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Tax Uncertainty Swirls Around Principles-Based Reserves

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I. Introduction

The treatment of life insurance reserves has always been a significant element in the federal income taxation of life insurance companies. Insurance companies in general and life insurance companies in particular present challenges in the measurement of taxable income. Historically, the tax laws applying to life insurance found in Subchapter L have been among the most complex in the Internal Revenue Code (the "Code"). As life insurers face the same tax rates as other corporate taxpayers, the unique features of life insurance company taxation involve the definition of taxable income.

As work continues on principles-based life insurance reserve requirements (PBR), the federal income tax issues that would result from state adoption of a PBR methodology continue to be unresolved. A key challenge in the transition to a PBR methodology is to determine whether such an approach can coexist with the current structure of the Code as it relates to the deductibility of life insurance reserves. The very elements that make PBR appealing, including the reliance on actuarial judgment and the use of more sophisticated financial modeling tools, create challenges in a tax valuation system. While some discussions have occurred between the industry and the Treasury, it is unlikely that definitive guidance will be forthcoming until the regulators finalize the proposed PBR methodology. However, while the resolution remains unclear, recent discussions and papers published in *Taxing Times* and the *Actuarial Practice Forum*, the on-line journal of the Society of Actuaries, have identified several issues related to the tax treatment of PBR.¹



In the May 2007 issue of the *Actuarial Practice Forum*, Doug Hertz and I co-authored an in-depth analysis of the background and implications of principles-based reserves on the taxation of life insurance companies entitled "Treading into the Thicket: Federal Income Tax Implications of Principles-Based Reserves." Based on the analysis presented in that paper, this article considers three issues from the viewpoint of tax policy:

1. How are the amounts of the life insurance reserve deduction determined?
2. What is the effect of the life insurance reserve system on the measurement of taxable income?
3. What questions are raised by the transition to a PBR reserve system as it relates to federal income tax issues?

II. The Deduction of Life Insurance Reserves

Although the tax rules applicable to life insurance companies have gone through significant changes over the years, it has been a fundamental concept that a life insurer should not be taxed on income that is set aside to meet future contingent benefit liabilities. The ability of life insurance

companies to reflect reserves in determining taxable income is perhaps the defining feature of life insurance company taxation. Under the 1984 Tax Act, life insurance companies are permitted to deduct the increase in a "federally prescribed reserve" (FPR), enabling the insurer to offset premium income by some measure of their expected future benefits. Under current law, section 807(c)(1) allows a deduction for life insurance reserves as defined in section 816(b)(1), in amounts described in section 807(d). Section 816 defines life insurance reserves as amounts "which are set aside to mature or liquidate . . . future unaccrued claims. . . ." If more than 50 percent of its total reserves qualify as life insurance reserves under section 816(b), then the insurance company is a life insurance company.

Since the inception of the income tax, the reserves recognized for tax purposes have been based on statutory reserves, as accounting methods for state regulatory purposes generally apply to insurance company taxation to the extent they are not inconsistent with federal accounting rules. However, state valuation laws have as their purpose the protection of the solvency of the in-



¹ These include "The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System," Joseph F. McKeever, III, John T. Adney and Lori A. Robbins, *Taxing Times*, May 2006; "Treatment of Taxes in Principles-Based Reserves," Edward L. Robbins, *Actuarial Practice Forum*, October 2006; "Actuary/Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM," Peter Winslow and Edward Robbins, *Taxing Times*, February 2007; and "Actuary/Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves (Part II)," Peter Winslow and Christian DesRochers, *Taxing Times*, May 2007.

insurance company and are primarily focused on the balance sheet, not period-by-period income. The operation of the statutory reserve system is neither intended nor designed to reflect accurately the economic income flowing through a life insurance company. Therefore, not every item allowed or required by state authorities as a reserve is necessarily deductible.

