Article from:

# Taxing Times

February 2009 – Volume 5 – Issue No. 1

# Effective Date and Statutory Reserves Capping Issues under Actuarial Guideline XLIII

*by Peter H. Winslow*

This issue of *TAXING TIMES* includes an article which provides an excellent summary of tax issues that arise from the adoption of VACARVM by the National Association of Insurance Commissioners (NAIC)[1] as well as an American Council of Life Insurer's (ACLI) update of its dealings with the Treasury Department (Treasury) on the same issue.[2] VACARVM is now designated as Actuarial Guideline XLIII (AG 43). The above referenced article makes the important point that, despite its retroactivity for statutory purposes, AG 43 probably will have only prospective effect for tax purposes. Both the article and the ACLI Update note that, regardless of whether the Stochastic Excess will be considered part of CARVM reserves for tax purposes, it may be included in the statutory reserves cap for purposes of the three-way test under I.R.C. § 807(d)(1). These points deserve some elaboration.

***Does AG 43 apply to all contracts issued in 2009?***

Under I.R.C. § 807(d)(3), the tax reserve method that must be used for variable annuity contracts is the Commissioners' Annuities Reserve Valuation Method (CARVM) prescribed by the NAIC in effect on the date of the issuance of the contract. Implementation of this statutory rule has resulted in disputes between the Internal Revenue Service (IRS) and life insurance companies where the NAIC has adopted actuarial guidelines with retroactive effect. IRS auditors generally have taken the position that a newly-adopted actuarial guideline cannot apply for tax purposes to contracts issued prior to the year the guideline was adopted. As support for this position, IRS auditors cite a technical advice memorandum that currently is being challenged in the U.S. District Court in a tax refund suit.[3] Life insurance companies have argued that an actuarial guideline should apply retroactively when the new method is used for statutory reserves and it was one of several permissible interpretations of CARVM at the time the contract was issued.[4]

There does not appear to be a major dispute on this issue as a result of the NAIC's adoption of AG 43. The IRS is likely to take the position that AG 43 should not be used for contracts issued prior to 2009, and taxpayers are equally likely to accept this interpretation, at least for most pre-2009 contracts. This is because—prior to the adoption of AG 43—the NAIC had clear guidance on the interpretation of CARVM in AG 34 and AG 39 that was required to be used for the tax reserve method under I.R.C. § 807(d)(3). There is a lingering issue, however, relating to contracts subject to AG 43, but issued prior to the adoption of AG 34 or AG 39. It could be argued that AG 43 should be used for these contracts because there was no NAIC-prescribed interpretation of CARVM at the time they were issued, and AG 43, at least in theory, was one of several permissible interpretations. Therefore, because AG 43 will be used for statutory reserves for these contracts, it is arguable that it also should be used as the tax reserve method. Nevertheless, it appears from comments sent to the Treasury and the IRS by the ACLI on Oct. 24, 2008, that the industry does not intend to press this issue. Perhaps, this issue will be revisited after the pending litigation on the retroactive application of AG 33 is resolved.

Assuming that AG 43 will not have a retroactive effect, there still remains an open issue as to whether it will apply to all contracts issued in 2009 on the basis that it was adopted prior to 2009 by the NAIC and effective for all contracts issued in that year. Other potential approaches could be that AG 43 will apply to contracts issued after Sept. 24, 2008, the date AG 43 actually was adopted by the NAIC, or only to contracts issued on or after Dec. 31, 2009, AG 43's effective date. There is no clear answer to this question in the statute or legislative history, but preliminary indications are that the IRS may conclude that AG 43 will apply for tax purposes to all contracts issued in 2009. This is the most reasonable and administrable result, and has been recommended by the ACLI.

***Will the Stochastic Excess portion of AG 43 reserves be included in the statutory reserves cap?***

A major unresolved issue is whether the Stochastic Excess portion of AG 43 reserves will be recognized as part of CARVM reserves for tax purposes. This commentator believes that it should be,[5] but, it is possible, if not likely, that the Treasury and the IRS will reach a contrary conclusion. Assuming that it is concluded that the Stochastic Excess will not be included as part of the CARVM tax reserve method under I.R.C. § 807(d)(3), the next question is: will it be considered part of statutory reserves for purposes of determining the limitation on deductible tax reserves? This can be an important consideration if the amount of tax reserves computed under AG 34 and AG 39 for a pre-2009 contract is greater than the statutory reserves computed under the Standard Scenario in AG 43.

The better answer to this question is that a contract's portion of the Stochastic Excess allocated in accordance with AG 43 should be included in statutory reserves for the contract. This conclusion is supported by the statutory language, its legislative history and the tax policy considerations underlying the statutory provisions. Under I.R.C. § 807(d)(6), statutory reserves include the aggregate amount set forth in the Annual Statement for a contract "with respect to" the reserve items described in I.R.C. § 807(c). This statutory language incorporates two basic principles. First, reserves held on the Annual Statement do not themselves have to be deductible as insurance reserves described in I.R.C. § 807(c) to be included in statutory reserves. Had this been the test, the statute would have limited statutory reserves to I.R.C. § 807(c) items. The second principle is that there must be a nexus between an I.R.C. § 807(c) insurance reserve and a non-deductible Annual Statement reserve for it to be included in statutory reserves. That is, the reserve must be held "with respect to" an insurance reserve described in I.R.C. § 807(c). This nexus seems to be present for the Stochastic Excess portion of CARVM reserves under AG 43. After all, the NAIC has prescribed the Stochastic Excess as part of the basic CARVM minimum reserve for a variable annuity contract. This conclusion is supported by the legislative history that reflects Congress' intent to include deficiency reserves in the statutory reserves cap.[6] As in the case of the Stochastic Excess under AG 43, the minimum reserve required under the Commissioners' Reserve Valuation Method (CRVM) includes deficiency reserves even though they are not deductible for tax purposes. In both cases, the NAIC has established the requisite nexus between the nondeductible reserve and the I.R.C. § 807(c) insurance reserve to satisfy the criteria for statutory reserves under I.R.C. § 807(d)(6).

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Tax policy considerations also support this conclusion. When it was originally enacted as part of the Deficit Reduction Act of 1984 (1984 Act) the definition of statutory reserves was found in former I.R.C. § 809, which imposed an "add-on tax" on mutual life insurance companies determined by reference to their "equity base." Statutory reserves were a factor taken into account which had the effect of increasing the equity base and, therefore, the add-on tax imposed. Congress intended a broad interpretation of statutory reserves to ensure that the equity base would not be reduced. As a result, there is little doubt that the IRS would have concluded that, under former I.R.C. § 809, an NAIC-required reserve like the Stochastic Excess would have been required to be included in statutory reserves.

Similar considerations apply to the tax policy under I.R.C. § 807. Congress' primary objective in enacting the tax reserve rules in the 1984 Act was to create a level playing field by providing that life insurance companies would obtain essentially the same reserve deductions regardless of the states in which they were doing business. There was an exception to this equal deduction rule. Congress determined that it was not consistent with the level-playing-field principle to permit an insurer to obtain a tax reserve deduction for reserves that were not actually held on the Annual Statement because such a company would obtain a competitive advantage if its surplus were not reduced by the reserves. An overly narrow interpretation of statutory reserves would defeat

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Congress' desire to provide a level playing field by denying companies a tax reserve deduction enjoyed by their competitors even when, in fact, they hold reserves somewhere on the Annual Statement.

