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memorandum**

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from: Alexis A. MacIvor
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subject:

EIN:

You requested assistance with respect to calculating, under the proration rules of § 812, company's share of dividends received deductions (DRD) for separate account assets invested in partnership funds. This advice may not be used or cited as precedent.

FACTS

is the common parent of an affiliated group of corporations filing consolidated returns. It owns (Taxpayer), a life insurance company as defined in § 816.

Taxpayer issues variable annuity contracts. The variable annuity contract holders pay Taxpayer certain contract related charges, such as mortality and expense charges, through a transfer of funds from the contract holders' separate accounts to Taxpayer's general account. Taxpayer reports this amount as income.

The variable annuity contracts are supported by separate accounts.¹ The separate accounts invest in funds, some of which are organized as partnerships.² With respect to these funds, Taxpayer pays investment expenses to its nonlife affiliate.

ISSUES

1. Whether the proration calculation under § 812 requires Taxpayer to compute its gross investment income for separate accounts invested in partnership funds net of investment expenses.
2. Whether including the partnership fund investment fees in amount retained is consistent with Treas. Reg. § 1.801-8(e).
3. Whether § 811(c)(3) precludes Taxpayer from deducting the investment fees because it paid them with funds derived from dividend income for which it received a DRD.

LEGAL BACKGROUND

Life Insurance Company Taxable Income

Life insurance company taxable income (LICTI) under § 801(b) refers to life insurance company gross income under § 803(a)(1), less the life insurance deductions under § 804. Life insurance gross income includes premiums, decreases in reserves, and all other amounts includible in gross income under subtitle A of the Code.³ Life insurance deductions include the deductions listed in § 805 and, subject to certain modifications, other deductions under the Code.⁴

With respect to variable contracts, a life insurance company must separately account for the various income, exclusion, deduction, assets, reserve and other liability items properly attributable to such variable contracts.⁵

Life Insurance Company DRD

Section 805(a)(4)(A)(ii) permits a deduction under § 243 for the life insurance company's share of dividends received deduction (other than 100%). Section 243(a) allows a corporation a deduction for amounts received as dividends from a domestic

¹ Each separate account is registered as unit investment trusts under the Investment Company Act of 1940.

² This memorandum is based on the treatment of the partnership funds as a partnership under Subchapter K and not as a publicly traded partnership, corporations, or trusts for Federal income tax purposes.

³ See, e.g., §§ 61(a)(7) (dividends), 61(a)(13) distributive share of partnership gross income, and 702 (income of a partner).

⁴ Sections 804(1), 805(a)(8).

⁵ Section 817(c).

corporation.⁶ Depending on the receiving corporation's stock ownership percentage in the dividend-paying corporation, and other factors, the corporate shareholder receives a 70%,⁷ 80%,⁸ or 100%⁹ DRD.

The company's share is determined under § 812. The company's share is the amount of net investment income that remains after the life insurance company pays or credits amounts to policyholders.¹⁰ This allocation between life insurance company's share and the policyholder's share of net investment income, as provided in § 812, is intended to eliminate the double tax benefit that would arise if the company were allowed to fund deductible reserve increases with tax exempt or tax preferred income. Proration limits the exclusion of tax exempt income, or the amount of DRD, to the company's share of such income.

Partnership and Partner DRD

In determining taxable income, each partner takes into account separately the partner's distributive share of taxable income or loss (excluding certain items for which the Code requires a separate computation), including the dividends that qualify for the DRD under § 243.¹¹

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under § 702(a) is determined as if the partner realized the income directly from the source (rather than through the partnership), or incurred the item in the same manner as incurred by the partnership.¹²

Under § 702(a)(5), dividends the partnership receives that qualify for the DRD pass separately to the partners. Under § 702(b), the dividends retain their character when allocated to the partners.¹³

⁶ The DRD prevents double taxation of income (operating/investment income to the corporation and dividend income to its corporate shareholder) for multi-level corporate structures.

⁷ Section 243(a)(1).

⁸ Section 243(c) provides that a corporate shareholder receiving a dividend from a 20% owned corporation (any corporation if 20% or more of the stock of such corporation (by vote and value) is owned by the corporate shareholder) is allowed an 80% DRD.

⁹ The 100% DRD applies to dividends received by a small business investment company and for qualifying dividends. Section 243(a)(2) and (3).

¹⁰ Joint Committee on Taxation, "General Explanation of the Revenue Provisions of the Tax Reform Act of 1984," p. 625.

¹¹ Sections 702(a)(5) and (8).

¹² Section 702(b).

¹³ In Treas. Reg § 1.701-2(d), Ex. 5, Corporation X and Corporation Y form Partnership. Partnership purchases Z common stock allocating the dividend income from the stock to provide Corporation X a floating-rate return based on the London Inter-Bank Offered Rate, allocating the remainder of the dividend income to Corporation Y, and permitting X and Y to claim the § 243 DRD on dividends allocated to each.

