DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Qualification as a life insurance company

This Field Service Advice responds to your memorandum dated December 3, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
State A =
Year 1 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 11 =
Date 1 =
Date 2 =
$X =
Y =

ISSUE:

Whether certain health insurance policies issued by Taxpayer may be considered "guaranteed renewable" for Federal income tax purposes, thereby allowing Taxpayer to remain qualified as a life insurance company and maintain as nontaxable its policyholder surplus account (PSA).

CONCLUSION:

We agree with the Field that the policies in question are not "guaranteed renewable" under the definition provided at Treas. Reg. § 1.801-3(d) and in accordance with the opinion of the United States Court of Appeals for the Fifth Circuit in Group Life and Health Insur. Co. v. United States, 434 F.2d 115 (5th Cir. 1970).[1] Taxpayer, therefore, does not qualify as a life insurance company. Consequently, Taxpayer's PSA account should be included in its taxable income for Year 3, the last year in which Taxpayer qualified as a life insurance company for Federal income tax purposes.

[redacted] These concerns are discussed infra.

[redacted]

FACTS:

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and in effect during the taxable years in issue.

[2] [redacted]

Taxpayer is incorporated as a life insurance company in State A. Taxpayer is licensed and authorized to write health, life, and accident insurance by State A's insurance regulatory authority. Until Year 1, Taxpayer primarily sold life and major medical hospitalization insurance. Starting in Year 1, Taxpayer suffered financial difficulties and began ceding most of its life insurance policies to reinsurers. Taxpayer again ceded life policies to reinsurers in Year 4. Taxpayer was under the supervision of State A during Years 4 and 5, and was placed in a state of conservatorship on Date 1, Year 6.

Following the reinsurance transaction in Year 4, Taxpayer's remaining business consisted primarily of its major medical hospitalization policies. For the taxable Years 4 and 5, Taxpayer filed Forms 1120, "U.S. Corporation Income Tax Return," rather than Forms 1120L, "U.S. Life Insurance Company Income Tax Return." Taxpayer's return for taxable Year 3, the last year in which it filed as a life insurance company, reflects a Policyholder's Surplus Account (PSA) in the amount of $X.

The Service issued a notice of deficiency which determined that Taxpayer ceased being a "life insurance company" in Years 4 and 5. Consequently, the Service determined that Taxpayer should have included the entire PSA account in its taxable income for Year 3, the last year in which Taxpayer qualified as a life insurance company for Federal income tax purposes. Taxpayer then filed a petition to the Tax Court, arguing that it qualified as a life insurance company for tax purposes for Years 4 and 5. Specifically, Taxpayer contends that it qualifies as a life insurance company because its major medical hopitalization policies constitute "guaranteed renewable contracts" for purposes of § 816(e).

LAW AND ANALYSIS

In order to qualify as a life insurance company, a taxpayer must meet the reserve ratio test set forth in § 816(a). Under the reserve ratio test, an insurance company will qualify as a life insurance company if its "life insurance reserves," plus the total amount of unearned premiums and unpaid losses (whether or not ascertained) on "noncancellable" life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of that insurance company's total reserves. § 816(a)(1), (a)(2). Section 816(e) further provides that "guaranteed renewable" life, accident, and health insurance shall be treated in the same manner as "noncancellable" life, accident, and health insurance.[3] Accordingly, whether

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[3] Under a "noncancellable" contract, the insurer agrees to provide coverage renewable for greater than one year, and the yearly premiums are fixed when the contract is entered. Under a "guaranteed renewable" contract, the insurer offers

Taxpayer in this case qualifies as a life insurance company for Years 4 and 5 turns on whether the major medical hospitalization policies at issue should be considered "guaranteed renewable" for purposes of § 816(e). If the policies are not considered guaranteed renewable for tax purposes, Taxpayer will not qualify as a life insurance company for Years 4 and 5. Consequently, Taxpayer's tax deferred PSA balance would be taxed subject to taxation in Year 3, the last year in which Taxpayer qualified as a life insurance company.

The Code treats guaranteed renewable health and accident policies in similar fashion to life insurance policies because the insurer under a guaranteed renewable contract, during the early years of a such policies, must typically set aside reserves to pay for claims in succeeding years where the premiums are generally insufficient to cover actual losses. Group Life and Health Insur. Co. v. United States, supra, at 117. Accordingly, to qualify as a guaranteed renewable contract, the regulations applicable to life insurance companies require that a policy meet two tests set forth in Treas. Reg. § 1.801-3(d): a "terms" test and a "reserves" test. Specifically, Treas. Reg. § 1.801-3(d) defines a guaranteed renewable life, health and accident insurance policy as a contract which is not cancellable by the company, but under which the company reserves the right to adjust premium rates by classes in accordance with its experience with the type of policy involved (the terms test), and with respect to which a reserve in addition to the unearned premiums, as that term is defined in Treas. Reg. § 1.801-3(e),[4] must be carried to cover that obligation (the reserves test). The terms test ensures that the policy is in fact guaranteed renewable as that term is understood within the industry, i.e., it is a policy under which the insurer cannot unilaterally adjust premiums due to the age and health of the insured individual. Cf. National States Insur. Co. v. Commissioner, 81 T.C. 325, 327 (1983), aff'd. 758 F.2d 1277 (8th Cir. 1985). The reserve test ensures that the policy is similar to a life insurance product insofar as it requires that the insurer maintain a reserve in addition to unearned premium

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coverage renewable for greater than one year, but may adjust yearly premiums to account for rising medical costs or experience with respect to the class of policy involved. See United Fire Insur. Co. v. Commissioner, 81 T.C. 368, 370-371 (1983), affd. 768 F.2d 164 (7th Cir. 1985). Under neither policy may the insurer adjust premiums due to the insured's age or specific health.

