

Excess Interest Reserves as Defined Under Internal Revenue Code §811(d)

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Key Points

Excess interest reserves for tax purposes are likely to occur for annuities in a rapidly increasing interest rate environment.

- Tax basis excess interest differs from excess interest in actuarial valuation.
- An interactive example of the computation of tax excess interest is included with the paper.

Notes and Disclaimers

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A number of terms referred to in this paper are found in actuarial literature. However, some of these terms may be defined differently in the Internal Revenue Code (IRC). The IRC definitions of certain terms are provided throughout this paper. If there are additional questions about the meanings of terms, the reader should consult with a tax advisor.



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Introduction

The purpose of this paper is to discuss the concept of excess interest reserves (as described in IRC §811(d)) in the context of calculating tax reserves for insurance companies under IRC §807(c)(1). The potential impact and implementation of the excess interest concept as related to principles-based reserves (PBR) is beyond the scope of this paper.

Excess interest reserves are unlikely to arise in a low or declining interest rate environment. As interest rates increase, however, the actuary should consider excess interest reserves in calculating tax reserves. This paper will discuss what constitutes an excess interest reserve under the IRC, why excess interest reserves have increased visibility in the current economic environment and some of the issues involved in determining the calculation of excess interest reserves.

It is important to emphasize that “excess interest,” as defined for tax reserving, is different from what actuaries usually think of as “excess interest.” For example, a company can be crediting no interest in excess of what was guaranteed at issue but have excess interest reserves as defined under the IRC, which are not deductible.

Background

IRC §811(d), which prescribes the limitation on tax basis excess interest reserves, was meant to address concern that allowing tax deductions for reserves attributable to interest guarantees beyond the end of the year in excess of the rate used in calculating state law reserves would unduly accelerate tax reserve deductions. The concern was expressed in terms of avoiding a timing mismatch: the interest earnings funding such interest guarantees would not be brought into income until the future year or years, but the reserve reflecting the guarantee, and hence the deduction, would arise in the current year. The following passage from the 1982 TEFRA Blue Book relating to IRC §818(h), which was the predecessor section to IRC § 811(d), reflects the reasoning underlying the provision:

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Under prior law, certain taxpayers had calculated reserves for certain deferred annuities and similar contracts (including certain tax-qualified pension contracts) in a manner that accelerated deductions for interest (in excess of the rate assumed for State law purposes) guaranteed for periods subsequent to the taxable year. In general, the reserve was computed by assuming that the interest guaranteed for future periods would be paid at the guaranteed rate but discounting the amount so computed to present value at the end of the company's taxable year at the low rate assumed for State regulatory purposes (typically at a rate of approximately 4 percent). The effect of computing reserves in this manner was to accelerate deductions in computing gain from operations for interest payable in subsequent taxable years. This computation also increased the reserves for purposes of computing the portion of investment yield excludable from taxable investment income.¹

Tax Basis Excess Interest Reserves

Tax basis excess interest reserves in the context of an insurance company calculation of tax reserves are reserves that result from the guarantee of interest that is to be paid or credited after the end of the current tax year, which is in excess of the prevailing state assumed interest rate (PSAIR). The limitation on the deduction of tax basis excess interest reserves is described in IRC §811(d)²:

“§811(D)METHOD OF COMPUTING RESERVES ON CONTRACT WHERE INTEREST IS GUARANTEED BEYOND END OF TAXABLE YEAR

For purposes of this part (other than [section 816](#)), amounts in the nature of interest to be paid or credited under any contract for any period which is computed at a rate which—

- (1) exceeds the interest rate in effect under [section 808\(g\)](#) for the contract for such period, and
- (2) is guaranteed beyond the end of the taxable year on which the reserves are being computed, shall be taken into account in computing the reserves with respect to such contract as if such interest were guaranteed only up to the end of the taxable year.”

¹ Staff of the Joint Committee on Taxation, 97th Cong., General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 348-349 (Comm. Print 1982).

² A general background on the calculation of tax reserves under IRC § 807(c) is included in the Appendix.

The PSAIR is defined in the Internal Revenue Code under §808(g) as:

“§808(g)Prevailing State assumed interest rate

For purposes of this subchapter—

(1) In general

The term “[prevailing State assumed interest rate](#)” means, with respect to any contract, the highest assumed interest rate permitted to be used in computing [life insurance reserves](#) for insurance contracts or [annuity contracts](#) (as the case may be) under the insurance laws of at least 26 States. For purposes of the preceding sentence, the effect of nonforfeiture laws of a State on interest rates for reserves shall not be taken into account.

