Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **20144702F**

Release Number 11/21/2014
CC:LB&I:HMP:NEW:2:DDHelfgott
POSTF-107970-13

date: August 18, 2014

to: Caryl Toron
Revenue Agent

from: Diane D. Helfgott
General Attorney (Newark, Group 2)
(Large Business & International)

---

subject:
Taxable Years
Inclusion of Funding Agreement Interest in Policy Interest

<u>This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.</u>

<u>Issue</u>:

Does interest paid on Funding Agreements issued by Life Insurance Company qualify as "policy interest" under I.R.C. § 812(b)(2), excluded from the company's share of net investment income under I.R.C. § 812(b)(1)?

<u>Conclusion</u>:

Interest paid on Funding Agreements qualifies under I.R.C. §812(b)(2)(D) as "policy interest" under I.R.C. § 812(b)(2) because it is interest on amounts left on deposit with the company under I.R.C. § 812(b)(2)(D).

<u>Facts</u>:

Life Insurance Company (" ", or "Taxpayer") is a wholly owned subsidiary of the consolidated group. It offers funding agreements to various . Life's funding agreement business comprises approximately % of its total contractual liabilities, including insurance contracts and deposit type contracts. According to a recent survey of , Life issues most of the funding agreements issued in connection with .[1]

Included in the funding agreements outstanding during the period were the following contracts:

Plan Contractholder	Date of Issuance

As an example, in Life entered into a funding agreement with "), designated as "policyholder," on behalf of the .

The policyholder provides "premiums" under the contract which are accounted for in a Funding Agreement Account. Life credits guaranteed and nonguaranteed interest to the Funding Agreement Account and deductions expenses and withdrawals to account owners) as follows:

1. Premiums paid to from Policyholder ( )
2. Guaranteed interest paid by Life.
3. Additional interest in excess of the guaranteed.
4. Less: premium taxes
5. Less: amounts of any withdrawals, rollovers, and transfer of Funds.

1

The contract was scheduled to expire in three years, subject to renewal. (Some of the contracts had a five year term). At expiration, the remaining balance in the account not used for qualified withdrawals, transfers, or rollovers would be paid out over a five year period in equal annual installments.

During the period , life paid approximately $ million in guaranteed and nonguaranteed interest on its funding agreements.

On its annual statement Summary of Operations, Life included the interest credited to its funding agreements on line 17, “interest and adjustments on policy or deposit type contracts”. On its income tax returns, Taxpayer included the interest expense on page 1, line 9 (Death benefits, etc.).

<u>Law:</u>

<u>Classification of Funding Agreements</u>

The National Association of Insurance Commissioners defines a funding agreement as “an agreement for an insurer to accept and accumulate funds and to make one or more payments at future dates in amounts that are not based on mortality or morbidity contingencies.” See, Annuity Disclosure Model Regulation, Section 4(E). This definition, with minor variations, has been accepted in states which have issued statutes addressing funding agreements.[2]

For statutory accounting purposes, SSAP 50 classifies contracts issued by insurance companies in the following categories: life (including annuity) contracts, accident and health contracts, property and casualty contracts, and deposit-type contracts.

Deposit-type contracts do not incorporate insurance risk, and are “more comparable to financial or investment instruments issued by other financial institutions than to insurance contracts.” SSAP 50, § 43. Deposit type contracts include supplemental contracts, structured settlements, guaranteed interest contracts, dividend and coupon accumulations, annuities certain, premium and other deposit funds, and funding agreements without well-defined, class based annuity purchase rate guarantees. SSAP 50, § 44.

SSAP 52 describes the statutory accounting for deposit type contracts. Amounts received as payments for such contracts are not reported as revenues but are recorded directly to an appropriate policy reserve account. Although the contracts are not

---

[2] <u>See</u>, A.C.A. §23-62-109(a)(1)(Arkansas); Cal. Ins. Code § 10541(b) (California); I.C. 27-1-12.7-1(3)(Indiana); I.C.A. §508.31A (Iowa); M.D. Code, Insurance §16-113(c)(2)(Maryland); M.S.A. §61A.276 Subd. 3 (Minnesota); Neb. Rev. St. §44-708(7) (Nebraska); N.H.Rev.St. § 408-E:2I (New Hampshire); McKinney’s Insurance Law § 3222(c)(New York); N.C.G.S.A. § 58-7-16(a) (North Carolina); Gen. Laws. § 27-4-0.1(b)(1)(Rhode Island); VA Code § 38.2-3100.2B (Virginia).

classified as insurance contracts, policy reserves must be held and satisfy the requirements of SSAP 52, §§7-11, Appendices A-820 and A-822, and actuarial guidelines.

