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"A KNOWLEDGE COMMUNITY FOR THE SOCIETY OF ACTUARIES"

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SUPPLEMENT

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From the Editor: About this Supplement

This is our first special supplemental issue of *Taxing Times*. We're publishing it for our readers to keep you as informed and up-to-date as possible regarding tax issues impacting our industry.

On Jan. 14, 2008, the Internal Revenue Service (IRS) released Notice 2008-18. The Notice was issued to alert life insurance companies to federal income tax issues that may arise as the result of the adoption of proposed Actuarial Guideline VACARVM (AG VACARVM) and/or a proposed principle-based approach for calculating statutory reserves for life insurance contracts (PBR). The Treasury Department (Treasury) and the IRS acknowledge in the Notice that these proposed methods have not yet been adopted by the National Association of Insurance Commissioners (NAIC), but they want to consider the tax issues that arise now so that guidance will be forthcoming in time for taxpayers to fill out tax returns after adoption.

Under eight general issue subheadings, the Notice sets forth a variety of positions that the Treasury and the IRS might take and asks for written comments submitted by **May 5, 2008**. The eight general issue subheadings are:

1. Continued taxation of life insurers under Part 1 of subchapter L.
2. Qualification of contracts as life insurance contracts.
3. Contract-by-contract versus aggregate reserves.
4. Prevailing state assumed interest rate.
5. Prevailing mortality tables.
6. Transition rules and the application of section 807(f) to in-force contracts.
7. Tax principles that override statutory accounting.
8. Tax administration.

Because the submission date for written comments comes before many of our members will receive the May 2008 issue of *Taxing Times*, we decided that this special supplement was necessary to encourage thought, discussion and written comments prior to the comment deadline of May 5, 2008.

Brian G. King

Brian G. King, FSA, MAAA, is a managing director, Life Actuarial Services, with SMART Business Advisory and Consulting and may be reached at *bking@smartgrp.com*.

Tax Attorney and Tax Actuary Dialogue on IRS Notice 2008-18—AG VACARVM and Life PBR (Part III)

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com*.

Christian DesRochers, FSA, MAAA, is a senior managing director, Life Actuarial Services, with SMART Business Advisory and Consulting and may be reached at *cdesrochers@smartgrp.com*.

Edward L. Robbins, FSA, MAAA, is a senior managing director, Life Actuarial Services, with SMART Business Advisory and Consulting and may be reached at *erobbins@smartgrp.com*.

The February and May 2007 issues of *Taxing Times* contained interdisciplinary dialogues between Peter Winslow, a tax attorney, and Edward Robbins and Christian DesRochers, tax actuaries, on selected tax issues related to proposals to change statutory reserving from a formula-based methodology to a principle-based approach. In this special supplemental edition of *Taxing Times*, we bring these three experts back again for a three-way dialogue on IRS Notice 2008-18 (issued Jan. 14, 2008.) The discussion that follows assumes the reader is generally familiar with the prior dialogues and, as a result, technical legal background on many of the issues will not be repeated here. Readers can download these issues of *Taxing Times* (February and May 2007) from the Taxation Section Web page on the SOA Web site at *http://www.soa.org/news-and-publications/newsletters/taxation/tax-detail.aspx* for the two previous discussions.

Note: The opinions expressed in this dialogue are solely those of Peter Winslow, Christian (Chris) DesRochers and Edward (Ed) Robbins. With that, let's turn the discussion over to Peter, Chris and Ed.

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Taxation Section of the Society of Actuaries
475 N. Martingale Road, Suite 600
Schaumburg, IL 60173

- ph: 847.706.3500
- f: .847.706.3599
- www.soa.org

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Peter: My first reaction after reading Notice 2008-18 was one of gratification that *Taxing Times* may be having an impact. It appears to me that the Treasury Department (Treasury) and Internal Revenue Service (IRS) personnel have read our prior dialogues and the articles you two have written for *Taxing Times* because the Notice covers almost all of the issues we have discussed previously. Beyond that, what strikes me is the apparent willingness to work with the industry to fashion tax solutions in this complex area within the parameters of current law. That the Notice expresses concern on several important issues is understandable, but it does not reflect a defeatist attitude that solutions are impossible. Overall I am encouraged that the issues can be resolved administratively, particularly if the authors of VACARVM and PBR make some adjustments to reflect the concerns of the Treasury and the IRS. Chris, what is your overall impression of the Notice?

Chris: As the Treasury and IRS do not generally comment on developing issues, I believe that it shows that they recognize the importance of the issue to the life insurance industry. Anyone who has been following our *Taxing Times* dialogues will be familiar with many of the issues raised in the Notice. Although some in the industry could have been hoping for a shorter list of issues, no one should really be surprised, as the Treasury and the IRS are raising questions which need to be clarified in the absence of Congressional action to accommodate principle-based reserves. What is helpful to the discussion is that, where the Treasury and the IRS have a tentative view, they have expressed it, and have outlined possible guidance that could be issued in the future. This gives the industry an opportunity to react, see what would be workable from a taxpayer's viewpoint and respond accordingly.

