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Tax Aspects of VA CARVM (aka Actuarial Guideline XLIII)

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After much work, deliberation and debate, the National Association of Insurance Commissioners (NAIC) has adopted a new principle-based reserve standard for variable annuity contracts with guarantees (VACARVM). Now that this new standard has been adopted, variable annuity writers will need to begin to prepare for the Dec. 31, 2009 implementation date. While there are many aspects to this preparation, one part will be to understand how the reserve calculations will differ under tax and statutory accounting. This article will address what those differences might be in light of recent concerns expressed by the Treasury Department (Treasury) and hopefully will provide the reader with some insights regarding tax planning under the new required methodology.

Background

While the introduction of life insurance principle-based statutory reserve requirements still appears to be at least several years in the future, statutory requirements for annuity "quasi principle-based reserves" have arrived. A guideline known as Actuarial Guideline XLIII (AG43) specifies statutory reserve requirements for variable annuities and related products. It has had a long history, and it is good to see that it has reached the end of the road, thanks to the hard work of the Variable Annuity Reserve Working Group (VARWG) of the American Academy of Actuaries (Academy) and the NAIC Life and Health Actuarial Task Force (LHATF). The effective date of AG43 is Dec. 31, 2009¹ and it is intended to replace Actuarial Guidelines 34 and 39. Given a short implementation period and its impact on both statutory and taxable income, the effect of this new guideline is substantial. For example, it is a ret-

roactive guideline, requiring compliance for all policies issued beginning in 1981—thus, it encompasses virtually all inforce variable annuity contracts subject to CARVM.

The types of contracts that fall within the scope of AG43 include the following:

- Variable deferred annuity contracts subject to CARVM.
- Variable immediate annuity contracts.
- Group annuity contracts not subject to CARVM, but which contain guarantees such as Guaranteed Minimum Death Benefits (GMDBs) and/or Guaranteed Living Benefits (VAGLBs).
- Variable life contracts that contain guaranteed living benefits.

The Components of the Statutory Reserve Requirements under VACARVM

The reserve approach under AG43 is a "quasi principle-based" approach, combining both deterministic and stochastic elements. The two key components that comprise the reserve are the Standard Scenario Amount (SSA), plus the excess, if any, of the CTE² Amount over the SSA (this excess amount will be referred to from this point forward as the "Stochastic Excess"). The SSA is a deterministic reserve that serves as a floor for the AG43 reserve. It is determined by a seriatim (contract-by-contract) valuation approach, which, for interest and mortality assumptions, uses generally prescribed assumptions locked in from the issue date. Certain other assumptions, such as lapse and VAGLB election rates, which are a function of moneyiness,³ reflect current economic conditions as of the valuation date. The CTE Amount is a stochastically generated amount,

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using randomly varying interest rates and equity paths, and using prudent estimates for other assumptions (*e.g.*, mortality, persistency, etc.).

We will be discussing the SSA in the remainder of this article, leaving aside the CTE Amount in this article, for two reasons:

1. The pragmatic reason, that the entity-specific assumptions and modeling instructions underlying the CTE Amount would make it difficult to write a comprehensive but short document on this that would also contain insights on tax implications.
2. Recent industry commentary has reported that VACARM surveys of major variable annuity writers show that the SSA dominated over the CTE(70) amount in almost all cases. When this occurs there is no Stochastic Excess element to the reserve. Thus, the deterministic component generally sets the reserves under AG43.

Description of the Standard Scenario Amount

The SSA is based on a seriatim calculation of the Standard Scenario Reserve (SSR) for each contract. If a contract has guaranteed benefits (as defined in AG43, Section III), the SSR equals the Basic Adjusted Reserve (BAR) plus a “greatest present value” (GPV) measure.

- The BAR is essentially the Actuarial Guideline 33 CARVM methodology, with two exceptions:
 - Free partial withdrawal provisions are disregarded.
 - The NSV “floor” is ignored at this point in the calculation.
- The GPV equals the greatest present value measured at the end of each projection year of the negative of the Accumulated Net Revenue (ANR). The ANR at the end of any future projection year equals:
 - The ANR at the end of the prior projection year accumulated one year at the prescribed interest rate, plus the “margins” defined in AG43, less benefits paid in excess of account values applied.