Although funding agreements are typically not characterized as life insurance or annuity contracts, states generally classify the issuance of funding agreements as doing an insurance business in the state[3], "an activity necessary, convenient, or expedient to the business of a life insurance company"[4], or an activity "reasonably related to and incidental to its insurance activities…[5]". The purpose for these provisions is to ensure the state insurance department has jurisdiction to regulate the issuance and sale of funding agreements, including the persons selling such funding agreements on behalf of the insurer. Contract forms must be approved by the state insurance department, and such contracts are generally given equal status with insurance contracts in any insolvency proceeding.

For federal income tax purposes, risk shifting is an indispensable characteristic of insurance. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk at issue must be an "insurance risk" in the commonly understand meaning of that term. Id. at 539-540. A contract providing annuity purchase rate guarantees will create a mortality-based risk because the insurer's gain or loss will depend, at least in part, on the mortality experience of the insured. UNUM Life Insurance Co. v. United States, 897 F2d 599, 604 (1st Cir. 1990). A contract providing only a purely investment risk, such as that incurred by a bank, is not an insurance contract. Helvering v. LeGierse, 312 U.S. at 542.

Proration

I.R.C. § 805(a)(4)(A)(ii) provides that, with respect to dividends other than "100 percent dividends" a life insurance company is allowed the deductions provided by sections 243, 244, and 245 only to the extent of the "life insurance company's share" of such dividends.

I.R.C. § 812(a)(1) defines the life insurance company's share as the percentage obtained by dividing (i) the company's share of net investment income for the taxable year, by (ii) the net investment income for the taxable year. In turn, § 812(a)(2) defines the policyholders' share as the excess of 100 percent over the company's share percentage.

I.R.C. § 812(c) defines net investment income as 90 percent of gross investment income or, in the case of gross investment income attributable to assets held in a

[3] C.G.S.A.§38a-459 (Connecticut); I.C.A. § 508.31A1. (Iowa); M.G.L.A. 175 §1321 (Massachusetts); M.S.A. § 61A.276 (Minnesota); N.H.Rev. Stat. §408-E:1 (New Hampshire); N.Y. Insurance Law. Ch.28, § 3222 (New York); Gen. Laws.§27-4-0.1 2) (Rhode Island); VA Code Ann. § 38.2-3100.2 (Virginia).
[4] IC 27-1-12.7-6 (Indiana)
[5] A.C.A. §23-62-109 (Arkansas); Cal. Ins. Code. § 10541

segregated asset account under variable contracts, 95 percent of gross investment income.

I.R.C. § 812(b)(1) provides that the company's share of net investment income is the excess, if any, of net investment income for the taxable year over the sum of (i) policy interest, plus (ii) the gross investment income's proportionate share of policyholder dividends for the taxable year.

I.R.C. § 812(b)(2) defines the term “policy interest” as follows:

Policy Interest -- For purposes of this subsection, the term "policy interest" means

> 812(b)(2)(A). -- required interest (at the greater of the prevailing State assumed rate or the applicable Federal interest rate) on reserves under section 807(c) (other than paragraph (2) thereof),
>
> 812(b)(2)(B). -- the deductible portion of excess interest,
>
> 812(b)(2)(C). -- the deductible portion of any amount (whether or not a policyholder dividend), and not taken into account under subparagraph (A) or (B), credited 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 starting date, and
>
> 812(b)(2)(D). -- interest on amounts left on deposit with the company.