To get the discussion started, Peter and I agreed in our prior dialogue that the IRS had a real incentive to recognize that PBR qualify at least in part as life insurance reserves under section 816 so that companies would continue to be taxed under the life insurance company provisions of Subchapter L. That said, I was not at all surprised by the IRS' position that it would be inappropriate "to apply a literal application of the 50-percent reserve ratio test of section 816(a)." For purposes of determining qualification as a life insurance company, the Notice suggests four possible approaches:

1. Require the use of statutory reserves for purposes of the reserve ratio test, even if those reserves are principle-based.
2. Require the continued use of CARVM or CRVM, as applicable, under such terms as applied before the adoption of principle-based reserves.
3. Apply principles similar to those of Proposed Reg. §1.801-4(g) (requiring principle-based reserves to be recomputed under the current CRVM or CARVM methods for purposes of determining qualification under 816).
4. Require the use of only the standard scenario amount (VACARVM) or deterministic reserve (PBR) for purposes of the reserve ratio test.

Ed or Peter, do you see any connection between the approach the Treasury and IRS might adopt for qualification under section

Note from the Editor

All of the articles that appear in *Taxing Times* are peer reviewed by our editorial board and section council members. These members represent a cross-functional team of professionals from the accounting, legal and actuarial disciplines. This peer-review process is a critical ingredient in maintaining and enhancing the quality and credibility of our section newsletter.

While this newsletter strives to provide accurate and authoritative information in the content of its articles, it does not constitute tax, legal or other advice from the publisher. It is recommended that professional services be retained for such advice. The publisher assumes no responsibility with assessing or advising the reader as to tax, legal or other consequences arising from the reader's particular situation. *Citations are required and found in our published articles, and follow standard protocol.*

—Brian G. King

816 and what they might do under section 807?

For the moment, it appears that the Treasury is very concerned about the potential tax character of the stochastic excess reserve. …

Ed: Well, first of all, it seems clear that in the Notice the IRS and the Treasury attempted to retain significant flexibility going forward, as they suggested a number of alternative future directions they might consider, so these comments should be taken in that light. For the moment, it appears that the Treasury is very concerned about the potential tax character of the stochastic excess reserve, both for VACARVM and PBR, as might have been expected. This concern is picked up throughout the Notice, first in section 816, in the fourth approach you mentioned. It appears that the Notice views the stochastic excess reserve as potentially fitting effectively into the same treatment category as deficiency reserves for purposes of both sections 807 and section 816. With respect to section 816, the fourth approach is identical to the treatment of deficiency reserves, as the latter are also excluded from life insurance reserves and from total reserves in the reserve ratio test. Later on, the Notice raises concerns about the deductibility of the stochastic excess reserve under section 807, characterizing it as a solvency reserve, similar to deficiency reserves. Moreover, it raises a concern that, even if allocated to individual policies, such stochastic excess reserve would not constitute an increment to the statutory ceiling on federally prescribed reserves (statutory cap). For those who have not been following IRS audit positions, some individuals in the Service have taken the position that deficiency reserves should not be included in the statutory cap as well. In my opinion, that position is incorrect.

The Service appears to have three major concerns with the stochastic excess reserve: the difficulty of auditing, the large degree of discretion allowable in choosing assumptions and the fact that that reserve is based on "extreme (CTE)[1] values" rather than close-to-expected values. The Notice indicates significantly more comfort on these issues with respect to both Standard Scenario (VACARVM) and deterministic (PBR) reserves.

Peter: From my perspective, probably the most important part of Notice 2008-18 is the statement that the Treasury and the IRS believe that it is inappropriate to reclassify life insurance companies as non-life companies for tax purposes as a result of the adoption of VACARVM or PBR. This is critical because it necessarily means, as a legal matter, that VACARVM reserves and PBR qualify as life insurance reserves either in their entirety or at least in part. This is because it is clear under section 816(b), and its legislative history, that the 50-percent reserve test refers to statutory reserves, not tax reserves as recomputed under section 807. The Notice says that the Treasury and the IRS do not want to adopt a "literal" application of the 50-percent reserve test, but they cannot ignore the statute. So, at the outset, if companies are not going to be reclassified under the 50-percent reserve test, we no longer have to address **whether** VACARVM reserves or PBR qualify as life insurance reserves subject to revaluation for tax purposes under section 807. The Notice implicitly agrees that they are. The only questions now are: Do the reserves qualify **in their entirety** as life reserves? If not, what part qualifies? And finally, for whatever portion qualifies as a life reserve, how do we recompute it under section 807 for tax purposes?

Stated another way, the issues identified in the Notice can be broken down into two general categories. One category of issues is whether a portion of the reserves should be disallowed because that portion does not qualify in some respect as a life insurance reserve. These issues include, for example, whether the stochastic reserve is a non-deductible contingency reserve and whether a gross premium method is permissible. The second category of issues comes into play once we have identified what qualifies as a life insurance reserve. These issues involve what adjustments need to be made to the reserve to recompute it under section 807 or to comply with the accounting rules in section 811. Issues that fall into this category include what mortality table and interest rate

[1] Conditional Tail Expectation (CTE) also known as Tail Value-at-Risk *(TVaR)*, is the probability-weighted average severity of the worst outcomes of a distribution, based on a stated percentile (*e.g.,* the average outcome in the worst 10 percent of cases would be called "*CTE* (90)" or "*TVaR* (90)").

