Article from:

Taxing Times

September 2010 – Volume 6, Issue 2

SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

VOLUME 6 | ISSUE 3 | SEPTEMBER 2010

Uncertainty Remains in Tax Reserve Assumptions for Guaranteed Renewable and Noncancellable Health Insurance

By Edward L. Robbins and Peter H. Winslow

At the time the 1984 Tax Act was developed, efforts were made to conform tax reserves to the statutory reserve environment at the time. The drafters of the Act seemingly presumed that the National Association of Insurance Commissioners (NAIC) and state law always would provide for deterministic minimum reserves computed using defined tables and discount rates. Since then, statutory reserve regulation has undergone substantial changes prompted by product innovation and technological advances, whereas section 807,[1] which deals with deductible tax reserves, has remained relatively unchanged. Consequently, it has become increasingly more difficult to fit statutory guidance (most recently Actuarial Guideline 43)[2] and new product forms into the Code's tax reserve regime. Principle-based reserves likely will exacerbate this problem.

With all the activity surrounding reserving changes for life insurance and variable annuities, tax reserve issues relating to guaranteed renewable and noncancellable health insurance sometimes are overlooked. Certain reserves in these product lines are treated as "life insurance reserves" and thus subject to recomputation for tax purposes under section 807. Actuaries have been struggling for years to fit these reserves into the rules of that Code section.

By its nature, the health insurance product lines contain enormous variations in benefits, and even within one product line, significant differences in benefit terms arise. Thus, standard tables do not function as effectively for health insurance as for life insurance. This additionally complicates the application of the provision for adjustment "as appropriate

CONTINUED ON **PAGE 6**

to reflect the risk."[3] Further, there is the matter of rapid table obsolescence in several health product lines, which undoubtedly caused the Treasury Department (Treasury), in its crafting of Treas. Reg. § 1.807-1 (described below), to prescribe the morbidity table for tax purposes in most health product lines. Interestingly, Treasury in its regulation, apparently acknowledging the difficulty in prescribing specific tables for health insurance, in most instances simply prescribes the table used for statutory annual statement purposes.

Another complication for health insurance is that there are potentially four reserve categories in the statutory reserve environment, each with its particular statutory rules for conversion to tax basis reserves:

- Premium reserves (Annual Statement "Unearned premium reserves," Exhibit 6)
- Contract reserves (Annual Statement "Additional reserves," Exhibit 6)
- Claim reserves (located in Annual Statement Exhibit 6)
- Claim liabilities (located in Annual Statement Exhibit 8, Part 1)

It is not always easy to determine whether an annually renewable contract falls within the requisite category of guaranteed renewable or noncancellable. Model Regulations adopted by the NAIC define a guaranteed renewable policy as one that has the right to continue in force by the timely payment of premiums until at least the later of:

It is not always easy to determine whether an annually renewable contract falls within the requisite category of guaranteed renewable or noncancellable.

- Age 50, or
- Five years from its date of issue

and, during which period the insurer has no right to make unilaterally any change in any provision of the policy while the policy is in force. Under those Model Regulations, the insurer's right to make changes in premium rates by class does not eliminate the contract from guaranteed renewable treatment.

Treasury Regulations contain a similar definition, but include subtle and potentially important differences: "The term 'guaranteed renewable life, health, and accident insurance policy' means a health and accident contract, or a health and accident contract combined with a life insurance or annuity contract, which is not cancellable by the company but under which the company reserves the right to adjust premium rates by classes in accordance with its experience under the type of policy involved . ..." These definitional differences have led to uncertainty, with the Internal Revenue Service (IRS) sometimes concluding that policies that are guaranteed renewable under state law fail to qualify as such for tax purposes. For example, in a private letter ruling,[4] the IRS ruled that a health insurance policy was not guaranteed renewable for tax purposes because the insurer retained the right to cancel the contracts on a state-by-state basis—a right typically retained by the insurer but nevertheless treated as if it were a guaranteed renewable policy for regulatory purposes.

Apart from basic contract-qualification matters, the tax problems that arise for actuaries dealing with contract and claim reserves[5] usually fall into four types of issues: 1) what is the "issue date" for tax reserving purposes; 2) what is the appropriate morbidity table that should be used under section 807(d); 3) when can the table be "adjusted as appropriate to reflect the risks" under section 807(d)(2)(C); and 4) when does a modification to reserve assumptions rise to the status of a change in basis of computing reserves subject to the ten-year spread rule of section 807(f)?

WHAT IS THE ISSUE DATE FOR PURPOSES OF SECTION 807(d)?