ANALYSIS

Life’s funding agreements, like funding agreements generally, 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 over a period of years, the agreements do not provide any annuity forms of settlement (either for life or a period certain), nor do they include any annuity purchase rate guarantees. Although the guarantees offered under the funding agreements created certain risks for Taxpayer, these risks are investment risks and not insurance risks. Therefore, Taxpayer’s funding agreements do not qualify as insurance or annuity contracts.

Because Taxpayer’s funding agreements do not constitute insurance or annuity contracts, the guaranteed interest it credits to the accounts does not qualify as policy interest under section 812(b)(2)(A) (required interest on §807(c) reserves), section 812(b)(2)(B) (excess interest)[6], or section 812(b)(2)(C) (interest paid on a pension plan contract or a deferred annuity). Accordingly, to be included in policy interest, the interest paid on funding agreements must qualify as interest on amounts left on deposit under section 812(b)(2)(D).

In determining whether the phrase, "interest on amounts left on deposit with the company," includes interest paid on funding agreements, statutory interpretation begins with the language, or plain meaning, of the statute. United States v. Locke, 471 U.S. 84, 93 (1985). Among the canons of construction used in interpreting the plain meaning of a statute are that the meaning is arrived at by consideration of the statute as a whole and that effect be given to every element of a statute. Bennett v. Spear, 520 U.S. 154, 173 (1997); United States v. Menasche, 348 U.S. 528, 538-39 (1955)

The phrase, "interest on amounts left on deposit with the company" is broadly written and does not include any terms specialized in the insurance industry. In the everyday sense of the phrase, it includes any contractual arrangement in which the life insurance company accepts funds, holds the amounts for the benefit of the depositor, and pays interest on the funds, similar to an arrangement between a bank and its customer. There is no language in the statute limiting this provision to deposits involving insurance or annuity contracts, thus indicating it applies to other deposit arrangements. This interpretation is supported by the fact that interest paid pursuant to any deposit arrangement involving an insurance or annuity contract would be covered by sections 812(b)(2)(A) or (B). Therefore, an interpretation limiting section 812(b)(2)(D) to insurance or annuity arrangements would impose limits contrary to the plain language of the statute, and would render section 812(b)(2)(D) superfluous.

The legislative history is consistent with this interpretation, as it indicates that Congress intended to include in policy interest, interest paid to any customer of the life insurance company, whether or not pursuant to an insurance or annuity arrangement.

Section 812(b)(2)(D) was added by Section 1821(i)(I)(D) of the Tax Reform Act of 1986, as part of the technical corrections to the Tax Reform Act of 1984. The Senate Report states as follows:

> The technical corrections title contains clerical, conforming, and clarifying amendments to provisions enacted by the Tax Reform Act of 1984, which was part of the Deficit Reduction Act of 1984 (P.L. 98-369), the Retirement Equity Act of 1984 (P.L. 98-397), and other recently enacted tax legislation. All amendments made by the title are meant to carry out the intent of Congress in enacting the original legislation. Therefore, no separate "Reasons for Change" is

[6]Defined in section 808(d)(1) as any amount in the nature of interest (A) paid or credited to a policyholder in his capacity as such and (B) in excess of interest determined at the prevailing state assumed rate for such contract.

> set forth for each individual amendment.

S. Rep. No. 99-313; 99th Cong., 2d Session p. 893 (May 29, 1986). Consistent with this intent, the corrections took effect "as if included in the provision of the Tax Reform Act of 1984 to which such amendment relates." Pub. L. 99-514, § 1881. Thus, a review of the legislative history of section 812(b)(2)(D) should start with the legislative history of section 812 as enacted in 1984.

As enacted in 1984, section 812 included in policy interest, interest on any section 807(c) reserve (812(b)(2)(A)), the deductible portion of excess interest, (section 812(b)(2)(B)), and interest under section 812(b)(2)(C). Section 812(b)(2)(C) includes "the deductible portion of any amount (whether or not a policyholder dividend), and not taken into account under subparagraph A or B, (i) credited to "a policyholder's fund under a pension plan contract for employees (other than retired employees)" and (ii) "a deferred annuity contract before the annuity starting date."