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to use, how contract-by-contract comparisons are made, whether there are deficiency reserves, etc.

Ed: Peter, can you explain how your analysis relates to Chris' question dealing with the situation where a statutory reserve, or a portion of such statutory reserve, does not qualify as a life insurance reserve under section 816, and the implications of that situation in the section 807 requirements?

Peter: There is a direct interconnection between section 816 and section 807 in the first category of issues (but less so in the second category). For example, as you know from our past dialogues, I believe that the stochastic reserves are held for future unaccrued claims within the meaning of section 816(b) and otherwise satisfy the definition of life insurance reserves. If the Treasury and the IRS disagree, however, the first option listed in Notice 2008-18, that all statutory reserves are included in the 50-percent reserve test, would be off-the-table, and the stochastic reserves presumably would be considered a non-deductible solvency reserve (*i.e.*, reserves not held for future unaccrued claims). Similarly, if it is determined that some portion of the reserve is held for expenses, presumably that portion of the reserve would be disallowed as failing to qualify as a life insurance reserve under section 816(b). This leads me to the following basic conclusions about the Notice's four options for the 50-percent reserve test and the link to section 807.

Option 1—All VACARVM reserves and PBR are used in the test.
If this option is adopted, it necessarily means that many of the other issues have been resolved favorably—gross premium reserves are life insurance reserves; stochastic reserves are not solvency reserves; and all of the reserves are held for future unaccrued claims, etc.

Options 2 and 3—Require continued use of CARVM or CRVM or require recomputation of statutory reserves.
I simply do not see the legal authority for either of these two approaches in light of the clear Congressional mandate to use statutory reserves in the 50-percent reserve test.

Option 4—Use only the standard scenario amount or deterministic reserve.
This option is appropriate only if it is concluded that the stochastic reserves in their entirety do not qualify as life insurance reserves; but, it also would suggest a favorable conclusion on several other issues, *e.g.*, the entire standard scenario amount and deterministic reserves are held for future unaccrued claims.

I have one final observation on this topic. The Notice probably should have listed a fifth option to deal with the possibility that the Treasury and the IRS could conclude that a non-section 807 adjustment to the reserves should be made. For example, if it were to be concluded that a portion of the stochastic reserve is a solvency reserve, then a fifth option would be to use statutory reserves for the 50-percent test, with adjustments to exclude any portion of the reserve that is determined not to qualify as part of life insurance reserves as defined in section 816(b). I do not advocate this option because I think that VACARVM reserves and PBR satisfy all the requirements for life insurance reserve treatment. And, as a general proposition—once it is concluded that we have a reserve held for future benefits—the quantity of the tax reserve is not determined by section 816(b), but is governed by specific adjustments to the statutory reserve authorized by I.R.C. § 807 and § 811. I am merely saying that if my position is not accepted, this fifth approach, omitted from the Notice, may be another option. Your turn Chris.

Chris: As Peter points out, the next logical question is whether the reserves qualify **in their entirety** as life reserves? If not, what part(s) qualifies/qualify? Here the obvious question deals with the treatment of the deterministic (or standard scenario) and the stochastic elements of the reserves. In the Notice, the Treasury and IRS pose the question regarding the appropriate tax reserve treatment of the stochastic component of PBR and VACARVM. The Notice points out "the Treasury Department and IRS believe that the standard scenario or deterministic reserve determined under Proposed AG VACARVM or Proposed Life PBR would more closely resemble the methodology in effect when Congress enacted section 807 in 1984 than would the CTE amount or stochastic reserve." While conceding that both methods provide a methodology for apportioning the stochastic reserve among individual contracts, the fundamental concern of the Treasury and the IRS appears to be that the stochastic reserve component would not represent an expected value of a company's obligations with respect to the underlying contracts, making some or all of these amounts nondeductible "solvency" or "contingency" reserves. A related question dealt with the degree of discretion permitted in determining the VACARVM CTE amount or the PBR stochastic reserve. Here the Treasury and IRS were focused on the difficulty of auditing the results, noting the issue "will weigh heavily in the resolution of the issues identified and may weigh in favor of recognizing only the standard scenario amount or the deterministic reserve."

