

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM  
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CASE MIS No.: TAM-106568-99  
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District Director

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No:  
Years Involved:  
Date of Conference:

LEGEND:

Taxpayer =

Surplus Notes =

Tax Year =

Month =

Date 1 =

State Commissioner =

a =

b =

ISSUE:

Whether Taxpayer's Surplus Notes must be included in surplus and capital under section 809(b)(2)(A) of the Internal Revenue Code for purposes of calculating Taxpayer's equity base under section 809(b)(2) for Tax Year.

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## CONCLUSION:

Taxpayer properly excluded its Surplus Notes from surplus and capital under section 809(b)(2)(A) for purposes of calculating Taxpayer's equity base under section 809(b)(2) for Tax Year.

## FACTS:

During Tax Year, Taxpayer was organized and taxed as a mutual life insurance company. In Month of Tax Year, Taxpayer issued Surplus Notes. Taxpayer represents that its business purpose in issuing the notes was to improve its financial strength and capital position, and to enhance its ability to improve and expand its insurance operations.

The Surplus Notes were issued pursuant to authorization granted in an Order of the State Commissioner dated Date 1 ("Date 1 Order"). Pursuant to the Date 1 Order, payment of interest on the Surplus Notes, repayment of the principal amount at maturity, and any redemption payment may be made by Taxpayer only with the prior written approval of the State Commissioner. The Date 1 Order further provides that if Taxpayer issues the Surplus Notes in the form acceptable to the State Commissioner, the Surplus Notes will not be required to be reported as part of the legal liabilities of Taxpayer. The Surplus Notes are denominated as indebtedness. The District concedes that the Surplus Notes are to be treated as debt for purposes of computing deductions and does not argue that the Surplus Notes should be treated as equity for all tax purposes. The Surplus Notes specify a stated principal amount of indebtedness, a term of a years, and a stated interest rate of b percent. The proceeds of the Surplus Notes were recorded by Taxpayer as admitted assets on Taxpayer's books. The Surplus Notes were reported as surplus on Taxpayer's Tax Year annual statement.

For tax purposes, Taxpayer included the Surplus Notes on line 1(b) of Schedule C to Form 1120L for Tax Year, "Annual statement surplus and capital." Taxpayer deducted the Surplus Notes under line 6(b) of Schedule C to Form 1120L for Tax Year, "Other voluntary reserves." On Form 8390 for Tax Year, Taxpayer excluded Surplus Notes from line 1(d) "Surplus and capital" per the instructions to Form 8390.

## LAW AND ANALYSIS:

### Background

Section 808(a) of the Code prescribes a policyholder dividends deduction which, under section 808(c)(1), for any tax year is an amount equal to the policyholder dividends paid or accrued during the tax year. Section 808(c)(2) provides that in the case of a mutual life insurance company, the deduction for policyholder dividends for any tax year shall be reduced by the amount determined under section 809. Section

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809(a)(1) requires a mutual life insurance company's deduction for policyholder dividends to be reduced (but not below zero) by the differential earnings amount which, as defined in section 809(a)(3), is the life insurance company's average equity base for the tax year multiplied by the differential earnings rate for such tax year.

The average equity base of a company is the component of the section 809 calculations which represents an individual company's equity (for purposes of the differential earnings amount) and aggregate company equity (for purposes of the differential earnings rate). The differential earnings rate used in section 809(a) is computed by analysis of data from all mutual insurance companies and the top fifty stock insurance companies. These companies are required to report their equity base each tax year on Form 8390.

The term "equity base" is defined as follows:

(2) EQUITY BASE.--The term "equity base" means an amount determined in the manner prescribed by regulations equal to --

(A) the surplus and capital,

(B) adjusted as provided in paragraphs (3), (4), (5), and (6) of this subsection.

No item shall be taken into account more than once in determining equity base.

I.R.C. section 809(b)(2).

Definitions and special rules applicable to section 809 are covered by section 809(g):

(g) DEFINITIONS AND SPECIAL RULES.--For purposes of this section--

(2) OTHER TERMS.--Except as otherwise provided in this section, the terms used in this section shall have the same respective meanings as when used in the annual statement.

(3) DETERMINATIONS BASED ON AMOUNT SET FORTH IN ANNUAL STATEMENT.--Except as otherwise provided in this section or in regulations, all determinations under this section shall be made on the basis of the amounts required to be set forth on the annual statement.

(4) ANNUAL STATEMENT.--The term "annual statement" means the annual statement for life insurance companies approved by the National Association of Insurance Commissioners.