***Will the 10-year spread rule of I.R.C. § 807(f) apply to the change to AG 43?***

I.R.C. § 807(f) provides for certain reserve adjustments where there has been a change in the basis of determining reserves for contracts issued prior to the year of change. There are two basic rules in I.R.C. § 807(f). First, the change in basis is delayed for tax purposes for one year and tax reserves continue to be computed on the old method for these pre-change-year contracts for the taxable year in which the change occurs. Second, the difference between the ending tax reserve for the year of change computed on the new basis and the ending tax reserve computed on the old basis is spread ratably over 10 years.

It generally is believed that this 10-year spread rule should not have much impact upon the adoption of AG 43 because AG 34 and AG 39 should continue to apply for tax purposes to contracts issued prior to 2009. However, there is one nagging unresolved issue that could come into play. Since the enactment of the 1984 Act, the life insurance industry has wrestled with the question of whether a change in statutory reserves is a change in basis of determining reserves subject to I.R.C. § 807(f) even if the amount of the uncapped federally prescribed reserves in I.R.C. § 807(d) does not change. There has been no direct guidance from the IRS on this issue although it arises frequently when Annual Statement reserve assumptions change. Resolution of this issue involves analysis of case law and rulings relating to changes in method of accounting under I.R.C. § 446. The IRS and the courts have concluded that the 10-year spread rule will apply if the change in computing tax reserves would have been considered a change in method of accounting but for the special I.R.C. § 807(f) rule.[7]

It is a close question whether a change in method of accounting is involved when the statutory reserves cap, but not the federally prescribed reserve, is recomputed. It could be argued that the impact on reserves from a change in the cap affects the timing of the reserve deductions and, therefore, is in the nature of a change in method of accounting.[8] An equally persuasive argument could be made that a change in method of accounting is not involved unless the computation of the federally prescribed reserves is adjusted. Under this approach, a change in the statutory reserves cap that occurs solely by reason of a change in Annual Statement reporting is a change in external facts not subject to the change-in-method-of-accounting rules.

Although resolution of this issue could go either way, this commentator believes that the IRS likely will conclude that I.R.C. § 807(f) does not apply. The most likely scenario will be that AG 34 and AG 39 reserves will be higher than the AG 43 reserves held on the 2009 Annual Statement. If the IRS were to conclude that I.R.C. § 807(f) applies, we could have the anomalous result that statutory reserves for 2009 would be computed using the old AG 34 and AG 39 method for purposes of the cap even though they are higher than the reserves actually held on the 2009 Annual Statement. In its October 24 letter, the ACLI recommended that I.R.C. § 807(f) not apply in these circumstances.

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**End Notes**

1 Adopted on Sept. 24, 2008.
2 *See* E. Robbins, M, LeBoeuf and V. Akin, *Tax Aspects of VA CARVM (aka Actuarial Guideline XLIII)*, p. 1 and *ACLI Update Column*, p. 29 of this issue.
3 TAM 200328006 (Mar. 20, 2003). *See* P. Winslow, *IRS's Position on Retroactivity of Actuarial Guidelines to be Tested in Court, TAXING TIMES*, VOL. 4, ISSUE 1, February 2008.
4 *See* P. Winslow and S. Hotine, *IRS Requires Use of Prevailing State Minimum Reserve Standard Where There Is No Specific NAIC Guidance at Issue Date, TAXING TIMES,* VOL. I, ISSUE 2, September 2005, for a more complete discussion of this issue.
5 *See* P. Winslow, *The Tax Reserve Method Should Be PBR Once It Is Adopted by the NAIC, TAXING TIMES,* VOL. 4, ISSUE 3, September 2008.
6 *See* S. Mitchell and P. Winslow, *The Statutory Reserve Cap on Tax Reserves Includes Deficiency Reserves, TAXING TIMES,* VOL. 2, ISSUE 2, September 2006.
7 Rev. Rul. 94-74, 1994-2 C.B. 157; *American General Life and Accident Ins. Co. v. United States*, 90-1 USTC ¶ 50,010 (M.D. Tenn. 1989).
8 Treas. Reg. § 1.446-1(e)(2)(ii)(a).