US A A Life Insurance Co. v. Commissioner, 94 T. C. 149 (1990)

Life insurance reserves computed as net level reserves, even if labeled as preliminary term reserves, are not eligible for revaluation under section 818(c).

Summary

US A A Life Insurance Co. sought to revalue its universal life insurance reserves under section 818(c) for 1983, arguing they were computed on a preliminary term basis. The court held that the reserves were actually net level reserves, despite the company's labeling, and thus ineligible for revaluation. The company had used the aggregate cash surrender value as its reserve, which was required by Texas law and closely approximated the net level reserve under the NAIC model. The court's decision was based on the statutory definition of life insurance reserves and the legislative intent behind section 818(c), emphasizing that only reserves genuinely computed on a preliminary term basis qualify for revaluation.

Facts

US A A Life Insurance Co. , a Texas-based life insurance company, sold universal life insurance policies starting in 1982. These policies had flexible premiums and death benefits, with cash values calculated monthly. The company calculated its 1983 universal life reserves using the aggregate cash surrender value of its policies, which was required by Texas law to be at least equal to the cash surrender value. The company attempted to follow the NAIC model for calculating a preliminary term reserve but used the aggregate cash surrender value as an approximation of the net level reserve. The resulting reserve was reported in two parts on the company's annual statement: a purported preliminary term reserve in exhibit 8A and a reserve for excess cash surrender value in exhibit 8G.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the company's federal income tax for 1982 and 1983, disallowing the revaluation of the universal life reserves under section 818(c). The company conceded some issues but contested the disallowance of the revaluation. The Tax Court held that the reserves were not eligible for revaluation because they were essentially net level reserves, not preliminary term reserves.

Issue(s)

1. Whether the life insurance reserves for the company's universal life policies in 1983 were computed on a preliminary term basis, making them eligible for revaluation under section 818(c).

Holding

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1. No, because the reserves were computed as net level reserves rather than on a preliminary term basis. The company's use of the aggregate cash surrender value as a reserve, required by Texas law, resulted in a net level reserve, not a preliminary term reserve, making it ineligible for revaluation under section 818(c).

Court's Reasoning

The court analyzed the statutory definition of life insurance reserves under section 801(b) and the legislative history of section 818(c). It determined that the company's reserves, despite being labeled as preliminary term reserves, were actually net level reserves because they were based on the aggregate cash surrender value, which closely approximated the net level reserve under the NAIC model. The court emphasized that section 818(c) was intended to equalize the tax treatment between companies using preliminary term methods and those using net level methods, not to allow companies to revalue net level reserves. The company's attempt to bifurcate its reserves into exhibit 8A and 8G was seen as an attempt to create a preliminary term reserve artificially, which was not supported by the law or legislative intent.

Practical Implications

This decision clarifies that life insurance companies cannot artificially create preliminary term reserves for tax purposes by labeling net level reserves differently. It impacts how companies calculate and report their reserves, especially in states with minimum reserve requirements based on cash surrender values. The ruling may affect companies' tax planning strategies, particularly those involving universal life insurance products. Subsequent cases have applied this principle to ensure that only genuine preliminary term reserves qualify for section 818(c) revaluation, reinforcing the need for accurate reserve computation and reporting.

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