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Generally, statutory accounting principles require that indebtedness be reported as debt liability on the annual statement. However, the National Association of Insurance Commissioners ("NAIC") Accounting Practices and Procedures Manual (at page 27-2) recognizes that, because of the payment restrictions placed on surplus notes, some jurisdictions grant "an insurer permission to report a surplus note instrument as a component of its surplus account." Recognizing this fact, the NAIC Accounting Practices and Procedures Manual provides that, if permitted by State law, surplus note "instruments may be reported as surplus and not as debt."

#### District's Primary Argument: NAIC Annual Statement Controls

The District's primary argument is that because Surplus Notes were included as surplus on Taxpayer's Tax Year annual statement, section 809(b)(2)(A) requires their inclusion in capital and surplus for purposes of computing Taxpayer's equity base for purposes of Form 1120L, Schedule C. Taxpayer responds, in part, that reporting Surplus Notes as surplus, rather than a liability, is permissive and not mandatory. Thus, Taxpayer argues, Surplus Notes were not amounts "required to be set forth on the annual statement" as surplus. See section 809(g)(3).

Section 809(b)(2)(A) is not explicit as to how surplus notes should be treated. No regulations directly on point, that is, mandating the inclusion or exclusion of surplus notes in the calculation of equity base, have been issued. The only regulation issued which is pertinent to the calculation of equity base is Treas. Reg. section 1.809-10. The regulation clarifies that for purposes of section 809, the equity base of a life insurance company includes both the asset valuation reserve and interest maintenance reserve. This clarification was necessary because of changes made to annual statement reporting requirements.

Section 7805(a) is a general grant of authority by Congress to the Commissioner to promulgate – as necessary – "interpretative regulations" stating the agency's views of what the existing Code provisions already require. *E.I. duPont de Nemours & Co. v. Commissioner*, 41 F.3d 130, 135 & n.20 (3<sup>rd</sup> Cir. 1994). "Section 7805(a) does **not** require the promulgation of regulations as a prerequisite to the enforcement of each and every provision of the Code." *U.S. v. Langert*, 902 F. Supp. 999, 1002 (D. Minn. 1995) (emphasis in original). The Commissioner's power to promulgate regulations pursuant to section 7805(a) . . . "is not the power to make law," but only the power "to carry into effect the will of Congress as expressed by the statute." *Lovett's Estate v. United States*, 621 F.2d 1130, 1135 (Ct. Cl. 1980) (citations omitted). Thus, if the Congressional mandate of a Code provision is sufficiently clear, an interpretative regulation is not necessary. *Russell v. United States*, 95-1 U.S. Tax Cas. (CCH) P 50,029, at 87,122 (W.D. Mich. Nov. 23, 1994).

Where an interpretative regulation has not been promulgated, other forms of guidance may prove useful to taxpayers. Section 601.601 of the Treasury Regulations

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provides:

Rules and regulations.

(a) Formulation. (1) Internal revenue rules take various forms. The most important rules are issued as regulations and Treasury decisions prescribed by the Commissioner and approved by the Secretary or his delegate. Other rules may be issued over the signature of the Commissioner or the signature of any other official to whom authority has been delegated. . . .

Section 601.602 of the Treasury Regulations provides:

Tax Forms and instructions.

. . .

(b) Other forms and instructions. In addition to tax return forms, the Internal Revenue Service furnishes the public copies of other forms and instructions developed for use in complying with the laws and regulations. These forms and instructions lead the taxpayer step-by-step through data needed to accurately report information required by law.

For tax years after 1987, Form 8390 contains the following instructions with regard to how to compute surplus and capital for purposes of calculating equity base: “**Do not** include surplus notes” (Form 8390, emphasis in original). These instructions were added to Form 8390 after the Internal Revenue Service studied the issue and conferred with industry representatives. The conclusion was reached that the purpose of determining a company’s “equity base” is to help establish the amount of earnings mutual companies distribute to their owners. The formula created by Congress assumed these amounts would be proportional to the owners’ equity in the business. See S. Pt. No. 169 (Vol. I), 98th Cong., 2d Sess. 549, 551(1984). Thus, the purpose of the calculation of a company’s “equity base” is to provide an approximation of that company’s equity. With respect to surplus notes in general, it is well established that surplus notes are treated as debt for tax purposes. See *Rev. Rul.* 68-515, 1968-2 C.B. 297; *Anchor National Life Insurance Company v. Commissioner*, 93 T.C. 382 (1989). The Internal Revenue Service made an administrative decision that surplus notes are properly excluded from surplus in the calculation of equity base. The decision would also achieve consistency between section 809 and other sections of the Code. This request for advice arose because the wording “do not include surplus notes” (emphasis quoted from Form 8390) used on Form 8390 was not concurrently carried to Schedule C of Form 1120L. Because both Form 8390 and Schedule C of Form 1120L involve calculations which include equity base, the administrative decision regarding the instructions of Form 8390 should also apply to filing Form 1120L.

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Although Form 8390 does not speak directly to the issue of the calculation of equity base for purposes of Form 1120L, the Internal Revenue Service has indicated that the calculation of equity base for purposes of section 809 should be consistent for both purposes:

. . . Under the final regulations, the asset valuation reserve and the interest maintenance reserve must be included in the calculation of the equity base for purposes of section 809. This requirement is reflected on both Form 1120L and Form 8390. See Announcement 93-117, 1993-29 I.R.B. 85. Thus, there is consistency between the calculations of the equity base on Form 1120L and on Form 8390. Preamble, T.D. 8564, 59 F.R. 49577, 49578 (September 29, 1994).

The Preamble also notes that a comment was received on Temporary Regulation section 1.809-10 arguing that the temporary regulation was “. . . inconsistent with the requirement that all determinations generally be made on the basis of the amounts required to be set forth on the annual statement . . .”. Nonetheless, no changes were made to the final regulation based on this comment. The drafters of section 809 recognized that referencing the annual statement could be problematic because the NAIC regularly updates the annual statement including the manner in which items are required to be reported. As such, as reporting requirements change, annual statement reporting may be altered in ways which impact the interpretation of section 809.

. . . Amounts included in equity under the bill would generally refer to and be valued as amounts shown on the annual statement of the company. However, a classification or characterization of an item on a company's annual statement in an attempt to avoid the requirements of the bill is to be disregarded. S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 549, 551(1984).

Any alteration in the annual statement by the NAIC may cause interpretative problems under the literal terms of section 809, regardless of whether or not the alteration is an attempt to avoid the requirements of section 809. Treas. Reg. 1.809-10 was necessary because the NAIC replaced the mandatory securities valuation reserve with the asset valuation reserve and interest maintenance reserve for NAIC annual statements for years covering 1992 and later years. As a result, the terminology used in section 809(b)(5)(A) became obsolete. The Preamble to Treas. Reg. 1.809-10 clarifies the Internal Revenue Service's perspective on the role of the annual statement for section 809 purposes:

. . . By providing in section 809(b)(5)(A) that the equity base includes the amount of the mandatory securities valuation reserve, Congress demonstrated its intent to include interest-related capital gains and losses

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in the equity base. Modification of the annual statement by the NAIC to eliminate and replace the mandatory securities valuation reserve cannot override the specific inclusion that Congress required for these gains and losses. Preamble, T.D. 8564, 59 F.R. 49577, 49578 (September 29, 1994).

Congress intended “equity base” for purposes of section 809 of the Code to approximate company equity. The statute does not speak explicitly to the proper treatment of “surplus notes.” Regardless of further evolution in annual statement reporting requirements mandated by the NAIC concerning surplus notes, it is well settled that they are to be treated as debt for tax purposes. Regulations are not necessary in order to implement section 809. Under the general authority granted to the Commissioner under section 7805(a) and Treas. Reg. section 601.602, the Commissioner has provided guidance on the proper treatment of surplus notes for purposes of the calculation of equity base in the instructions to Form 8390. This guidance implements Congressional intent. Finally, the calculation of equity base for purposes of section 809 should be consistent for purposes of both Form 1120L and Form 8390.

#### Additional District Arguments

The District makes the following additional arguments for including Taxpayer’s Surplus Notes in the calculation of Taxpayer’s equity base:

- Exclusion of surplus notes from statutory surplus results in inequitable treatment among mutual companies since two mutual companies with the same statutory surplus would have different surplus for tax purposes if only one had issued surplus notes.
- A debt-equity analysis is not relevant in order to determine average equity base for purposes of the differential earnings amount. Although surplus notes are considered debt for purposes of computing deductions, this characterization should not be controlling for purposes of the differential earnings amount because Congress dictated that annual statement accounting, rather than federal tax criteria, should determine whether notes should be included in the equity base.
- The instructions to Form 8390 provide no authority for Taxpayer to exclude surplus notes from its average equity base reported on Form 1120L.
- The NAIC adopted the Risk Based Capital Model in 1992. Companies can now access capital through surplus notes without negatively affecting their Risk Based Capital Ratio. As a result, mutual insurance companies have issued significantly more surplus notes than in previous years. This change in business

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practice works to the disadvantage of the government in terms of section 809 if surplus notes are allowed to be removed from surplus and capital for purposes of calculating equity base.