In the legislative history to section 812 as enacted in 1984, in describing prior law, Congress distinguished the proration formula under Phase I (taxable investment income) from that under Phase II (gain from operations). A key difference between proration under Phase I and Phase II was that Phase II, unlike Phase I, did not include "interest on indebtedness" under former section 805(e)(1). Former section 805(e)(1) "interest on indebtedness" included both interest on general debt and interest on certain products offered by life insurance companies that would not qualify for reserve treatment under former section 810, such as contracts holding amounts at interest without purchase rate guarantees. In contrast, Phase II (former section 809(a)(2)) did not include either category of "interest on indebtedness", but only included required interest on reserves and excess interest on annuity contracts.

Congress described section 812 as retaining the general concept under prior law of allocating items of investment yield between the policyholders and the company. It further described its relationship to the prior law as follows:

> Under the bill, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under present law in computing gain or loss from operations. Thus, amounts credited to policyholders will no longer include interest paid on indebtedness **if the interest is paid to a person who is not a customer**. For example, interest paid on a loan that is incurred to purchase a subsidiary company or other asset will not be included in determining the policyholders' share of investment yield items. (emphasis added).

S. Prt. 169, Vol. I, 98^{th} Cong. 2d Sess. pp. 557-558 (1984).

As indicated above, although the legislative history states that section 812 is based "generally" on the Phase II model, the pertinent distinction drawn above is between interest on general debt and interest paid to a “customer”, such as interest on products without purchase rate guarantees.[7] Unlike the word “policyholder”, the word “customer” does not necessarily describe the purchaser of an insurance or annuity product. This intention is reflected in section 812(b)(2)(C)(i) which includes interest on pension plan contracts in policy interest, whether or not a policyholder dividend, to the extent not qualifying under section 812(b)(2)(A) or section 812(b)(2)(B). Interest would only qualify under section 812(b)(2)(C)(i) if the interest was paid under a pension plan contract that was not an insurance or annuity contract. In recognition of that fact, the legislative history describes section 812(b)(2)(C) as including “any amount in the nature of interest (whether or not a policyholder dividend) credited to a policyholder <u>or customer</u> fund under a pension plan contract for employees not yet retired…” (emphasis added). H. R. Rep. No. 98-861; 98th Cong. 2d Sess. 1066 (1984).

In 1986, as a technical correction or “clarification,” Congress added section 812(b)(2)(D). Congress presumably added section 812(b)(2)(D) out of concern section 812(b)(2)(C) was unduly restrictive because it was limited to interest paid on indebtedness incurred in connection with pension plan contracts. The important criteria was that the interest was paid to a “depositor or any customer.” This interpretation is affirmed by the legislative history of section 812(b)(2)(D):

> Under the bill, the definition of the company's share of net investment income is amended to clarify that, in arriving at such amount, net investment income should be reduced by all interest paid to a depositor or any customer for the services provided by the life insurance company, whether it is interest guaranteed on the contract (like required interest) or excess interest. For example, net investment income should be reduced by all interest paid on deposit administration contracts that provide no permanent purchase rate guarantees; although the purchaser of such a contract may not technically be a "policyholder," the purchaser may be viewed as a depositor or a customer for the services provided by the life insurance company.

S. Rep. No. 99-313; 99th Cong; 2d Sess. p. 972.

[7] Congressional intent to award special treatment to products without permanent purchase rate guarantees was also reflected in the enactment of section 816(f).

The legislative history reiterates Congress' intention that section 812(b)(2)(D) should be applied broadly to interest paid pursuant to any contractual deposit arrangements offered to customers, whether or not pursuant to an insurance or annuity contract. Under Taxpayer's funding agreements , it credited guaranteed and additional interest to the accounts held on deposit. As purchasers of the funding agreements, are Taxpayer's customers (referred to by Taxpayer, as "policyholders"). Accordingly, the interest Taxpayer credited to the funding agreements is "interest on amounts left on deposit with the company" and policy interest under § 812(b)(2)(D).

MICHAEL P. CORRADO
Area Counsel
(Heavy Manufacturing & Pharmaceuticals)

By: ____/s/_________________________
Diane D. Helfgott
General Attorney (Newark, Group 2)
(Large Business & International)