[4] Treas. Reg. § 1.801-3(e) provides:

> The term "unearned premiums" means 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.

reserves in order to provide for the increasing cost of coverage as the aging insured renews the policy. See Rev. Rul. 75-542, 1975-2 C.B. 262.

We first address the terms test. With respect to its major medical hospitalization insurance policies, Taxpayer contends that the policy form approved by State A is a guaranteed renewable policy. In this regard, Taxpayer maintains that it is required to renew these policies each year, provided that the policyholder pays the required premium. Taxpayer also explains that under the terms of the policy, and consistent with normal industry practice, it is permitted to increase premiums each year on relevant business by class but it cannot single out individual policies for premium increases. Since these facts are not in dispute, the policies satisfy the terms test.

We now address the reserves test. As mentioned, Taxpayer will meet this test if it has maintained reserves under these policies in addition to its unearned premium reserve. Taxpayer's Annual Statements for Years 4 and 5 reflect that, with respect to the policies at issue, Taxpayer failed to maintain any reserves in addition to an unearned premium reserve.[5] Thus, the Field maintains that the reserve test has not been met with respect to these policies and that, consequently, these policies cannot be considered guaranteed renewable for tax purposes.

In contrast, Taxpayer argues that since it is obligated to renew the policies at issue until the insureds reach age Y, the premium charged for any period often exceeds the anticipated cost of providing coverage for that policy year. Thus, argues Taxpayer, premiums in the present year are calculated to pay claims in succeeding years. With respect to its failure to maintain separate reserves for these anticipated claims, Taxpayer explains that it determined its unearned premium reserves relating to the policies at issue by using the "gross unearned premium" method. Under this method, an insurer does not indicate separately the component of the premium attributable to the anticipated cost of providing coverage for the policy year from the component of the premium attributable to commissions, expenses, taxes, and the cost of providing coverage for succeeding years in which the policy is renewed. Taxpayer contends that, because it determined its unearned premium reserves on a "gross" basis, the unearned premium reserve "inherently" includes the additional reserve component contemplated by Treas. Reg. § 1.801-3(d), i.e., the anticipated cost of providing coverage to insureds in succeeding policy years.

The plain language of Treas. Reg. § 1.801-3(d) supports the Field's position; the phrase "reserve in addition to unearned premiums" requires the existence of actual

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[5] The term "Annual Statement" refers to the statement approved by the National Association of Insurance Commissioners and filed annually by insurers with state insurance regulatory agencies.

reserves in addition to unearned premiums, regardless of whether the policies in question could be canceled by the insurer. In this regard, the Field's interpretation of the regulation is consistent with Service position. See Rev. Rul. 75-452, supra (explaining that the taxpayer must maintain a reserve in addition to its unearned premium reserve in order to qualify policies as "noncancellable"). Moreover, the Fifth Circuit, has held that an insurer could not treat certain renewable group health insurance policies as guaranteed renewable because the insurer failed to set aside actual reserves in addition to an unearned premium reserve with respect to those policies. Group Life, supra. The court rejected the conclusion of the United States District Court for the Northern District of Texas that, simply because a policy is renewable at a premium rate that remains level for a "long period of time," the policies must be considered guaranteed renewable for tax purposes. The Fifth Circuit criticized the lower court's failure to consider whether the taxpayer maintained a reserve in addition to unearned premium reserves as required by Treas. Reg. § 1.801-3(d). Id. at 120. The court regarded this requirement as important because the taxpayer's unearned premium reserve, once it becomes "earned," may be used by the taxpayer for any purpose while an additional reserve for unpaid claims may not. Id. Therefore, the Fifth Circuit's opinion, by explaining this inherent distinction between an unearned premium reserve and a reserve for future claims, implicitly suggests that neither a gross nor net unearned premium reserve may ever contain the additional reserve required by the regulation. See National States, 81 T.C. at 361-362 (Korner, J., dissenting) (arguing that a gross unearned premium reserve is "inherently incapable" of serving the function of the "additional" reserve contemplated by Treas. Reg. § 1.801-3(d)).