### Potential for Inequitable Treatment

As confirmed by the administrative decision to exclude surplus notes from the equity base on Form 8390, surplus notes do not constitute equity in a mutual company. Because equity base calculations are intended to measure the equity in a company, excluding surplus notes from this calculation ensures the accuracy of the measurement of companies' equity. It then follows that two companies having the same equity for tax purposes will be treated equally, even if their statutory surplus is not equal.

### Debt-Equity Analysis

The District argues that a debt-equity analysis is irrelevant in determining average equity base since referencing the annual statement in section 809(g) produces a number which correlates to "surplus" for State regulatory purposes. The District concedes that the Surplus Notes are to be treated as debt for purposes of computing deductions and does not argue that the Surplus Notes should be treated as equity for all tax purposes. In essence, the District's position is that even though the Surplus Notes are debt, they should be included in Taxpayer's equity base under section 809 because they were reported as "surplus" for State regulatory purposes. This argument must fail. As previously discussed, such a philosophy undermines Congressional intent that "equity base" approximate the equity in a company (for purposes of calculating the differential earnings amount) and the aggregate company equity (for purposes of calculating the differential earnings rate).

### Instructions to Form 8390

The District argues that the instructions to Form 8390 provide no authority for Taxpayer to exclude surplus notes from its average equity base reported on Form 1120L. As discussed above, it is clear that the Service believes there is consistency in the calculation of equity base for purposes of section 809 for both Form 8390 and Form 1120L. See Preamble, T.D. 8564, 59 F.R. 49577, 49578. The term "equity base" has one consistent meaning for all purposes of the application of section 809. As such, it is reasonable for Taxpayer to assume that the instructions are intended to describe the proper calculation of a company's "equity base" applicable for all purposes of section 809. If there were instructions to Schedule C of Form 1120L regarding surplus notes, they may have provided that surplus notes were to be excluded from line 1 of Schedule C, Form 1120L, to be consistent with Form 8390. Although there are no instructions specifically directed to the treatment of surplus notes on Schedule C of Form 1120L, the Taxpayer's Tax Year Schedule C computation reflected the proper interpretation of section 809.

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### Change in Business Practices

As discussed above, the legislative history to section 809 clarifies that amounts included in equity under the statute generally refer to the amounts shown on the annual statement of the company. Surplus notes are not required to be reported as surplus. While this is likely the preferable reporting position for mutual insurance companies for State regulatory purposes, it is not the only correct reporting position for State regulatory purposes. In any event, strict adherence to annual statement reporting without regard to Congressional intent in the application of section 809 is inappropriate. Congress recognized that annual statement reporting requirements may change and evolve. As the District points out, the NAIC's 1992 adoption of the Risk Based Capital Model to measure company solvency has helped fuel the increased proliferation of surplus notes issued by mutual companies. Thus, industry business practices have changed since 1992 and this change is reflected in companies' annual statement reporting. Congress intended "equity base" to approximate equity and thus surplus notes are properly excluded from the calculation of equity base regardless of the fact that they may be reported as surplus for regulatory purposes.

Assuming that the fact that more surplus notes are being issued by more mutual companies impairs the ability of section 809 to operate as intended by Congress, that fact does not enable us to interpret the term "equity base" in a manner that is inconsistent with Congressional intent; that is, that certain debt instruments must be included in a company's equity base. If business practices have changed so dramatically as to render section 809 impotent as drafted, Congress has the constitutional authority to change the statute.

### Taxpayer Demutualization

In addition to responding to the District's arguments, Taxpayer contends that if the Surplus Notes are to be included in Taxpayer's equity base, they must be treated as equity for all tax purposes. This treatment requires a finding that the Surplus Notes represent equity as opposed to debt. Under this analysis, the holders of the Surplus Notes are now equity owners of Taxpayer. Thus, Taxpayer is no longer a mutual insurance company and as such, is no longer subject to section 809. Stated another way, Taxpayer argues that if the Surplus Notes are equity, then the sale and purchase of the Surplus Notes resulted in a defacto demutualization of Taxpayer in Tax Year even though one did not occur under state law. We choose not to resolve this conceptual quandary in light of our conclusion stated above.

### CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.