LAW AND ANALYSIS

ISSUE 1: Whether the proration calculation under § 812 requires Taxpayer to compute its gross investment income for separate accounts invested in partnership funds net of investment expenses.

Section 805(a)(4) prevents a life insurance company from funding its deductible reserves with tax preferred dividends by limiting the company's dividends received deduction to the company's share of the dividends received.¹⁴

Section 812 provides, for purposes of § 805(a)(4), the calculation of the company's share. Under § 812(d), this calculation starts with the life insurance company's gross investment income for the taxable year.

LB&I suggests that Taxpayer should compute its gross investment income for separate accounts invested in partnership funds net of investment expenses. However, Taxpayer does not compute its gross investment income for separate accounts invested in partnership funds net of investment expenses.

Partnerships distribute gross investment income to their partners and the partners receive their distributive share of the corporate dividends and a flow-through of their share of partnership investment expenses. Section 702(a)(5). A partner that is a life insurance company includes its distributive share of the partnership gross investment income in its gross investment income under § 812(d). Taxpayer does not reduce its gross investment income by investment expenses when computing its gross investment income under § 812(d).

ISSUE 2: Whether including the partnership fund investment fees in amount retained is consistent with Treas. Reg. § 1.801-8(e).

Treas. Reg. § 1.801-8(e)(1)(i)¹⁵ defines amount retained¹⁶ as “[a]ny amount retained with respect to all of the reserves on a segregated asset account... from gross investment income... on segregated assets, to the extent such retained amount

¹⁴ See § 805(a)(4)(A)(ii).

¹⁵The calculation of required interest involves multiplying the mean of reserves for the taxable year by a rate of interest. With respect to calculating required interest at another appropriate rate the Service has allowed a modified version of the formula, set forth in Treas. Reg. § 801-8(e), to be used to determine another appropriate rate. *Examination of Dividends Received Deduction on Separate Accounts of Life Insurance Companies*, LMSB-4-0510-015 (May 20, 2010). We express no opinion whether required interest on life insurance reserves is determined using another appropriate rate.

¹⁶ Historically, amount retained was the amount the life insurance company held from the gross investment income on all segregated asset accounts to cover general expenses in excess of the expenses provided for in the charges made against premiums to cover actuarial contingencies and increase surplus. See Senate Report No 291, 86th Cong, 1st Session 36, 43.

exceeds the deductions allowable under [prior law] § 804(c) which are attributable to such reserves.” The regulation provides two Examples, simplified below.

For Separate Account A, the company had retained with respect to such reserves from gross investment income a total of \$4,720. It had allowable prior law¹⁷ § 804(c) deductions with respect to the account of \$4,000. Therefore, the amount retained was \$720 (\$4,720 - \$4,000).

For Separate Account B, the company had retained with respect to such reserves from gross investment income a total of \$5,720. It had allowable prior law § 804(c) deductions with respect to the account of \$4,400. Therefore, the amount retained was \$1,320 (\$5,720 - \$4,400).¹⁸

LB&I argues that including the partnership fund fees in amount retained is not consistent with Treas. Reg. § 1.801-8(e). LB&I proposes to include in amount retained only the amounts for fees and expenses transferred from the separate account to the Taxpayer’s general account. However, including the partnership fund fees in amount retained is consistent with Treas. Reg. § 1.801-8(e).

Treas. Reg. § 1.801-8(e) provides, and the related examples show, that amount retained includes any amount of gross investment income not credited to the reserves. Accordingly, it is consistent with Treas. Reg. § 1.801-8(e) for Taxpayer to include in amount retained the amount transferred from the separate account and paid by Taxpayer to its nonlife affiliate as investment fees.

ISSUE 3: Whether § 811(c)(3) precludes Taxpayer from deducting the investment fees because it paid them with funds derived from dividend income for which it received a DRD.

LB&I posits that § 811(c)(3) denies Taxpayer its distributive share of the investment expense deduction because Taxpayer already received a DRD on its distributive share of dividend investment income and allowing both gives Taxpayer a double deduction. We disagree.

Section 811(c)(3) disallows a double deduction for the same item. However, because the dividend for which Taxpayer received the DRD is an income item¹⁹ (albeit, due to the DRD, subject to tax at a lower effective tax rate) and investment expenses are a general deduction,²⁰ they are not the same item. Furthermore, LB&I’s theory is inconsistent with DRD proration. Once a life insurance company determines its company’s share of DRD, it can use the resulting dividend income to pay deductible expenses or fund its reserves just as it could with any other income. Therefore,

¹⁷ Internal Revenue Code of 1959.

¹⁸ Treas. Reg. § 1.801-8(e)(4)(c) and (d).

¹⁹ Section 812(d)

²⁰ Section 805(a)(8).

§ 811(c)(3) does not preclude Taxpayer from deducting investment expenses even if it paid them from dividend income for which it received a DRD.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call 202-317-4426 if you have any further questions.

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