An answer to this question is far from certain in the case of claim reserves that qualify as life insurance reserves under health insurance contracts. Under section 807(d), the applicable tables, prevailing statutory assumed interest rates (PSAIRs), and applicable federal interest rates (AFIRs) are all "issue-year driven." That is, the issue year of the contract determines the table and corresponding interest rate for tax reserve valuation. In the case of tax basis health claim reserves, however, most companies have adopted the claim incurral date as the deemed issue date for tax reserve purposes, which makes the most sense from an economic perspective. This practice may appear to be inconsistent with the Code requirement to use the table and interest rate that were applicable when the contract was originally issued. But, there are at least two legal arguments for using the claim incurral date as the deemed issue date.

First, Congress may have intended that the determination of when a contract is considered issued be made in a manner consistent with the industry's statutory reserving practices. As in section 807(d), the Standard Valuation Law prescribes minimum reserves computed using the interest rate and table applicable as of the time a contract is "issued." In the case of health insurance claim reserves, NAIC guidance specifies that the appropriate discount rate and table are determined at the time the claim is incurred and the claim reserve is first established.[6] Thus, for reserve purposes the NAIC appears to treat the basic contract as matured when a claim is incurred with a new issue date for the contract liability to which the claim reserve relates. Because section 807(d)(4) uses a term of art directly borrowed from the Standard Valuation Law—the year in which the contract was "issued"—Congress can be presumed to have intended that the NAIC's interpretation of the issue date should be followed in computing reserves.

The second argument is that the determination of the issue date for reserve purposes is just one of many assumptions that is part of the reserve methodology. Because section 807(d) defers to the NAIC reserve method for computing tax reserves, the NAIC's requirement as to the issue date for health claim reserves should be followed for tax purposes. This analysis is supported by a technical advice memorandum issued by the IRS National Office in which the IRS held that the taxpayer was entitled to use graded interest rates in computing tax reserves for structured settlement annuities.[7] The IRS reached this conclusion because it determined that the use of graded interest rates was a permissible interpretation of CARVM. That is, the company was permitted to deviate from explicit use of the PSAIR or AFIR as of the issue date of the policy. In other words, although the applicable interest rate is determined for "the calendar year in which the contract was issued" under section 807(d), the reserve method in effect at the time the contract is issued determines the means by which the interest rate is selected.[8]

In short, resolution of this problem boils down to whether the concept of issue date as used in section 807(d) is exclusively a tax term to be read literally (*i.e.,* when the contract in fact was issued) or whether it is a term of art to be read in the context of its meaning under the Standard Valuation Law. Surprisingly, this is still an unresolved issue. However, to our knowledge, the majority of insurers currently use the claim incurral date for claim reserves, in part for the pragmatic reason that the claim reserve data record generally does not contain the original contract issue date.

WHAT TABLES SHOULD BE USED TO COMPUTE TAX RESERVES FOR HEALTH INSURANCE?

The Code defines the tables to be used as of the contract issue date as follows:

> IN GENERAL-The term "prevailing commissioners' standard tables" means, with respect to any contract, the most recent commissioners' standard tables prescribed by the [NAIC] which are permitted to be used in computing reserves for that type of contract **under the insurance laws** of at least 26 States when the contract was issued. **(Emphasis added.)**[9]

Note that it is not sufficient for a state official merely to indicate a preference for a particular table (by statutory examination or otherwise). Rather, the insurance laws and regulations of a state must include the table as a requirement to be followed.

As noted previously, historical state-by-state adoption of mortality and morbidity tables for health insurance has been extremely sporadic, with very few tables reaching the 26-state criterion for "prevailing." This led to the above-cited Treas. Reg. § 1.807-1, which prescribes tables in the absence of prevailing tables.[10] That regulation specifically excludes product lines for which a table has been adopted by 26 or more states. That is, once a particular table has been so adopted, that part of the Treas. Reg. is then superseded.

Moreover, where this regulation prescribes use of the statutory table for tax purposes, it does not deal with the issue of changes in the statutory table on in-force business (which happens more frequently in health insurance than in life insurance). Is the old tax basis table to be locked in at issue, effectively accommodated and the change recognized in the year of change, or subjected to a section 807(f) 10-year spread on the change? There is little guidance on this point.