Under the Code, the deduction of reserves is generally limited to insurance companies. That is, one of the consequences of the accrual method of accounting is that taxpayers generally are not entitled to currently deduct amounts set aside to cover anticipated future expenses. For non-insurance company taxpayers, the Supreme Court has noted that a “reserve based on the proposition that a particular set of events is likely to occur in the future may be an appropriate conservative accounting measure, but does not warrant a tax deduction.”² In fact, reserve accounting is generally inconsistent with the goal of the tax system, which is the generation of tax.

The tax rules applied to life insurance reserves have been a constant source of tension between taxpayers, who seek to maximize reserve deductions, and the tax authorities, who are concerned with generating tax revenues. Much of the litigation that has arisen over the years with respect to life insurance reserves deals with the definition of what items can be considered as deductible reserves, given that the general rule in the Code is to disallow reserve deductions. Ultimately, the definition was codified and is now found in section 816. What emerged was a definition that focused on the “scientific” actuarial present value of amounts “reserved” from premiums for the payment of future benefits.

Congressional tax writers and others have long recognized that the problem in determining an equitable tax base for life insurance companies was related to reserve deductions. Tax authorities came to see deductions for state law–based additions to reserves as exceeding the amounts economically necessary to cover expected future liabilities, resulting in a distortion of income and a significant deferral of tax. The congressional intent to allow a deduction for no more than “economic” reserves first manifested itself in the 1984 enactment of section 807(d), which sets forth specific rules for computing the deductible amount of life insurance reserves.

It is clear that it is in the interest of the Treasury for life insurance companies to be taxed under the life insurance company provisions of Subchapter L. Thus, some accommodation must be reached so that the introduction

of PBR does not cause life insurers to lose their qualification as life insurance companies under section 816. At the same time, almost 100 years of precedent would seem to weigh against the full deduction of a comprehensive principles-based reserve, which includes not only specific assumption margins, but also reserves for future expenses and non-guaranteed benefits. How that conflict is resolved will be critical to the federal income tax treatment of PBR.

III. Reserves and the Measurement of Taxable Income

An insurance reserve system has two functions, which often conflict. The first is to ensure that sufficient funds are set aside so that the insurance company can meet its obligations to its policyholders. The second is to control the emergence of profit, and thereby the growth of surplus. The objectives and operation of a reserve system will change depending on the relative importance of the two functions. For example, a solvency-based system may be better served when valuation assumptions are changed to reflect current conditions, whereas an earnings-based system generally looks to more stable valuation assumptions. Reserve systems are a function of the accounting system on which they are based. The actual cash flows from a block of life insurance policies are independent of the policy reserve. Therefore, the basis of valuation does not directly affect the value of the surplus that will ultimately accrue, but merely the incidence of the emergence of surplus. In general, a reserve system is at its heart an accounting device that adjusts the flow of accounting income; that is, in general terms, the policy reserve system can be considered a timing mechanism, which determines the emergence of reported earnings on the books of a life insurer.³

Under the current PBR proposal, the minimum reserve as of the valuation date equals “The Stochastic Reserve but not less than the Deterministic Reserve, where the Reported Reserve is calculated as the Deterministic Reserve plus the excess, if any, of the Stochastic Reserve over the Deterministic Reserve.” The Deterministic Reserve is a seriatim (policy-by-policy) reserve using a single scenario and a set of Prudent Best Estimate assumptions, which is no less than the policy cash surrender value (or zero, for a non-cash value product). The Stochastic Reserve equals the amount determined by applying a prescribed contingent tail expectation (CTE) level to a range of Scenario Reserves over a broad range of stochastically generated scenarios and Prudent Best Estimate assump-

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² United States v. General Dynamics, 481 U.S. 239, 246 (1987).

³ When the reserve calculation involves net premiums of uniform amounts and is based on the mortality and interest assumptions used in computing the net premium, the resulting reserve is known as a net level premium reserve. One characteristic of a net premium valuation is that the retrospective reserve is at all times equal to the prospective reserve. See CHESTER W. JORDAN, JR., SOCIETY OF ACTUARIES' TEXTBOOK ON LIFE CONTINGENCIES, 101 (2nd Ed. 1967).

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tions for all assumptions not stochastically modeled. Scenario Reserves are the reserves for all policies on an aggregated basis for a given scenario.