In an attempt to distinguish the facts in this case from the facts in Group Life, Taxpayer argues that the policies at issue in Group Life covered groups, whereas Taxpayer's policies covered individuals. Accordingly, argues Taxpayer, the taxpayer in Group Life did not accept risks which increased yearly, because the average age of the members of the covered group remained the same from year to year. Thus, Taxpayer contends that it was possible for the taxpayer in Group Life to establish gross unearned premium reserves which contained no component attributable to claims anticipated in succeeding policy years. In this case, argues the Taxpayer, since the policies are guaranteed renewable policies which cover individuals, the risks associated with the policies necessarily increase with as the insured gets older. Therefore, Taxpayer's gross unearned premiums reserves must contain amounts to cover future losses.

We conclude that this distinction is immaterial. The court in Group Life was not primarily concerned with whether the risks attributable to the policy actually increased with each yearly renewal; rather, the court examined whether the taxpayer had complied with Treas. Reg. § 1.801-3(d) by establishing a reserve in addition to its unearned premium reserve. As discussed supra, the court in Group

Life explained that unearned premium reserves are different than reserves to pay claims in succeeding years. In this regard, we disagree with Taxpayer's argument that its gross unearned premium reserve inherently contains the additional reserve component required by Treas. Reg. § 1.801-3(d). As explained by the court in Group Life, Taxpayer's gross unearned premium reserve expires at the end of each policy term and does not earmark funds to pay for claims beyond that term. Moreover, unlike funds placed in a loss reserve, Taxpayer has free use of the proceeds in an unearned premium reserve once the premium is earned.

We also note that if Taxpayer's argument were accepted, the reserve test provided in Treas. Reg. § 1.801-3(d) would be unnecessary; as long as the terms of the policy appear to increase the insurer's risks were the insured to renew the policy, then the reserves test will be deemed satisfied. Taxpayer's approach, if accepted, would require courts on a case by case basis to analyze in detail the provisions of each policy to determine the precise nature of the risks shifted; effectively, the reserves test would become an expanded and complicated terms test. The Service's position addresses Taxpayer's concern in a simpler fashion; as long as the insurer establishes reserves in addition to its unearned premium reserve, it is assumed that the insurer anticipates increased risks as the policy is renewed in succeeding years, and may treat the policy as guaranteed renewable.

In further support of its position, Taxpayer cites United Fire Insur. Co. v. Commissioner, 81 T.C. 368 (1983), affd. 768 F.2d 164 (7th Cir. 1985) and National States Insur. Co. v. Commissioner, supra. In each of those cases, the Tax Court concluded that, although the taxpayers failed to maintain a reserve in addition to their unearned premium reserves during the first two years following policy issuance, the policies could be treated as guaranteed renewable for tax purposes. In so doing, the court rejected the Service's argument that the taxpayers' failure to establish reserves in addition to an unearned premium reserves precluded, per se, the taxpayers' treatment of their renewable health and accident insurance policies as "guaranteed renewable" for tax purposes.[6] The court in both cases reasoned that the taxpayers had elected a "preliminary term" method of calculating reserves, whereby the applicable state regulatory authorities did not require that the taxpayers maintain actual reserves in addition to unearned premium reserves until the policy had been in effect for more than two years. The taxpayers actually established reserves in addition to unearned premium reserves once the policy was renewed for a third year. The court in National States further noted that for any given year, the "additional reserves" attributable to policies renewed for greater than two years could be attributed to similar policies in effect for less than two years. National States, 81 T.C. at 340.

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[6] The Eighth Circuit in affirming National States characterized the Government's position as "hypertechnical." 758 F.2d at 1279.

We conclude that the facts in this case are distinguishable from the facts in National States and United Fire. With respect to the policies at issue in those cases, the taxpayers eventually established significant reserves in addition to their unearned premium reserves. The court accorded significant weight to this fact. In contrast, it does not appear the Taxpayer has ever established reserves in addition to its gross unearned premium reserves with respect to the policies in effect during Years 4 and 5.

For the foregoing reasons, we agree with the Field that the contracts in question do not constitute "guaranteed renewable" contracts for purposes of § 816(e).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Due to the Tax Court's opinions in United Fire and National States, it is possible, albeit unlikely, that the court will reject our argument that Taxpayer's failure to establish additional reserves precludes the policies in question from being considered "guaranteed renewable." Therefore, our case would be strengthened were we to persuade the court that Taxpayer failed to establish additional loss reserves for business reasons, rather than because of its belief that the Code did not require a separate reserve. [redacted]

Accordingly, we encourage you to develop the following facts:

(1) What portion of Taxpayer's gross unearned premium reserve was actually attributable to future anticipated claims as opposed to commissions, taxes, and expenses? It appears that Taxpayer did not earmark additional reserves for future claims because they were not necessary from a business standpoint, given the terms of the policies.

(2) On what basis did Taxpayer increase premiums under these policies? It is possible that the policies allowed Taxpayer to make sufficient premium increases in future years to meet the rising costs of coverage. Accordingly, an additional reserve would not be necessary from a business standpoint. The court in <u>Group Life</u> discussed expert

testimony that, under the terms of the policies at issue, additional reserves were not necessary from a business standpoint.

[redacted]

Please call if you have any further questions.

By: ______________________________

JOEL E. HELKE
Branch Chief
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cc: