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ACLI Update Column

by Bill Elwell

In past issues of *TAXING TIMES*, The American Council of Life Insurers (ACLI) has reported on its ongoing efforts with the Treasury Department (Treasury) regarding the National Association of Insurance Commissioners (NAIC) reserve modernization efforts. After nearly a decade of work by ACLI and representatives of its member companies, the Society of Actuaries (SOA), the American Academy of Actuaries (Academy), and the NAIC's Life and Health Actuarial Task Force (LHATF), on Sept. 24, 2008, the NAIC adopted a new actuarial guideline for applying the method of computing statutory reserves for variable annuity contracts (AG VACARVM). We appreciate Treasury's and the Internal Revenue Service's (IRS) continuing willingness to discuss the tax implications of AG VACARVM while the modernization effort is underway. The release of Notice 2008-18 earlier this year and the opportunity for input has been very valuable, and ACLI continues the timely consideration of the recently adopted Guideline.

On Oct.10, 2008, ACLI and representatives from the Academy, NAIC, and Affordable Life Insurance Alliance (ALIA) met with representatives from Treasury and IRS to discuss the need for immediate guidance regarding the tax treatment of reserves determined under AG VACARVM because life insurance companies are now preparing for annuity contracts that will be issued in 2009 and planning for the related tax liabilities. Shortly thereafter, ACLI sent Treasury and IRS a letter focusing on the aspects of AG VACARVM that have immediate and significant ramifications to our member companies and requesting that Treasury and IRS issue published guidance before the end of 2008 on three key issues: (1) the effective date of AG VACARVM for tax purposes; (2) the status of the Standard Scenario as a tax deductible reserve under section 807(d) of the Internal Revenue Code;[1] and (3) the limitation based on statutory reserves under section 807(d). ACLI believes it has given Treasury and IRS sufficient information and policy rationales for Treasury and IRS to issue favorable guidance on these issues this year.

Effective Date of AG VACARVM for Tax Purposes Should be 2009

In the meeting and its follow-up letter, ACLI explained that because AG VACARVM has an effective date of Dec. 31, 2009, and it applies to all contracts issued on or after Jan. 1, 1981, for 2009 annual statements, all insurance companies issuing contracts must calculate reserves for these variable annuity contracts in accordance with AG VACARVM.

Section 807(d) requires the use of "CARVM" to compute reserves for an annuity contract. CARVM is the Commissioner's Annuity Reserve Valuation Method prescribed by the NAIC that is in effect on the date of the issuance of the contract.[2] For contracts issued in 2009, companies will determine the tax reserves for these contracts for the first time at the end of the year—Dec. 31, 2009. Because companies determine the tax reserves for a contract at the end of the year, an actuarial guideline that becomes effective during a year should be effective for all contracts issued that year; this treatment is particularly appropriate in this case where NAIC adopted the Guideline before the start of the year in which the Guideline becomes effective.

Consequently, ACLI requested that Treasury and IRS issue guidance that provides that for contracts issued in 2009, AG VACARVM will be the actuarial guideline in effect, and the effective date of AG VACARVM for tax purposes should therefore be 2009.

Standard Scenario Satisfies Requirements in Section 807(d)

ACLI also explained to Treasury and IRS that the AG VACARVM reserve is comprised of the Standard Scenario and Stochastic excess (if any) determined under the Guideline. IRS Notice 2008-18 recognizes that AG VACARVM reserves are determined in two parts, first by computing the Standard Scenario amount and then by Stochastic modeling. The Standard Scenario portion of the AG VACARVM reserve is determined on a contract-by-contract basis and is based on a prescribed interest rate determined by the year of issue of the contract and on standard mortality tables. As Treasury and IRS observed in the Notice, the computation of the Standard Scenario amount resembles the current reserve methodology's computation of the tax reserve. The Notice suggests that Treasury and IRS may conclude that the Standard Scenario portion of the AG VACARVM reserve satisfies the requirements of section 807(d), a conclusion with which ACLI would agree. Although it is ACLI's view that both parts of AG VACARVM satisfy section 807(d), ACLI recognizes that the portion of the reserve determined by stochastic modeling presents a more difficult question for which Treasury and IRS may need more information.

Consequently, ACLI requested that Treasury and IRS issue guidance that provides that the portion of the reserve determined using the Standard Scenario satisfies the

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requirements in section 807(d) as an amount of reserves for the purposes of determining taxable income.

Limitation Based on Statutory Reserves Under Section 807(d)

A life insurance company generally must pay tax on its life insurance company taxable income, which is life insurance gross income less life insurance deductions.[3] The Code authorizes a deduction for the net increase in reserves under section 807(b).[4] The tax reserve for a life insurance contract is the greater of: (i) the net surrender value of the contract, or (ii) the reserve calculated in accordance with section 807(d)(2).[5] This amount, however, can never "exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves."[6] Accordingly, the statutory reserves with respect to a contract operate as a limit on the amount of the contract's life insurance reserves that might otherwise be taken into account in determining a life insurance company's taxable income. The term "statutory reserves" is defined as "the aggregate amount set forth in the annual statement with respect to items described in section 807(c)," but does not include any reserve attributable to a deferred and uncollected premium if section 811(c) does not permit the establishment of this reserve.[7] Section 807(c) includes life insurance reserves under section 816(b).[8] The reserves determined under AG VACARVM are "life insurance reserves" under section 816(b).