The proposed PBR methodology is not a net premium valuation method, but instead is a gross premium reserve (GPR), equal to the present value of future benefits (including non-guaranteed benefits) and expenses (excluding federal income tax) less the present value of future gross premiums. Under a gross premium approach, reserve assumptions are determined for all material risks, including not only mortality and interest, but also expense, lapse and premium payment pattern. Both the stochastic reserve and deterministic reserve calculations require the use of cash flow models, which project the premiums, benefits, expenses and other applicable items to be used in the reserve calculations. In addition, the model is to reflect the impact of all material product features, including both the guaranteed and nonguaranteed elements of the policies.

As a result, the emergence of profit under the proposed system is fundamentally different from that under a net level reserve system. A key characteristic of the GPR system is that the present value of future profits is recognized at issue.⁴ That is, the initial valuation of a block of policies “capitalizes” the difference between the pricing assumptions and the valuation assumptions, while subsequent valuations capitalize the difference in valuation assumptions: that is, the system effectively “fronts” the present value of gains and losses.

Any tax system is effectively defined by the various accounting rules that are used to determine the various elements of taxable income. For life insurance companies, the reserve deduction is a key element in computing taxable income. Were PBR to be used as the basis for tax reserves, a key question is whether the pattern of income that emerges is appropriate to determining year-by-year taxable income. Determining the answer may well require significant modeling not only of the effect of the change in reserves, but also the income effects, including both the initial and subsequent valuations.

IV. Transition to a PBR System

There are several questions for which guidance is needed to clarify the tax issues created by a transition to a PBR system for statutory reserves. While these are discussed in more detail in the paper Doug Hertz and I authored, a summary of the issues follows. Answers to these questions are needed

so that taxpayers will have some indication of how principles-based reserves interact with current tax law.

Do PBR reserves qualify as life insurance reserves under section 816 to determine qualification as a life insurance company?

The answer isn't clear. It could be argued that PBR satisfy at least some (or all) of the section 816 criteria. They would be held with respect to the required types of contracts, and they would be required by law. They are based on interest and mortality. On the other hand, given the inclusion of expenses and non-guaranteed benefits, the history of the development of the technical definition of life insurance reserves, and the Service's rulings position with respect to gross premium reserves, the Treasury may find it difficult to simply accept that either the deterministic or the stochastic elements of the PBR will qualify in their entirety as life insurance reserves under section 816.

What is the definition of CRVM under section 807 as it applies to principles-based reserves?

In reality, it may not matter. For life insurance contracts, the tax reserve method is “CRVM in the case of contracts covered by CRVM.” For other contracts, the method is “the reserve method prescribed by the National Association of Insurance Commissioners [NAIC] which covers such contract (as of the date of issuance).” Thus, it may be the prescription of the method by the NAIC and not the label applied that may be relevant. In practice, characterization of PBR as other than CRVM may make it easier for Treasury to accept all or some of the elements of PBR to be treated as FPR under section 807(d).

What effect does the inclusion of factors other than interest and mortality have on the status of the reserves? What is the effect of the introduction of nonguaranteed elements and expenses?

One view is that tax reserves are fully defined by the federally prescribed reserve in section 807(d). Another view is that courts have generally permitted factors other than interest and mortality to be recognized in the calculation of life insurance reserves, but have tempered that view by adding: “We do not believe that Congress intended to permit an insurance company to exclude any amount it saw fit from its taxable income by creating reserves.”⁵ Thus, some factors, including lapse rates, may be permissible in the calculation of tax reserves, but this is likely to be tempered by the admonition concerning the reasonableness of the assumptions. The use of additional factors in the calculation



4 For example, an embedded value calculation, which has many elements in common with a gross premium valuation, is intended to show the present value of all amounts that will be distributable to shareholders based on best-estimate assumptions. The present value of gains or losses from the sale of a block of policies will be recognized in the year in which the policies are sold.

