(4).* Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts. Pension plan deposit-administration funds often fall into this category as well as into the 807(c)(3) category.

*Section 807(c)(5).* Advance premiums and liabilities for premium-deposit funds. Premiums already paid that are not yet due fall into this category. Eighty percent of the gross advance premium in this category is deductible if the amount is with respect to contracts that are neither life insurance contracts nor noncancellable accident and health.

*Section 807(c)(6).* Reasonable special contingency reserves under contracts of group term life insurance or group health and accident coverage for the provision of insurance on retired lives, premium stabilization, or a combination of both. Group term life and health premium-stabilization funds and amounts accumulating at interest during both active and retired lives of participants to pay for retiree life and/or health benefits fall into this category.

Rules for calculating these reserves are found in a number of sections of the Code and are discussed in detail in later chapters. They are briefly summarized here. Rules for calculating life insurance reserves are found in Sections 807(d) and 807(e)(1) through 807(e)(6). Section 807(e)(7) provides rules for calculation of unearned premiums under Section 807(c)(2) and premiums received in advance under Section 807(c)(5). Section 807(f) provides a special rule that, if the basis for determining a reserve is changed, the difference between the reserve on the new basis and the old basis is spread into income or taken as a deduction over 10 years. See Chapter 7 for a more detailed discussion of changes of method.

Section 811 sets out four accounting rules that apply to reserves. Section 811(d) provides that interest in excess of the greater of the prevailing state assumed interest rate (PSAR) or the applicable

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<sup>7</sup> I.R.C. § 807(e)(7) (2004).

federal interest rate (AFR) can be taken into account only as if such interest was guaranteed until the end of the taxable year. Section 811(c)(1) prevents a company from establishing a reserve for any item unless the gross amount of premiums and other consideration attributable to such item is included in gross income. Section 811(c)(2) prevents an item from being counted more than once for reserve purposes. Section 811(c)(3) prevents any item from being deducted (either directly or as an increase in reserves) more than once.

Finally, Sections 817 and 817A, respectively, provide special reserve guidance for certain variable contracts and modified guaranteed contracts held in separate accounts. Section 846 provides the rules for computation of Section 807(c)(2) unpaid losses.

Part I of the Appendix to this chapter contains a brief listing of the various tax acts that have formed the primary underpinning for the guidance that exists today for tax reserves and related items. Part I also includes a brief description of the major changes to tax-reserve treatment caused by each tax act. Those brief descriptions are elaborated on later in this chapter. Nevertheless, it is important to bear in mind that many elements of prior law carry over to the authoritative guidance brought into existence by the 1984 Act. The legislative history to the 1984 Act makes clear that, unless the 1984 Act indicates to the contrary, prior law (defined as including regulations, cases, etc.) continues to be in effect.<sup>8</sup>

Since the structure of the relevant parts of the Internal Revenue Code for purposes of this book changed significantly with the advent of DEFRA84, and inasmuch as many cases and rulings throughout the book refer to pre-DEFRA84 code sections, a table of the equivalent Internal Revenue Code sections between pre-DEFRA84 and post-DEFRA84 can be found in the Part II of the Appendix to this chapter.

Sections 2.2–2.7 of this chapter provide more detail with respect to each of the six reserve categories.

<sup>8</sup> SENATE COMMITTEE ON FINANCE, DEFICIT REDUCTION ACT OF 1984, S. PRT. NO. 169, at p. 524 (1984); GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1984, JOINT COMMITTEE ON TAXATION, at p. 581 (1984) (the Blue Book); Rev. Rul. 92-94, I.R.B. 1992-45; Rev. Rul. 94-74, I.R.B. 1994-49, 4; Rev. Rul. 89-43, 1989-1 C.B. 213; FSA 1998-236; FSA 1998-258; FSA 1999-589; *Best Life Assurance Co. v. Comm'r*, 281 F.3d 828 n. 4 (9th Cir. 2002); Tech. Adv. Mem. 200427024 (March 5, 2004); Tech. Adv. Mem. 200435015 (May 11, 2004); Priv. Ltr. Rul. 8817008 (Nov. 5, 1987).

In Tech. Adv. Mem. 200038008, the Service agreed that the methodology that should be used to compute the company share of a separate account should be based upon the formulas contained in former Code § 801(g)(5) and regulations (§§ 1.801-8(e) and (f)). The Service stated in part:

Most importantly, we are not at liberty to disregard the plain instruction of Congress in 1984 that the provisions of subchapter L, as revised, are to be interpreted consistent with prior law to the extent possible. In the present case, the proration regime was based on that formerly set forth in prior section 809(a) and section 1.801-8(e) of the regulations. We accordingly conclude that Company B's method of determining the amount of the policyholders' share and the company's share was appropriate under section 812 of the Code.

In Priv. Ltr. Rul. 200044028 (Aug. 7, 2000), the Service used the definition of cancellable accident and health insurance for life insurance tax purposes as the definition for purposes of § 1.832-4(a)(5), in particular, referring to the definition of noncancellable accident and health insurance in § 1.801-3(c) and guaranteed renewable in § 1.801-3(d). The Service noted in footnote 1 of the ruling that these 1959 Act regulation definitions carried over to the 1984 Act.

## 2.2 SECTION 807(c)(1); LIFE INSURANCE RESERVES

Section 807(c)(1) allows a deduction for life insurance reserves as defined in Section 816(b)(1). Section 816(b)(1) defines life insurance reserves as amounts:

- (A) which are computed or estimated on the basis of recognized mortality tables and assumed rates of interest, and
- (B) which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.

Section 816(e) provides that, for purposes of Sections 801 through 818, guaranteed renewable health insurance is treated in the same manner as noncancellable health insurance. "Guaranteed renewable" has a special tax definition<sup>9</sup> that is not the same as the definition under NAIC rules. Thus, if a contract meets the tax definition of a guaranteed renewable contract and also meets the two rules above, the reserves are life insurance reserves.

Section 807(d)(1) defines the amount of life insurance reserve for any contract (other than for purposes of the definition of life insurance company under Section 816) as the greater of the net surrender value of the contract or the reserve determined according to Section 807(d)(2). Section 807(e) sets out various special rules for computing life insurance reserves. These special rules include the following: the definition of the net surrender value of a contract in Section 807(e)(1); the deemed issue date of group contracts in Section 807(e)(2); the definition and computation of supplemental benefits in Section 807(e)(3); special rules for certain foreign branches of domestic life insurance companies in Section 807(e)(4); and the treatment of substandard risks in Section 807(e)(5). A special rule in Section 807(e)(6) for term or annuity riders on contracts issued before January 1, 1989, allows a company to treat the rider as a separate contract for purposes of computing reserves if the plan of insurance was filed by the company prior to January 1, 1984.

See also Chapter 4, "Life Insurance Reserves Generally" and Chapter 9, "Supplemental Benefits and Qualified Substandard Risks."

## 2.3 SECTION 807(c)(2); UNEARNED PREMIUMS AND UNPAID LOSSES

An unearned-premium reserve is deducted under Section 807(c)(2). The 1959 Act regulations further define unearned premiums as "those amounts which shall cover the cost of carrying the insurance risk for the period for which the premiums have been paid in advance. Such term includes all unearned premiums, whether or not required by law."<sup>10</sup> Unearned premiums are earned ratably as the term of a policy expires and are fully earned at the end of the period for which the premiums have been paid.

Unearned-premium reserves for tax purposes are generally held at the statutory reserve amount. Section 807(e)(7)(C), however, allows a deduction for only 80% of the amount of gross unearned-premium reserves on any contract for which life insurance reserves are not held. Thus, an

<sup>9</sup> Treas. Reg. § 1.801-3(d).

<sup>10</sup> Treas. Reg. § 1.801-3(e).

unearned-premium reserve on a noncancellable accident and health contract, for example, is not subject to this 20% “haircut,” but an unearned-premium reserve on a cancellable accident and health insurance policy is subject to the 20% haircut.<sup>11</sup>

Unpaid losses consist of three categories of losses:<sup>12</sup>

- Losses reported and ascertained by the end of the year but where the amount of the loss has not been paid
- Losses reported by the end of the year but where the amount has not yet been ascertained or paid by the end of the year, or
- Losses that have occurred by the end of the year but which have not been reported or paid by the end of the year.

The annual statement currently differentiates claim reserves (for amounts not yet due, e.g., future disability income payments) from claim liabilities (for amounts due but not yet paid). However, the tax law makes this distinction only where the claim reserve is a life insurance reserve, that is:

- If the claim reserve is a life insurance reserve, the claim liability is a Section 807(c)(2) unpaid loss. For example, for a noncancellable disability income policy, the present value of disability payments to fall due in the future is a life insurance reserve, while the amounts already due and accrued as of the statement date are classified as a claim liability.
- If the claim reserve is not a life insurance reserve, both amounts due and amounts not yet due are a Section 807(c)(2) unpaid loss. Thus, if the above example were on a cancellable disability income policy, both amounts would be treated as a Section 807(c)(2) unpaid loss.

Section 807(c)(2) overlaps with Section 805(a)(1), which allows a deduction for all claims and benefits accrued and all losses incurred (whether or not ascertained). The discount rules that apply to Section 807(c)(2) unpaid losses apply equally to claims and benefits accrued.<sup>13</sup> The Code makes it clear that a company cannot double deduct an item as an unearned-premium reserve under Section 807(c)(2) and also as an unpaid claim under Section 805(a)(1).<sup>14</sup> The only difference between treatment under Section 807(c)(2) and Section 805(a)(1) appears to be that Section 807(c)(2) reserves are subject to the change in basis rules in Section 807(f), while an unpaid claim under Section 805(a)(1) would not get Section 807(f) treatment but instead is subject to the normal rules that apply to change in accounting methods.

See Chapter 5 for a detailed discussion of Section 807(c)(2) reserves.

<sup>11</sup>This provision is similar to the 20% haircut for unpaid unearned premiums in § 832(b)(4) and the exclusion in § 832(b)(7)(A) for unearned premiums on contracts described in § 816(b)(1)(B).

<sup>12</sup>See *id.* § 1.801-3(g).

<sup>13</sup>See *id.* § 807(c) flush language.

<sup>14</sup>See *id.* § 811(c)(3).