Finally, the GPV cannot be negative.

Additional adjustments to the SSR will be required for hedges and “aggregate reinsurance ceded.” Following these adjustments the SSR is floored at the net surrender value (NSV).

If there are no guaranteed benefits in excess of account value, then the traditional integrated reserve formula approach is to be used, instead of the above. However, since virtually all individual variable annuity contracts in force and currently issued contain guaranteed benefits (a return of premium feature on the GMDB at the very least), the SSR is applicable to virtually all of these products.

Thus for tax purposes the details of the SSR deserve serious consideration and appear to have a good chance to survive virtually intact.

Tax Implications

The Treasury promulgated Notice 2008-18 early this year. It was a product of Treasury discussions with representatives of the Academy and the American Council of Life Insurers (ACL), as well as the Treasury’s reading of certain articles published in *TAXING TIMES*. While the Notice registered significant concerns about stochastically generated reserves, it pointed out the following: “the Treasury Department and IRS believe that the standard scenario under proposed AG VACARM . . . would more closely resemble the methodology in effect when Congress enacted section 807 in 1984 than would the CTE amount or stochastic reserve.” Thus for tax purposes the details of the SSR deserve serious consideration and appear to have a good chance to survive virtually intact. Assuming this is true, the discussion below addresses a number of issues and observations that may result from implementation of SSR.

Interest Rates. It is expected that the tax basis SSR will generally be close in value to the statutory SSR. The primary differences will be in the valuation rate used in computing tax and statutory SSR.

- The valuation rate for the statutory SSR is the prescribed Discount Rate (DR) while the tax valuation rate for the SSR will likely use the greater

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of the DR or the applicable Federal interest rate (AFIR).⁴

- In case there are any forward interest guarantees on combination contracts (variable annuities with general account options), Code Section 811(d) will limit the forward deemed interest guarantee to the valuation rate for purposes of computing the tax SSR.

Prospective vs. Retrospective Application. AG43 applies retroactively to variable annuity contracts issued in 1981 and later. Any modifications to the methodology used to compute tax reserves under Internal Revenue Code Section 807(d) resulting from AG43 will apply on a prospective basis to newly issued contracts. This will cause Federally prescribed reserves (FPR) or tax reserves for contracts issued between 1981 and 2008 to be subject to the traditional CARVM rules [the Standard Valuation Law (SVL), as interpreted through Actuarial Guidelines 33, 34, and 39],⁵ while statutory reserves for virtually all inforce contracts will fall within VACARVM's scope. This will cause significant nonparallel effects between the two systems.

Stochastic Excess and the Statutory Cap. Statutory capping will most likely come into effect for significant portions of inforce business, largely because of the nonparallel effects described above.⁶ While there are Treasury con-

cerns about the deductibility of the Stochastic Excess, AG43 contains a reasonable methodology for allocation of such excess to individual contracts, based on each contract's relative contribution to the Stochastic Excess. As such, the Stochastic Excess will likely add to the statutory cap, since it constitutes part of the statutory reserve.

Contract Year vs. Calendar Year. There is possibly a subtle but important difference in the way in which SVL and AG43 define the term "year." The SVL specifies that the greatest of present values should be determined as of the "end of a contract year," while AG43 references calendar year in the SSR GPV calculation. Technical Advice Memorandum (TAM) 9452001 reiterates the "end of contract year" point, as follows:

Thus, CARVM specifically requires a determination of the present value of each of the future guaranteed benefits, including nonforfeiture benefits, provided for by an annuity contract at the end of each respective contract year. For many annuity policy designs, for example, when there is a grading off of surrender charges at each successive contract anniversary date, the use of end of year contract values to determine the present value of future guaranteed nonforfeiture benefits under CARVM results in a lesser reserve provision than if beginning of the year contract values were used.

For example, an actuarial textbook observes:

... CARVM requires calculating present values based on benefits as of the end of each policy year. The language specifically states end of year values should be used, and examples found in the NAIC Proceedings use end of year methodology, even though beginning of year methodology would have produced larger reserves for the policies shown in these examples. Thus it is clear that the drafters of CARVM intended for end of year values to be used, even though they realized (as evidenced by the example in the Proceedings) that typical SPDA designs would produce larger reserves if beginning of the year values had been used.