Section 807(d) therefore sets both a floor and a ceiling on the amount of the reserves to be used in determining income. The floor is the net surrender value of the contract; the ceiling is the amount taken into account for the contract in determining the statutory reserves. With the adoption of AG VACARVM, the NAIC-prescribed method for determining the statutory reserves for variable annuity contracts includes the Standard Scenario amount and the excess (if any) of the Stochastic reserve over the Standard Scenario. The Code requirement that the amount of reserves cannot exceed the amount of statutory reserves provides a limit based on the reserves a life insurance company actually holds. There is no basis in either the statute or the legislative history for adjusting the amount of statutory reserves to exclude the Stochastic reserves. Section 807(d) provides a tax reserve method, with specific parameters and adjustments for determining the amount deductible under section 807(d), subject to a limitation of the amount of the statutory reserves, but not for adjustments to the amount carried as a statutory reserve.

Section 807(d) refers to the amount of reserves "with respect to such contract." AG VACARVM allocates the excess of the Stochastic amount over the Standard Scenario (using prescribed methods) among the contracts to determine each contract's reserve amount. Specifically, AG VACARVM requires that when the stochastic amount is greater than the Standard Scenario amount, it must be allocated to each contract in a manner that reflects the contribution of each contract to the Stochastic excess. Thus, in instances where the stochastic amount exceeds the Standard Scenario amount, the stochastic amount results in a contract-specific reserve determination, so AG VACARVM provides a contract-specific statutory reserve amount for purposes of applying the statutory reserve limit of section 807(d).

While the allocation methodology has implications for federal taxation, understanding which contracts give rise to the stochastic excess also has value for management and regulatory purposes. State regulators, for example, use reserves determined on a contract-by-contract basis in the rehabilitation of a company when valuing policyholder claims against the company in rehabilitation. Similarly, guaranty funds use these reserves in valuing a business for purposes of selling a portion of the business.

ACLI therefore believes that statutory reserves are statutory reserves. A life insurance company is subject to regulation under the insurance laws of each state in which it does business. The state insurance regulatory authorities in each state apply the NAIC guidelines in prescribing the amount of reserves that a company must report on the annual statement as the amount the insurance company has set aside to mature or liquidate policyholder or beneficiary claims arising from its insurance and annuity contracts.

Issues for Future Resolution

During the meeting, Treasury and IRS also asked for clarification regarding other issues that might need guidance during 2009, including: (1) the status of the stochastic portion of the reserve as a tax-deductible reserve, (2) the effect of the elective three-year phase-in, and (3) the potential application of the 10-year spread rules in section 807(f) to a change in the calculation of the statutory reserves. ACLI will also consider whether AG VACARVM will require updates to other Treasury or IRS guidance, and intends to continue working with Treasury and IRS to resolve further questions regarding these and other issues necessary for the issuance of guidance.

The Stochastic portion of the reserve satisfies requirements in section 807(d). As mentioned above, it is ACLI's view that both the Standard Scenario and the Stochastic excess (if any) satisfy section 807(d). ACLI recognizes that the portion of the reserve determined by stochastic modeling presents a more difficult question for Treasury and IRS and will continue to provide additional information, as needed.

If utilized, this phase-in would affect the statutory cap because the company would be holding a lower statutory reserve, and therefore could never result in an increase in the company's tax deduction.

If a life insurance company elects the three-year phase-in for AG VACARVM, it should limit that company's statutory cap. ACLI explained that, if the Guideline results in higher reserves for a company than the prior CARVM, AG VACARVM permits that company to request an elective phase-in of up to three years. ACLI expects that few companies would use this elective provision, and even if a company does apply for relief under this provision, the state insurance commissioner must approve the election and confirm that such a delay would not cause a hazardous financial condition or potential harm to the company's policyholders. If utilized, this phase-in would affect the statutory cap because the company would be holding a lower statutory reserve, and therefore could never result in an increase in the company's tax deduction.

AG VACARVM should not result in a 10-year spread under section 807(f). ACLI explained that section 807(f) concerns a change in the tax reserve method. If, for tax purposes, the tax reserve method applies the old Guidelines for contracts issued prior to 2009 and AG VACARVM for contracts issued in 2009, this would not result in a change in reserve method or basis of computing reserves under section 807.

While the statute and legislative history do not specifically address the impact of the statutory reserve limit as a change in the basis of computing reserves, the legislative history does explain that "[c]hanges in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve, but a current liability."[9] Similarly, the statutory cap is a limitation, not a reserve, so a change in the statutory cap should not be subject to the 10-year spread.

End Notes

1 All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
2 Section 807(d)(3).
3 Section 801(b).
4 Section 805(a)(2).
5 Section 807(d)(1). Section 807(d)(3)(C) provides that the tax reserve cannot include deficiency reserves.
6 Section 807(d)(1) (flush language).
7 Section 807(d)(6).
8 Section 807(c)(1).
9 JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984 (Blue Book), AT 604.

Bill Elwell is senior tax counsel at the ACLI in Washington, D.C. and may be reached at *billelwell@acli.com*.