On the life insurance side, historical precedent may weigh against recognizing the stochastic component. Historically, deductions have been allowed for "technical actuarial reserves" and not "solvency reserves." As the IRS and Treasury point out, values based on a CTE methodology by definition only capture the "tail" of the distribution, not the expected value. Any allocation procedure for the stochastic reserve component may be problematic. In Revenue Ruling 67-435[2], the Service held that "a reserve computed on 'the basis of a percentage of life insurance reserves' is not a life insurance reserve," and case law reaching a similar result can be traced back to the 1920s. However, what each of those cases has in common is that the addition to reserves was arbitrary, at least in the result achieved. If we look to the property and casualty side, the deductibility of unpaid loss estimates is subject to the "fair and reasonable" standard of Treas. Reg. § 1.832-4(b). In a 2001 Tax Court case, a distinction was made between a "10 percent management add-on" to loss reserves, which was found to be "unreasonable" as the company "offered no contemporaneous documentary evidence supporting the basis for its add-ons," and the underlying annual statement reserves, which were "fair and reasonable." The Tax Court recognized that "this does not mean that there is (or could be, except in hindsight) a single 'correct' estimate." The Court went on to state that "It does mean, however, that the taxpayer must be prepared to objectively validate that the methods and assumptions it relied upon to make its estimate are reasonable."[3] If some way were found to import the "fair and reasonable" standard from section 832 to section 807, it could be the basis for answering the concerns of the Treasury and the IRS.

Ed, what are the alternatives if the stochastic reserves are not deductible?

Ed: If the stochastic reserves are not deductible, there is the "fallback" issue of whether, similar to the historical treatment of deficiency reserves, they can somehow be considered increments to the statutory cap. There are two issues involved in this case. First, recognizing that stochastic reserves are generally based on aggregate models, instead of calculated contract-by-contract, a method of allocation of stochastic excesses to individual contracts must be generally defensible. Put differently,

it would appear that an allocation of the stochastic reserve to a contract should be reasonably related to that contract's contribution to the stochastic excess. Thus, a variable annuity contract whose guaranteed living benefit (VAGLB) is currently "in the money" should probably deserve a greater amount of stochastic excess than a contract whose VAGLB is not "in the money." The second issue is the technical position the IRS may take that such a reserve cannot in fact be added to the statutory cap, similar to the position they have taken on some audits with respect to life insurance deficiency reserves. In my opinion, there are strong counterarguments the industry has at its disposal with respect to deficiency reserves, which to some extent can be used with respect to defense of the use of stochastic excesses for this purpose.

Chris, to fully answer your question, we must explore the issue raised in the Notice of the potential recalculation of the stochastic reserve at CTE(0).[4] In such a case, the statutory stochastic excess reserve would be divisible into two components: the CTE(0) component and the excess of the entire stochastic statutory reserve over the CTE(0) reserve ("extreme value reserve"). This might seem to justify the CTE(0) reserve as both a life insurance reserve (under section 816(b)) and a deductible reserve (under section 807, subject to any required

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[2] 1967-2 C.B. 232.

[3] *Physicians Ins. Co. of Wisconsin, Inc. v.* C.I.R., T.C. Memo. 2001-304, 82 T.C.M. 918, 925.

[4] Literally, the probability-weighted average of all scenarios.

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adjustments) and the extreme value reserve as nondeductible, since this bifurcation of the stochastic reserve would remove the major concern of the Service that the entire stochastic excess reserve is a solvency reserve and consists only of extreme values.

That said, such bifurcation may end up meaningless in most situations, as the practical effect of such bifurcation may generally result in the virtual elimination of any excess of the CTE(0) reserve over either the Standard Scenario Amount (under VACARVM) or the deterministic reserve

The NAIC has traditionally prescribed the mortality assumptions, interest rates and reserve "method" that would produce the minimum permissible statutory reserve.

(under PBR), with the result that the final stochastic excess consists solely of the "extreme value reserve."

Peter: Chris' analogy to the "fair and reasonable" standard for unpaid loss reserves is important and relates directly to Ed's comment. There is plenty of law on the question of margin in reserves—conservatism is not disqualifying either for life insurance reserves under the definition in section 816(b) or for unpaid loss reserves under section 832 as long as the reserves are held for future benefits. The real question is whether too much conservatism somehow disqualifies a portion of the reserve under section 807 and, if so, how do we measure the amount of unacceptable conservatism? Do we use a bright-line test, such as a uniform adjustment to the CTE or do we use a facts and circumstances test like the "fair and reasonable" standard? Or do we defer to the National Association of Insurance Commissioners (NAIC) and permit the entire stochastic reserve to qualify as long as it satisfies the NAIC's principle-based standards?

Let's turn to another topic. In our prior dialogue, Ed and I talked about the issue raised in the Notice about the impact of labeling PBR as CRVM. Chris, can you describe the issue and tell us what you think about this particular issue?

Chris: In some respects, the labeling issue is important, as a literal reading of section 807(d) could lead to the conclusion that were the NAIC to adopt AG VACARVM as "CARVM" or life PBR as "CRVM," the respective methods would then be the required method for computing the federally prescribed reserve. At that point, the Treasury Department and IRS nevertheless could conclude the methods do not constitute "CARVM" or "CRVM" as Congress envisioned those terms to apply in 1984. This in turn could lead to litigation under the so-called *Cambridge* doctrine[5] to determine how much authority Congress delegated to the NAIC under the 1984 Act and whether the NAIC characterization was a "gross misuse" of the terms CRVM and CARVM, a result that both government figures and taxpayers would prefer to avoid. In reality, however, 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 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 as other than CRVM or CARVM may make it easier for the Treasury to accept all or some of the elements of PBR under section 807(d). Whatever label is applied, it should be the one that the Treasury and the IRS believe provides them with the broadest possible discretion in providing guidance. What may be important is the characterization of principle-based reserves as a net premium or gross premium methodology. Ed, would you address this issue?

Ed: Certainly. The NAIC has traditionally prescribed the mortality assumptions, interest rates and reserve "method" that would produce the minimum permissible statutory reserve. The minimum reserve calculation process involves a theoretical "net premium" based on such prescribed mortality tables and interest rates. No expenses or lapse rates are explicitly assumed. Given that net premium, a reserve is calculated. CRVM is an example of such a net premium method. On the other hand, a gross premium methodology, or, what actuaries term a "gross premium valuation (GPV)" uses assumptions that purport to better reflect reality. The GPV equals present value of future benefits and expenses, less present value

[5] Dealing with the characterization of an organization as a building and loan association, which was not taxable, or as a bank, which was taxable, Justice Holmes said "[t]hey must be taken to accept what the States are content to recognize unless there is gross misuse of the name. . . . Very possibly the company has strained its privileges to the near limit, but we are not prepared to condemn the nomenclature adopted by the State." *United States v. Cambridge Loan & Building Co.,* 278 U.S. 55, 59 (1928).

of future gross premiums. In the GPV calculation, more realistic mortality and interest assumptions are used. Further, a GPV contains reasonably realistic assumptions for expenses and lapse rates (and premium persistency on Flexible Premium Universal Life).[6] The GPV under PBR is a one-scenario approach. Additionally, unlike traditional net premium requirements—under which the assumptions are locked in at the issue date of the contract—the assumptions under GPV are to be updated periodically for in-force business.

I indicated a moment ago that expenses and margins are not *explicitly* assumed under CRVM. However, they are *implicitly* assumed, despite what the Notice stipulates.[7] The excess of gross premiums over net premiums constitutes a "loading for expenses." That is, the "prescribed expense assumption" is the excess of the actual gross premium over the prescribed net premium. Further, the traditional mortality tables and interest rates contain margins for conservatism. Thus, the gross premium methodology is not as great a departure as the Treasury might currently believe.

Unfortunately, this particular similarity of CRVM to GPV approaches is diminished by the fact that in recent years such loading has been negative, due to the combination of redundant required assumptions and competitive pressure. However, that should not invalidate the fact that the structural concept of CRVM has not changed.

Peter: I believe the Notice has misstated the law when it says that the Treasury and the IRS are concerned about PBR because "the use of a gross premium valuation methodology … generally is not permitted under existing authorities." The Notice cites the *Maryland Casualty*[8] case and Treas. Reg. § 1.801-4(e) for this proposition, but these authorities do not support the conclusion. In *Maryland Casualty*, the Supreme Court held that a loss claims reserve is not a "reserve fund" for a property/casualty company because it appeared to be a reserve for expenses and therefore not set aside to pay future unaccrued claims under insurance contracts. In the same case, the Court noted that unearned premium reserves, which undoubtedly were computed as a percentage of gross premiums, "are familiar types of insurance reserves." So, the case actually supports an argument that a gross premium reserve can qualify at least as an insurance reserve. Similarly, Treas. Reg. § 1.801-4(e) says nothing about gross premium reserves; it merely reiterates that a reserve for ordinary operating expenses does not qualify as a life insurance reserve.

The only actual support for the Notice's statement is Rev. Rul. 77-451[9] (and its underlying G.C.M.) which do rule that a gross premium reserve is not a life insurance reserve. But this ruling had dubious merit when it was issued and has even less support under the 1984 Act. The primary reason given in the ruling for the conclusion is that the definition of life insurance reserves in what is now section 816(b) implicitly requires that prospectively computed reserves must equal retrospectively computed reserves, which can be achieved only by a traditional net premium valuation method. Nothing in pre-1984 section 801(b) actually required this result, implicitly or otherwise, and it is certainly not a requirement under current law. While this may be the case for "traditional" reserve computations, in fact, there are many formulaic CRVM reserves under current NAIC model regulations and actuarial guidelines that would flunk the revenue ruling's test, but nevertheless are widely accepted as deductible life insurance reserves under section 807. Another argument in the ruling is that the exclusion of deficiency reserves under former law implicitly acknowledged that only a net premium valuation method qualified. But, if anything, this statement is helpful to PBR qualification in light of what Congress did in the 1984 Act. After the 1976 amendment to the Standard Valuation Law, CRVM reserves include deficiency reserves. Congress recognized that deficiency reserves would be deductible as life insurance reserves under the 1984 Act (as part of CRVM) unless it added an exclusion for deficiency reserves, which it did in section 807(d)(3)(C). Thus, it appears that in 1984 Congress actually believed that a deficiency reserve otherwise could qualify as a deductible CRVM reserve. The third reason given in the ruling

6 As to the term "reasonably realistic," the PBR proposed guidance refers to "prudent estimates," which essentially mean expected assumptions plus inclusion of a margin. Those expected assumptions are generally planned to be a combination of company experience and industry assumptions, the weighting of the two based on the credibility of the experience.

