Highest Aggregate Reserves Qualify for Statutory Reserves Cap

by Peter H. Winslow, Lori J. Jones and Samuel A. Mitchell

On June 27, 2008, the Internal Revenue Service (IRS) released Rev. Rul. 2008-37[1] dealing with the application of the statutory cap when a company conducts business in several states with different minimum reserve requirements. The IRS concludes that statutory reserves defined in I.R.C. § 807(d)(6) for purposes of the limitation on tax reserves in I.R.C. § 807(d)(1) is the highest aggregate reserve amount for I.R.C. § 807(c) items actually held and set forth on the annual statement pursuant to the minimum reserve requirements of any state in which the company does business.

The revenue ruling contains two examples. In situation one, the life insurance company (IC) conducts business in 45 states and issues a life insurance contract (Contract A). IC actually holds and reports to each state insurance regulatory authority on its annual statement the highest aggregate minimum amount of reserves required for its insurance and annuity contracts under the rules of any state in which IC does business. As a result, on its 2007 annual statements, IC reported end-of-year aggregate reserves of $405,955,000 which included $9,992 of life insurance reserves with respect to Contract A.

In situation two, IC reported to each state the minimum amount of reserves required for its insurance and annuity contracts under the rules of that state. Following this principle, on its annual statement filed in State X, the state in which IC is chartered, IC reported $402,540,000 of end-of-year aggregate reserves and $9,942 allocable to Contract A. However, in its annual statement filed in State Y, IC reported $405,955,000 and included $9,992 allocable to Contract A. Thus, IC actually held and reported to at least one state the highest aggregate minimum amount of reserves required for its insurance and annuity contracts under any state in which IC does business.

The IRS concluded that in both situations, the statutory reserves as defined in I.R.C. § 807(d)(6) were $405,955,000—the highest aggregate minimum reserve amount for I.R.C. § 807(c) reserve items actually held pursuant to the minimum reserve requirements of any state in which IC does business. Therefore, for purposes of applying the statutory reserves limitation contained in the flush language of I.R.C. § 807(d)(1), the amount of statutory reserves to be taken into account with respect to Contract A is $9,992.

The revenue ruling is interesting in several respects. In a recent *Taxing Times* article,[2] we suggested that the IRS should rely on existing regulations and conclude that "statutory reserves" are the aggregate reserves reported on the annual statement included with the tax return which, at the election of the taxpayer, could be the annual statement reflecting the highest aggregate reserves in any state or jurisdiction in which it transacts business.[3] Rev. Rul. 2008-37 did not base its conclusion directly on these regulations. Instead, it appears to have concluded that statutory reserves are determined by the highest aggregate reserves in any state in which the company does business regardless of the annual statement attached to the return. If this is the correct reading of the ruling, it has several additional implications. For example, it suggests that statutory reserves can be determined by the annual statements of different states depending on which state yields the highest aggregate reserves in the particular tax year. This, in turn, implies that year-by-year changes to the statutory cap caused by changes in the applicable annual statement would not be considered changes in the basis of computing reserves subject to a ten-year spread under I.R.C. § 807(f). That is, any switch to another applicable annual statement yielding higher aggregate reserves would be a mere change in facts.

Another interesting, and somewhat puzzling, aspect of Rev. Rul. 2008-37 is its reference to the "minimum" reserve requirements of the states. In each of the examples, the taxpayer held the minimum aggregate reserves permitted by state law. The facts do not address a situation where the taxpayer holds reserves in excess of all states' minimum reserve requirements. Nevertheless, the actual holding of the ruling appears to state a broader principle than the facts. It defines statutory reserves as "the highest aggregate reserve amount for § 807(c) items actually held and set forth on the annual statement pursuant to the minimum reserve re-

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[1] 2008-28 I.R.B. 77.

[2] Winslow and Mitchell, "IRS to Rule in the Meaning of Statutory Reserves," *Taxing Times* (Feb. 2008).

[3] Treas. Reg. § 1.6012-2(c); § 1.801-5(a).

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quirements of any State in which [the taxpayer] does business." This does not seem to limit statutory reserves to the actual amount of minimum reserves required; instead, it properly focuses on the amount actually reported on the annual statement in satisfaction of state law.

Rev. Rul. 2008-37 is ambiguous in at least one respect. Under I.R.C. § 807(d)(1), the comparison of the actuarially-computed federally prescribed reserve to statutory reserves generally is on a contract-by-contract basis. As a result, it is possible to read the reference to aggregate reserves in the I.R.C. § 807(d)(6) definition of statutory reserves as referring to the aggregate reserves for the contract. Although it is by no means clear, Rev. Rul. 2008-37 appears to measure statutory reserves by the aggregate reserves reported on a single annual statement. Under that reading, multiple annual statements cannot be examined to determine the highest reserves for specific contracts. Despite this ambiguity, the ruling provides useful and timely guidance.

Tax Factors Influence the Viability of NAIC Securitization Initiatives

by Emanuel Burstein

Securitizations and Expanded Insurance Capacity

Congress, state insurance regulators and insurance companies have been examining ways to expand insurance capacity by promoting insurance securitization arrangements. In Congressional hearings on applying certain securitization methods to increase insurance capacity for catastrophe risk coverage, Michael Moriarty,[1] representing the National Association of Insurance Commissioners (NAIC), stated,

> *The NAIC's position is that U.S. regulators should encourage the development of alternative sources of capacity such as insurance securitizations, provided adequate standards governing these transactions are applied. Further deliberations of the [insurance securitization] working group at the NAIC led to a determination that it will be preferable if insurance securitizations could be done here in the United States instead of off-shore.*[2]

He added that "to further that position, the NAIC has adopted separate model acts to facilitate on-shore securitization using two different methods—protected cells and special purpose reinsurance vehicles."[3] Protected cells and special purpose reinsurance vehicles facilitate the transfer of insurance risks to capital markets and enable investors to fund a sizable portion of transferred coverage.

Tax factors, including tax uncertainty, significantly influence the viability of these risk-transfer vehicles. Moriarty stated, "it is our understanding that an important impediment to the utility of both of these options here in the United States is tax uncertainty. Both of these methods depend on certain tax treatment which may require amendments to the tax code." Although Congress has not amended related provisions of the Internal Revenue Code, the Internal Revenue Service (Service) is providing greater tax certainty, at least for protected cell securitizations, by addressing related tax treatment in pronouncements, principally in Rev. Rul. 2008-8[4] and Notice 2008-19,[5] and seeking input from insurance tax

[1] Mr. Moriarty was the director of the Capital Markets Bureau of the New York Department of Insurance.

[2] *Catastrophe Bonds: Spreading Risk: Hearing Before the Subcomm. On Oversight and Investigations of the House Comm. On Financial Services*, 107th Cong. (Oct. 8, 2002) at 7.[Hereinafter *Hearing on Catastrophe Bonds*]

[3] *Id.* Copies of the NAIC's Protected Cell Company Model Act (1999) and Special Purpose Reinsurance Vehicle Model Act (2001) are respectively included on pages 89-97 and 138-158 of the *Hearing on Catastrophe Bonds.*

[4] 2008-5 I.R.B. at 340.

[5] 2008-5 I.R.B. at 366.