

INTERNAL REVENUE SERVICE

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JUNE 13, 2000

Internal Revenue Service
National Office Technical Advice Memorandum

District Director,

Name of Taxpayer:

Taxpayer's Address:

Taxpayer's EIN:

Years Involved:

Taxpayer A =

Company B =

Year C =

State D =

Separate Account =

By Form 4463 you requested technical advice in the above captioned case. This memorandum responds to your request.

ISSUE:

Whether Company B's method of determining the amount of the company's share and the

policyholders' share for purposes of claiming a dividends received deduction is appropriate under section 812 of the Internal Revenue Code.

CONCLUSION:

Company B's method of determining the company's share and the policyholders' share of net investment income is an appropriate method under Internal Revenue Code section 812.

FACTS:

Company B is a stock life insurance company organized in Year C under the insurance laws of State D and is a wholly owned subsidiary of Taxpayer A. Company B is the depositor for separate accounts, including Separate Account.

Separate Account is a separate account established by Company B in Year C pursuant to the insurance laws of State D. Separate Account was formed for the purpose of segregating assets attributable to the variable portions of contracts from other assets of Company B. Separate Account is registered as a unit investment trust under the Investment Company Act of 1940 and meets the definition of "separate account" under the federal securities laws.

In determining the company's share of net investment income under section 812(b), Company B uses a methodology based upon the formulas contained in former Code section 801(g)(5) and regulations thereunder (sections 1.801-8(e) and (f)), substituting net investment income under section 812(c) for investment yield. The District Director proposes a similar methodology not taking into account the "net amount retained" as referred to in former section 801(g)(5).

LAW:

Section 805(a)(4) permits a life insurance company to deduct only the life insurance company's share of dividends (other than 100% dividends) received. Section 807 similarly excludes from certain reserves the policyholders' share of tax-exempt interest and other tax-favored items that might otherwise yield a double tax benefit.

Section 812 provides the rules for determining the company's share for purposes of section 805(a)(4) and the policyholders' share for purposes of section 807. Section 812(a)(1) defines the 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. Section 812(a)(2) defines the policyholders' share as the excess of 100 percent over the company's share percentage.

Section 812(b)(1) provides that the company's share of net investment income equals the excess, if any, of net investment income for the taxable year over the sum of (i) policy interest,

and (ii) gross investment income's proportionate share of policyholder dividends for the taxable year.

Section 812(b)(2) defines policy interest as the sum of (i) required interest (at the greater of the prevailing State assumed rate or the applicable Federal rate) on reserve items described in section 807(c), and (ii) certain other items. In a case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, another appropriate rate must be used for this purpose.

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

Section 817 prescribes special accounting rules with respect to variable contracts based on a segregated asset account. Section 817(c) requires a life insurance company that issues variable contracts to account separately for the various income, exclusion, asset, reserve, and other liability items properly attributable to those contracts.

Section 817(a) provides that with respect to variable contracts, the increases and decreases in the reserves are disregarded for purposes of section 807. Thus, deductions due to the variable contract reserve increases not generated by current taxable income are disregarded for purposes of computing a company's taxable income.

Under section 817(b), the basis of each asset in a segregated asset account is increased or decreased by the amount of appreciation or depreciation, to the extent the reserves are adjusted. This adjustment eliminates the corporate level capital gains tax with respect to appreciation income of assets held in a segregated asset account to the extent that the appreciation income is reflected in reserves for the variable contracts.

Section 817(f)(1) treats the reflection of the investment return and market value of the segregated asset account as an assumed rate of interest for purposes of determining qualification as a life insurance company under section 816.

ANALYSIS:

Section 812 contains no definition of required interest for purposes of computing the company's share of net investment income. Company B and the District Director agree that, in the case of variable contracts, neither the prevailing State assumed rate nor the applicable Federal rate is used. The issue, therefore, is what constitutes "another appropriate rate" for purposes of section 812(b).

Section 812 was enacted as part of the comprehensive revision of subchapter L in 1984. The committee reports indicate that where provisions of then-existing law were incorporated

into the revised provisions, the revised provisions are to be interpreted in a manner consistent with prior law. Thus, in the absence of contrary guidance in the committee reports, the regulations, rulings and case law may serve as interpretive guides to the new provisions. See H.R. Rep. No. 432, Part 2, 98th Cong., 2nd Sess. 1401 (1984); Sen. Rep. No. 167, Vol. 1, 98th Cong., 2nd Sess. 524 (1984). Moreover, with respect to proration, Congress made it clear that the formula in section 812 for determining the company's share and the policyholders' share was based generally on the proration formula under prior law in computing gains or loss from operations. Conference Report on the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., Report 98-861 at 1065 and 1066.

Prior to 1984, section 809(a)(1) generally defined the policyholders' share of investment yield as the percentage obtained by dividing the required interest by investment yield. Section 809(a)(2), in turn, defined required interest to mean the sum of the amount of qualified guaranteed interest plus the products obtained by multiplying (A) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in prior section 810(c), by (B) the means of the amount of such reserves computed at the rate at the beginning and end of the taxable year.

In the case of variable contracts, section 1.801-8(e)(1) of the regulations provided that the rate of interest assumed for purposes of prior section 809(a)(2) -- that is, required interest -- was a rate equal to the current earnings rate¹ determined under prior section 805(b)(2) and section 1.805-5 of the regulations, reduced by the percentage obtained by dividing:

the amount retained by the taxpayer from gross investment income on the segregated assets, to the extent the retained amount exceeded the deductions allowable under prior section 804(c) which were attributable to prior section 810(c) reserves, by

the mean of those reserves.

In the present case, Company B computed the company's share of net investment income using the formula set forth in prior section 809(a) and section 1.801-8(e)(1) of the regulations, except that Company B substituted net investment income under section 812(c) for investment yield. This substitution was made because "net investment income" under section 812(c) replaced "investment yield" under prior section 804(c) in 1984.

¹The 1984 Act originally provided that the amount of the required interest for reserves is determined at the prevailing State assumed interest rate. A technical correction in 1986 changed section 812 to provide that a company may use the prevailing State assumed rate or, if the prevailing State assumed rate is not used, another appropriate rate. S. Rep. No. 313, 99th Cong. 2d Sess. 972 (1986), 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 847 (1986) 1986-3 (Vol.4) 847.

The District Director argues that use of the formula, specifically the reduction for amounts retained, was distortive in this case, in part, because Company B computed its net investment income under section 812(c)(2) using a proxy rather than actual expenses, and at the same time took into account actual amounts retained under the formula. The District Director also argues that a more appropriate rate of interest under section 812(b) would be determined with reference to section 817(f)(1). Moreover, at least in one sense the amounts retained by Company B were economically more akin to fees than to tax-exempt interest or dividends received.

We are not persuaded that the simultaneous use of actual expenses under the proration formula of section 1.801-8(e) and a proxy under section 812(c) was distortive, since these amounts serve different purposes in the calculation. Nor do we believe that section 817(f)(1), which applies only for purposes of determining qualification as a life insurance company, has greater relevance to section 812 than does the actual predecessor to that section. 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.

Pursuant to section 6110(c)(1), names, addresses, and taxpayer identification numbers are required to be deleted from the copy of this technical advice memorandum that will be open to public inspection.

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