7 The Notice stipulates in pertinent part, "Thus, a reserve determined using a gross premium valuation may include amounts, such as future expenses and margins, that are not now included in life insurance reserves for federal income tax purposes."

8 251 US 342 (1920).

9 1977-2 C.B. 224.

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was that former section 818(c) implied a net premium valuation method. Of course, this too is wrong because a section 818(c) election under the approximate method, in fact, did not result in reserves that satisfied the revenue ruling's own prospective/retrospective test. In any event, that section was repealed in 1984. Another important point to be made about Rev. Rul. 77-451 is that, under pre-1984 law, the consequence of the ruling was not a disallowance of a reserve deduction, but rather a reclassification of the gross premium reserve from a life insurance reserve to an unearned premium reserve. This reclassification does not occur under the 1984 Act. Instead, a reserve that could have been calculated as a life reserve must be recalculated under section 807 regardless of the methodology used for statutory purposes. So, bottom-line, I am unaware of any authority on point that actually supports the Notice's conclusion that a gross premium methodology is impermissible under the 1984 Act.

The proper issue under *Maryland Casualty* is whether PBR are held for future unaccrued claims. This is where

the direct link between 816(b) and section 807 we discussed earlier comes into play. If PBR will not cause a company to flunk the 50-percent reserve test, which the Notice says it will not, then we necessarily have concluded that some or all of PBR qualify as deductible life insurance reserves even if they are computed on a gross premium method. The real issue is whether any portion of PBR is a non-deductible reserve for expenses. I do not think it is, for several reasons, including the one Ed cited earlier, namely that CRVM reserves consider expenses implicitly, through the CRVM expense allowance. The only change in PBR is that expenses are recognized explicitly. However, this is one area where I think we need more help from the actuarial profession to educate the Treasury and the IRS.

Chris: One issue not to lose sight of with expenses is that for many contracts, the inclusion of expenses will tend to reduce the reserves and not increase them. Thus, all else being equal, the only effect of excluding expenses for many contracts may be to bring the statutory cap into play. To me, the most important question related to a gross premium methodology is not so much whether it can fit under the current structure of section 807, but the potential effect it can have on taxable income. Any tax system is defined by the accounting rules that are used to compute the elements of taxable income. Under the proposed PBR and VACARVM, a key question is whether the pattern of income that emerges is appropriate to determining year-by-year taxable income. 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 that system is fundamentally different from that under a net premium reserve system, as the present value of future profits or losses (adjusted to reflect margins in the valuation assumptions), is recognized at issue.[10] 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. Simply stated, the system effectively "fronts" the present value of gains and losses. At a minimum, taxable income under that system is likely to be more volatile on a year-by-year basis than it is today.

[10] 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. However, the proposed PBR Method is a "modified" gross premium valuation as the minimum reserve is equal to zero (term) or the cash value (permanent). A "pure" gross premium valuation would recognize a "negative liability " (an asset) if the present value of future premiums was greater than the present value of future benefits and expenses.

Peter: Your comment suggests one reason why it is appropriate to reflect margin in the reserves for tax purposes. If the method effectively fronts income attributable to a risk charge, that is, the charge for the risk of adverse experience, consistency would seem to require an offsetting adjustment to reflect the possibility that the adverse experience may, in fact, emerge.

What the gross premium method in PBR does conceptually is to take future gross premiums, instead of net premiums, into account in the subtractive item in the traditional reserve formula.

Your comment also touches on another reason why I believe it is incorrect to view PBR as held in part for future expenses merely because expense cash flows are considered. A traditional CRVM reserve is not merely the present value of future benefits (PVFB), but rather, PVFB minus the present value of future net premiums (PVFP). Reserves using gross premium valuation methods that have been held by the courts not to qualify as life insurance reserves have one common characteristic—there was no PVFB in the calculation using discount rates and/or mortality tables. This is not a problem in PBR. What the gross premium method in PBR does conceptually is to take future gross premiums, instead of net premiums, into account in the subtractive item in the traditional reserve formula. As Chris says, this tends to "front" profits and reduce reserves (prior to considering margin). Because of the addition to the formula of gross premiums as a reduction in reserves, it is necessary for consistency to make an adjustment to that reduction to reflect future expenses. Otherwise, income will be improperly accelerated. But, this expense adjustment should be viewed, in essence, as an adjustment to the PVFP in the traditional formula, rather than a reserve for future expenses. Stated another way, the PVFB in PBR should be viewed as not changing substantially from the traditional reserve formula—it has all of the essential characteristics of a life insurance reserve and is a reserve for future benefits, not expenses. What is happening in PBR is that the subtraction from PVFB for PVFP to arrive at the net reserve in the traditional formula merely has been adjusted to reflect all future cash flows.

Chris, the Notice also deals with assumptions: mortality, interest and "factors other than interest and mortality." Can you please address these issues?