(2) When rate determined

The [prevailing State assumed interest rate](#) with respect to any contract shall be determined as of the beginning of the calendar year in which the contract was issued.”

The PSAIR is determined as of the beginning of the calendar year in which a contract is issued. This means that even if the National Association of Insurance Commissioners (NAIC) prescribes maximum valuation rates on a more frequent basis than annual, it is the maximum valuation rate as of the beginning of the calendar year in which a contract is issued that must be used to determine tax basis excess interest reserves.

Since changes in the valuation interest rate used to calculate U.S. statutory reserves generally lag changes in crediting rates, when interest rates are low or decreasing it is unlikely that the crediting rate will exceed the valuation rate. On the other hand, when interest rates are rising, especially if they are rising quickly, it is much more likely that the crediting rate will exceed the valuation rate. Frequent review of the relationship between crediting rates and valuation rates will alert the actuary to this situation and the need for an §811(d) adjustment.

The §811(d) adjustment may be more likely to arise on annuity contracts than on life insurance, because annuities may be repriced more frequently in response to changing interest rate environments.

Appendix I contains a simple example of the calculation of the tax-basis excess interest reserves for a single premium fixed deferred annuity without market value adjustments. Tax reserves are only filed with the IRS at the end of the tax year, which for this example is assumed to be December 31. Although quite simplified, the intent of the example is to show the impact of the interest guarantees on deductible and non-deductible reserves. The example is interactive in that assumptions (highlighted in green) may be updated.

Appendix 1

Example for Excess Interest Memo³



Appendix 2

General Background on the Calculation of Tax Reserves Under IRC § 807(c)

The starting point for the calculation of tax reserves for insurance companies under IRC § 807(c)(1) is the statutory reserve based on the NAIC-prescribed method as of the date of valuation for that type of contract. For life Insurance contracts, the NAIC-prescribed method is the Commissioners' Reserve Valuation Method (CRVM). For annuity contracts, the NAIC-prescribed method is the Commissioners' Annuity Reserve Valuation Method (CARVM).

The tax reserves included in IRC §807(c) are:

- (1) Life insurance reserves,⁴ which includes life, annuity, and certain health insurance.
- (2) Unearned premiums and unpaid losses.
- (3) The amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies.
- (4) Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.
- (5) Premiums received in advance and liabilities for premium deposit funds.
- (6) Reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

³ Please download this pdf document, and then you will be able to double-click the above icon to download the Example for Excess Interest Memo.

⁴ Such contracts include noncancellable accident and health insurance contracts (including life [insurance or annuity contracts](#) combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies, where the term "noncancellable" is as defined in the tax law.

The Tax Code also provides that the tax reserve with respect to any contract is not to be less than the net surrender value of the contract, and the amount of the tax reserve for any contract (the annual change in which affects taxable income) may not exceed the statutory reserve for that contract (appropriately adjusted), a concept known as “the stat cap.”

Tax reserves for contracts included in §807(c)(1) are based on statutory reserves multiplied by a percentage specified in the law. As of the date of this paper, that percentage is 92.81%.

There are two important things to be aware of in discussing such statutory reserves. First, the statutory reserve must be based on the NAIC-prescribed method as of the date of valuation for that type of contract. Second, certain statutory reserves, even if required under that NAIC-prescribed method, are excluded from that calculation.

These excluded reserves include:

- life deficiency reserves,
- reserves attributable to deferred and uncollected premiums and unpaid premiums,
- asset adequacy reserves,⁵
- voluntary reserves, and
- excess interest reserves.

⁵ Regulation §1.807-1(a) defines asset adequacy reserves as “(i) Any reserve that is established as an additional reserve based upon an analysis of the adequacy of reserves that would otherwise be established in accordance with the requirements set forth in the NAIC Valuation Manual, such as the CRVM or CARVM as applicable, or (ii) Any similar reserve.

In determining whether a reserve is a life insurance reserve, the label placed on such reserve is not determinative, provided, however, any reserve or portion of a reserve that would have been established pursuant to an asset adequacy analysis required by the NAIC’s Valuation Manual as it existed on December 22, 2017, the date of enactment of Public Law 115-97, is an asset adequacy reserve.”

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