Phoenix Mutual Life Insurance Co. v. Commissioner, 96 T. C. 497 (1991)

Reserves for extended life insurance coverage for disabled employees qualify as life insurance reserves under the Internal Revenue Code.

Summary

Phoenix Mutual Life Insurance Co. contested the IRS's determination that its reserve for extended life insurance coverage for disabled employees under group term policies did not qualify as a life insurance reserve. The court held that these reserves met the statutory definition under section 801(b) of the Internal Revenue Code, which requires reserves to be computed based on recognized mortality or morbidity tables and assumed rates of interest, and to be set aside for future unaccrued claims. The court also addressed the treatment of deferred and uncollected premiums in group term life insurance, affirming their inclusion in life insurance reserves, and clarified that a portion of agents' commissions could be treated as investment expenses related to policy loans.

Facts

Phoenix Mutual Life Insurance Co. issued group term life insurance policies that provided extended life insurance coverage without further premium payments for employees who became totally disabled. The company maintained a reserve for these disabled employees, which was challenged by the IRS as not qualifying as a life insurance reserve. Phoenix Mutual also included net deferred and uncollected premiums in its reserves, assets, and premium income for these group policies. Additionally, the company treated a portion of its agents' commissions as investment expenses, given the agents' role in explaining policy loan features.

Procedural History

The IRS issued a notice of deficiency to Phoenix Mutual Life Insurance Co. for the year 1980, disallowing the deduction of the reserve for disabled employees and the treatment of deferred and uncollected premiums as life insurance reserves. The company petitioned the United States Tax Court for a redetermination of the deficiency. The court issued a supplemental opinion after considering the remaining issues following its initial opinion.

Issue(s)

1. Whether a reserve set aside by Phoenix Mutual for insureds eligible for extended insurance coverage without further premium payment due to disability qualifies as a "life insurance reserve" under section 801(b) of the Internal Revenue Code.
2. Whether the portion of Phoenix Mutual's reserves attributable to net deferred and uncollected premiums on group term life insurance policies qualifies as a life insurance reserve under sections 801(b) and 818(a) of the Internal Revenue Code.
3. Whether a portion of the agents' commissions paid by Phoenix Mutual with

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respect to ordinary life insurance policies may be treated as a general expense assigned to investment expenses under section 804(c)(1) of the Internal Revenue Code, and if so, what portion.

Holding

1. Yes, because the reserve was computed using recognized tables and set aside for future unaccrued claims related to life insurance, meeting the criteria of section 801(b).
2. Yes, because the reserve was computed consistently with the method required for the annual statement and was required by law under section 801(b)(2), and the use of an annual premium assumption was supported by the Supreme Court's decision in Standard Life & Accident Insurance Co.
3. Yes, because the commissions were general expenses that could be assigned to investment expenses based on the agents' involvement in policy loan activities, with the court determining that 13% of first year and renewal commissions qualified as investment expenses.

Court's Reasoning

The court analyzed the statutory language of section 801(b), concluding that the disabled lives reserve was set aside to pay future unaccrued claims arising from life insurance contracts. The court rejected the IRS's argument that the extended insurance should be treated as health insurance, emphasizing that the reserve related to life insurance claims. For the deferred and uncollected premiums, the court relied on the Supreme Court's holding in Standard Life & Accident Insurance Co. , which allowed for the use of an annual premium assumption in reserve calculations. The court also found that these reserves were required by law under Connecticut regulations. Regarding agents' commissions, the court determined that a portion could be allocated to investment expenses due to the agents' role in facilitating policy loans, which generate investment income.

Practical Implications

This decision clarifies the treatment of reserves for extended insurance coverage for disabled employees, affirming their classification as life insurance reserves. It also supports the inclusion of deferred and uncollected premiums in life insurance reserves for group term policies, impacting how insurance companies calculate their reserves. The ruling on agents' commissions as investment expenses could influence how insurance companies allocate expenses between underwriting and investment functions, potentially affecting their tax liabilities. Subsequent cases, such as Aetna Life Insurance Co. v. United States, have followed this ruling, reinforcing its precedent in the insurance industry.

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