Chris: I'll start. With respect to mortality, I was happy to see that the Treasury and IRS are properly separating the issue of reasonable mortality under section 7702 from the reserve deduction. Section 7702(c)(3)(B)(i) requires that reasonable mortality charges "not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5))." Although this requirement ties valuation mortality to the definitional limitations, the more appropriate tie would be to nonforfeiture requirements and not valuation. Thus, by proposing to either exercise regulatory authority to continue to permit the 1980 and 2001 CSO Tables or to provide "a reasonable interpretation of the prevailing commissioners' standard mortality tables under section 807 that would not render the cross reference in section 7702(c)(3)(B) meaningless," the Treasury and IRS are demonstrating that they understand the issue and are willing to provide a workable approach to preserve the status quo with respect to the section 7702 and 7702A limitations.

With respect to company-specific valuation mortality assumptions, the Treasury Department and IRS are concerned that "determining an aggregate reserve stochastically and, after the fact, using the reserve so determined to 'map' to one of a large number of NAIC-approved mortality tables would not satisfy the requirement of section 807(d)(2) that the prevailing commissioners' standard tables be used for purposes of determining the tax reserve for a contract." They suggest four possible interpretations of the "prevailing commissioners' standard mortality tables under section 807(d)(5)" to be:

1. The 2001 CSO mortality tables.
2. The mortality tables, if any, which served as the basis for pricing the particular contract.
3. Whichever applicable table generally would yield the lowest reserve for the contract, consistent with section 807(d)(5)(E).
4. The mortality tables used for purposes of determining the standard scenario amount under VACARVM.

The approaches to mortality would seem to be connected to the interpretations of the "federally prescribed reserve" adopted by the Treasury and IRS. For example,

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the use of the 2001 CSO in connection with a table that maps to a lower mortality basis could easily result in tax reserves that were greater than statutory reserves, thus bringing the statutory cap into play. In considering the effect of a mortality table, it is important to keep in mind the different effects of a mortality table on a gross premium reserve (the basis of PBR) as compared to a net premium reserve. Where the net premium is a function of the mortality table, the reserve is related to the slope of the mortality table rather than to the level of mortality. Thus, whole life reserves under a select and ultimate table will generally be higher than the corresponding reserves under an ultimate table. However, this relationship is reversed under a gross premium valuation where the gross premium is the valuation premium, and a lower mortality table will correspond to a lower reserve.

Also, a rule that requires the use of a table yielding the lowest reserve for a contract would be problematic, particularly when a table may result in the lowest reserve at a particular duration, but a higher reserve at other durations.

Peter: I agree with you that the Notice's separation of section 7702 and the reserve assumptions is encouraging. But, I am troubled by the Notice's inclusion of mortality tables used in pricing as a possible solution to the mortality table issue. This would create uncertainty and disputes. Also, a rule that requires the use of a table yielding the lowest reserve for a contract would be problematic, particularly when a table may result in the lowest reserve at a particular duration, but a higher reserve at other durations.

Chris: Peter, you are absolutely right. The term "pricing" would need to be defined, particularly in contracts containing non-guaranteed elements. Does it apply each time the non-guaranteed elements change? It would also seem to lead to a difficult audit situation. What if the pricing has been done using a stochastic mortality process, an approach which is often used for variable annuity living benefits? Moreover, the current approach to determining the mortality table with the "lowest reserve" has been on an industry-wide basis. Trying to measure that in any other way would be difficult, to say the least.

Ed, the Treasury and IRS did not seem willing to determine tax reserves simply using the AFR as the assumed interest rate. Any comments on what they might do for the prevailing state assumed rate?

Ed: The Treasury appears to feel strongly that there needs to be a "prevailing state assumed interest rate" (PSAIR) as well as an AFR. They are concerned that the AFR could at some future time become unrealistically low, and that the PSAIR, as it is calculated differently, will offer a convenient floor under such an unrealistically low AFR.

The issue of how to calculate a PSAIR under PBR has been a topic of some robust discussion. This issue has been difficult because of two arguably conflicting facts: First, Code section 807(d)(4)(B) defines the PSAIR as, "…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." Second, under the PBR proposed guidance, the approach to generating the assumed interest rate (the discount rate) would be to use actual future earned interest rates in the applicable cash flow projection.

Thus the dilemma exists that the Code implies a fixed and determinable maximum interest rate, while PBR proposed guidance is toward fluctuating and entity-specific rates. Moreover, with the use of hedges, such future earned rates could conceivably be astronomically high at times. It has been discussed by some actuaries that the 26-state permitted discount rate used as the PSAIR could possibly be expressed as a formula rather than a number, could vary by policy duration and could vary by company (if expressed as the future earnings rate path). Opinions differ on the viability of such an approach.

The Notice appears to imply a single "rate" for any given contract, rather than a family of rates. However, it also mentions as possible alternatives "the rate used by the company in pricing the contract" and "the rate used to determine the deterministic or stochastic reserve," both of which would allow variation by company. The issue of a single rate for the PSAIR could possibly be resolved by solving for the level interest rate that produces a reserve equal to the reserve calculated by the non-level interest rate, although such a calculation might be quite difficult and it is unclear what that would accomplish.