Tullis and Polkinghorn, Valuation of Life Insurance Liabilities, 73 (2d ed. 1992).

The fact that this TAM explicitly referred to the definition of CARVM in the SVL—rather than to any actuarial guideline—is arguably consistent with the principle of law that a statute overrides any regulatory interpretation in case the two are in conflict. Hopefully, this timing difference in the guidance will not cause a difference between statutory and tax calculations. Furthermore,

the BAR requirement will continue to be as of contract year-end, while only the GPV contains a calendar year-end calculation requirement.

Static vs. Dynamic Assumptions. The discount rate and mortality assumption appear to satisfy the issue year lock-in concept under Code section 807(d). Certain other assumptions are functions of the current environment as of the valuation date, and such treatment would appear to be permissible under the Code, as long as those assumptions are the same for statutory and tax purposes. Those other assumptions would include lapse assumptions and VAGLB election assumptions, which are functions of the current moneyness of the contract as of the valuation date.

Assumption or Methodology Change? Several of the assumptions (e.g., lapse rates and election rates) are subject to change during the lifetime of a contract, but for which the assumption methodology is locked in from the issue date. This could possibly be construed to warrant section 807(f) treatment, under which the 10-year spread rules would be applicable. However, it appears that the better argument is that the assumptions are under a methodology that does not change from the issue date of the contract, and that therefore does not warrant spread treatment.

Margins. Another assumption that is subject to change during the lifetime of a contract is the margin used in the GPV calculation. This margin is a function of the Surrender Charge Amortization Period (SCAP), which in turn is a function of the “BAR duration.”⁷ Since the BAR is based on the current account value as of the valuation date, the SCAP, and therefore the future margin pattern, could possibly change over time for reasons beyond the simple passage of time between valuation dates. Here again, consistency between statutory and tax approaches would appear to be required, although the difference between tax and statutory discount rates might cause a difference between statutory and tax SCAPs.

Concluding Comments

We hope this article has provided you insights into the tax issues that must be reviewed and addressed as your company moves forward in implementing AG43. While the tax issues under AG43 have not been fully fleshed out or commented upon by the Treasury, we anticipate that more guidance will be forthcoming over the next year. ◀

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End Notes

- ¹ With a grade-in period of up to 3 years, subject to the permission of the Domiciliary Commissioner.
- ² “Conditional Tail Expectation.” This term is expressed as “CTE(X)”, or the average of the highest (100-X) percent “scenario greatest present values” in the stochastic process. A scenario greatest present value is the greatest present value of “accumulated deficiencies” in a given scenario projection, plus the starting asset value. “CTE(70)” is the average of the highest 30 percent scenario present values.
- ³ Moneyness is a term used to tell whether the current value of a guaranteed option is above the contract’s account value. “In the Money” means that such current value is currently in effect (i.e., above the account value). “Out of the money” means that such current value is less than the account value.
- ⁴ There is a possibility that the DR will not be considered the “Prevailing Statutory Assumed Interest Rate,” inasmuch as state action has not taken place to accept the DR in 26 or more states. It is unusual (and arguably improper) for an actuarial guideline to stipulate a mortality table or an interest rate, a matter more properly attended to by administrative action by the individual states.
- ⁵ It should be noted that Guidelines 34 and 39 both contain stochastic testing requirements, whose deductibility has been challenged by the IRS on audit. Further, Guidelines 33 and 39 each have two versions: an original one and a revised one. Under a reasonable interpretation of section 807(d), this causes a separation of “tax CARVM” into additional generational granularity. As section 807(d)(3)(B) indicates: “The term ‘CARVM’ means the Commissioners Annuities Reserve Valuation Method prescribed by the [NAIC] which is in effect on the date of the issuance of the contract.”
- ⁶ ‘Statutory capping’ refers to the language in section 807(d)(1), which stipulates in pertinent part, “In no event shall the reserve determined under the preceding sentence [the greater of NSV or FPR] for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves...”
- ⁷ The duration of the greatest present value used in the BAR calculation.