5 *Union Mutual Life Insurance Company v. United States of America*, 570 F.2d 382, 397 (1978).

of tax reserves may also result in differences in reserve deduction among taxpayers, depending on the assumptions. At a minimum, guidance is needed from Treasury as to what additional factors may be considered and what limitations may be placed on the factors, in establishing tax reserves.

What is the effect of company-specific mortality assumptions?

Under the PBR Model Regulation, company-specific mortality is used in reserves to the extent that it is credible. On its face, this approach is inconsistent with the current view of the Internal Revenue Service, as it has been expressed in Technical Advice, which interprets the statute as only permitting adjustments to the prevailing table for “risks not otherwise taken into account.” Further, the development of multiple mortality tables may cause the Treasury to require the use of the table that produces the lowest possible reserve, even though that table may not be used in statutory reserving.

What is the prevailing state assumed rate?

In determining the federally prescribed reserve for a life insurance contract, section 807(d)(4) mandates an interest rate, determined at the time the contract is issued, equal to the greater of (1) the AFIR or (2) the “prevailing State assumed interest rate” (PSR). The AFIR is published annually by the IRS, computed as a five-year average of the federal mid-term rates. The PSR is the “highest assumed (valuation) interest rate permitted to be used in computing reserves for the contract under the insurance laws of at least twenty-six states at the time the contract is issued.” The use of discount rates based in projected asset returns and projected interest scenarios may be difficult to reconcile with the AFIR/PSR statutory regime.

Are the stochastic reserves likely to be considered nondeductible “solvency” or contingency reserves?

Historically, deductions have been allowed for “technical actuarial reserves” and not “solvency reserves.” Not every reserve required or allowed by state regulatory authorities is deductible. Stochastic reserves are computed by

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simulating possible future economic scenarios, each of which provides a different yield curve of future interest rates. This creates two issues: (1) tax reserves are based on an assumed interest rate not a distribution of rates; and (2) values based on a CTE methodology capture the “tail” of the distribution, not the expected value. Moreover, uniformity by company has been a long-term goal of the various methods of reserve taxation.⁶ The description of the stochastic element of the reserve might lead some to conclude that it was a contingency reserve or “solvency reserve,” but not a life insurance reserve.

What are the implications of including margins in the valuation assumptions?

From a tax perspective, margins are problematic in two respects. First, as previously noted, the “best-estimate” assumptions represent the expected value of policy benefits and expenses, while the effect of the margins is to create a “contingency reserve,” which has historically not been deductible. Second, under the gross premium valuation method, the effect of the margins is to create an immediate deduction (at issue) for the difference between the “best-estimate” reserves and the reserves with margins included.

How will reserve increases and decreases that result from changes in assumptions be treated?

Section 807(f) addresses the treatment if there is a change in basis of computing reserves. In general, the total effect of the basis change (i.e., the reserve increase or decrease) is spread over 10 years, based on the difference in the reserves between the reserves on the old basis, and those on the new basis, determined at the end of the current tax year. The effect of the dynamic valuation aspects of PBR on the “10-year spread” will need to be clarified, or life insurance companies may find themselves in a constant 10-year spread position. Some people have argued that if reserves

are computed using dynamic assumptions, then a change in assumptions does not require a 10-year spread. The implication of that argument is any strengthening or weakening of reserves resulting from a change in assumptions would flow into income in the year the change occurs.

V. Conclusion

As the discussions of principles-based reserves continue, two fundamental questions may to a large degree determine the tax treatment.

First, what makes sense from a tax policy viewpoint? Second, what can be reconciled with the technical requirements of sections 807 and 816 of the Code? Under the 1984 Act, tax reserves are based on statutory reserves adjusted to meet the requirements of section 807. Before life insurance companies can determine their tax reserves under a PBR system, they must know what adjustments are needed from statutory to tax. When and how the Treasury chooses to answer these questions will be critical to the determination of deductible reserves under a PBR system. ●

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⁶ For example, an embedded value calculation, which has many elements in common with a gross premium valuation, is intended to show the present value of all amounts that will be distributable to shareholders based on best-estimate assumptions. The present value of gains or losses from the sale of a block of policies will be recognized in the year in which the policies are sold.