It is also unclear whether such formula approaches and/or entity-specific approaches to the generation of the PSAIR would satisfy the section 807(d)(4)(B) definition thereof.

Chris mentioned the volatility of taxable income under PBR, and he is certainly correct. The interest rate will be a significant driver of that volatility. Interest rates have been known to fluctuate significantly over time. Some will even say that interest rates are far more difficult to predict than mortality. PBR, with its requirements for calculating long-term liabilities valued under frequently updated assumptions, will be subject to significant volatility both for tax and statutory purposes if the PSAIR is not stabilized. This is especially true in the event that it is decided to unlock the PSAIR each financial period on in-force business, as opposed to fixing the PSAIR as of the issue dates of the contracts. Thus, the alternative of using the rate(s) generated under either the stochastic or deterministic reserve as the PSAIR will undoubtedly generate significant volatility, although that will be somewhat mitigated by the cash value floor (for the deterministic reserve) and the existence of the AFR, the AFR being a long (60-month) rolling average.

Somewhat related to interest rates is the issue of allocation of invested assets between liabilities for contracts in force as of the effective date of PBR and assets underlying liabilities for future contracts, inasmuch as PBR is intended to be prospective only for statutory, and must be prospective for tax purposes. The approach to such allocation will influence the discount rate and its interplay with the AFR.

Chris: In considering "factors other than interest and mortality," as we have already discussed, the treatment of expenses may be the most difficult issue. Courts have generally permitted experience factors other than interest and mortality to be recognized in the calculation of life insurance reserves, but have tempered that view by adding "[w]e 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."[11] *In Mutual Benefit Life Insurance Company v. Commissioner of Internal Revenue,* the Tax Court recognized additional reserves set up for the cost of life settlement options (beyond the policy face amount) which were computed using assumed interest, mortality and a rate of election of the option.[12] Recently, section 8 of Actuarial Guideline 38 introduced a lapse factor into the computation of statutory reserves. Section 8C, effective for policies issued beginning in January 2007, provides that for certain issue ages and policy durations, a specified lapse rate (either 2 percent or 1 percent) "may be used" in the reserve calculation. The effect of the use of the lapse factor is to reduce the reserve. As a result, it is likely that the Treasury and IRS will have to confront the issue before the implementation of PBR.

The Notice asks whether company-specific assumptions are permissible and whether the annual adjustments to assumptions would cause a 10–year spread under the reserve strengthening/weakening rules of section 807(f). Peter, what are your views on these issues?

Peter: I do not believe that company-specific assumptions are remarkable as a factor in computing insurance reserves. Obviously, by definition, claim reserves must be company-specific. Even some life insurance reserves include company-specific assumptions, particularly for long-term care and disability policies. Similarly, methods of computing claim reserves, and even some premium reserves, contemplate periodic adjustments to certain assumptions. So, I do not think annual adjustments to reserves somehow could make them non-deductible.

The 10–year spread question probably has the easiest answer. The IRS and case law have agreed that section

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

[12] *Mutual Benefit Life Insurance Company v. Commissioner,* 58 T.C. 679, 688 (1972).

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807(f) comes into play only when there otherwise would have been a change in method of accounting. Where an accounting method contemplates from the outset routine annual adjustments pursuant to an accepted methodology, those adjustments do not result in a change in method of accounting. A perfect example is claim reserves. Annual adjustments to the reserves are fully anticipated and are considered changes in estimates, not changes in accounting methods. This is true even if fundamental changes are made in the estimation method and assumptions. Therefore, I do not believe that the 10–year spread rule would apply to routine changes in PBR assumptions.

Chris, is the Notice correct that section 807(f) probably will not apply under VACARVM and PBR transition rules?

Chris: One difference between VACARVM and the life PBR proposal is that statutory VACARVM will apply more broadly to in force while PBR will be applied only to new business, at least as it is currently proposed. For in force, tax reserves under PBR will continue under the old rules. In the transition to VACARVM, it is likely that there will be changes from product-to-product in the relationship of the "old" CARVM and VACARVM. Thus, to the extent the statutory cap comes into play, there may be a potential 807(f) issue. However, generally speaking, I don't anticipate any problems.

One of the ways in which some of these impacts can be studied is through some modeling of the potential effects of the transition, and more broadly through an analysis of the likely income effects of both VACARVM and PBR. One of the areas in which the Treasury and the IRS asked for comments involved the status of efforts to model VACARVM or PBR, "either on a company-by-company basis, a product-by-product basis, or industry-wide." It is a fair question for the Treasury and IRS to ask about the possible impact of the implementation of VACARVM and life PBR on federal tax revenues. If it can be demonstrated that the revenue effects are minimal, then it could go a long way to help resolve some of the policy issues. On the other hand, if it leads to significantly higher tax revenues, the industry might want to rethink some of the issues.

Just to wrap up, I would like to remind our readers what Peter said at the outset. The Notice shows the willingness of the IRS and the Treasury to work with the industry on the issues raised in the Notice, and to do so while both VACARVM and PBR are not yet in final form. Hopefully, those working on the development of VACARVM and PBR will take full advantage of the opportunity that has been presented to them.

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