In 2001 an event took place that could have a significant impact on the proper table to use for health insurance tax reserves. That was the year that codification of Statutory Accounting Principles took place. Beginning shortly after "Codification," and the corresponding annual publication of the "Accounting Practices and Procedures Manual" ("APPM"), most states enacted statutes or regulations that automatically adopt the APPM by reference. The question, then, is: "Does a state statute or regulation adopting the APPM by reference con-

CONTINUED ON **PAGE 8**

The adoption of the APPM may have an effect on when adjustments to the table are appropriate.

stitute the ***law*** of such state adopting the table included in the APPM for purposes of the 26-state rules under section 807(d)?" It would appear so. A counterargument would be that the APPM only specifies accounting requirements and does not constitute a change in the valuation statutes or regulations of the state. However, there appears to be no reason why such "adoption by reference" fails to qualify as the law of the state affecting the tax reserve basis. This could mean that all the prescribed statutory morbidity tables (and health insurance mortality decrement tables) listed in Appendix A-010 of the APPM become prevailing tables once they are included therein, although the answer is not certain.[11]

In addition, inasmuch as statutory guidance on health insurance morbidity assumptions is subject to more frequent change than the equivalent statutory guidance on life insurance, Appendix A-010 requires that, for example, in the event of insufficient reserves, due to inadequate tabular morbidity assumptions, new basis reserves must be computed using increased morbidity assumptions, which becomes "the minimum standard.[12]

WHEN AND UNDER WHAT CIRCUMSTANCES MUST A COMPANY ADJUST THE PREVAILING TABLE IN COMPUTING HEALTH INSURANCE TAX RESERVES?

Section 807(d)(2) prescribes that a company compute the amount of the life insurance reserves for a contract using the prevailing commissioners' standard table for mortality and morbidity "adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account." Whether such adjustment is mandatory or optional varies by the guidance in question. The above Code language appears to make it mandatory. However, in explaining this provision, the legislative history of the 1984 Act suggests that an adjustment is possibly optional: "[c]ompanies ***may*** adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks" otherwise not taken into account;[13] "a company ***may*** use an appropriate multiple of a table."[14] (Emphasis added.) However, there is language in a TAM[15] that suggests that such adjustment is mandatory. The IRS National Office reasoned that, because the Code requires the company to use the prevailing commissioners' standard table irrespective of whether it used the same table for its annual statement reserves, the adjustment to the prevailing table is independent of what the company computed for annual statement purposes. Further, the term, "may" contains two alternative meanings: either that the company has an option whether to adjust, or that the particular fact pattern will dictate whether an adjustment must be made. The latter meaning would imply that the adjustment is mandatory. Indeed this latter meaning may be the only way to harmonize the legislative history with the explicit language of the Code.

Most disputes in this area regarding whether such an adjustment can be made at all revolve around whether the risks for which a company has made adjustments to the prevailing table are in fact risks present at the issue date of the contract which are not otherwise taken into account in the prevailing table. See for example, TAM 200416009[16] where the IRS National Office agreed with an agent's disallowance of a prevailing table adjustment for the company's own experience subsequent to issue.

The adoption of the APPM may have an effect on when adjustments to the table are appropriate. Although the APPM, in practice, may prescribe tables required to be used for tax purposes, it may not be sufficient, or even workable, for the APPM to prescribe a simple "adjustment to a table" that would rise to the level of a "standard table," when such adjustment is performed on a gross, overall basis (*e.g.,* without regard to issue ages, attained ages, gender, or other variables essential in determination of an actuarially appropriate table). One reason that such adjustment may not rise to the level of a "standard table" is that it would appear to contradict the "adjusted as appropriate" language of section 807(d)(2)(C). That is, the "adjusted as appropriate" language would not have a base reference table from which to make an adjustment. For example, for disability income claim reserves, the APPM, Appendix A-010, prescribes Table CIDC for claim incurrals beginning Jan. 1, 2002. The CIDC table in fact simply consists of a set of adjustment factors to the l985 CIDA table that vary only by duration from disablement. It is virtually impossible, from that adjusted table, to understand how to adjust the CIDC table based on, for example, liberalized contractual provisions defining compensable disability. Further, section 807(d)(2)(C) is not explicit as to the adjustment procedure to employ, thus giving the insurance company significant latitude to employ a professionally reasonable "adjustment as appropriate." As a result, it appears that one possible adjustment procedure would be to unwind the CIDC adjustment factors to get back to the l985 CIDA "Standard Table," and potentially adjust the latter for the difference in contractual provisions from the experience underlying that 1985 CIDA standard table.

IS A MODIFICATION TO RESERVE ASSUMPTIONS A CHANGE IN BASIS OF RESERVES SUBJECT TO THE TEN-YEAR SPREAD RULE OF SECTION 807(f)?

The answer to this question depends on whether the adjustment to reserve assumptions would be a change in method of accounting under general tax rules absent section 807(f). In general, section 807(f) provides a special rule that requires a ten-year spread of reserve differences that arise when there has been a change in basis of computing reserves. Courts and the IRS agree that the rule comes into place only where a change in method of accounting otherwise would occur.[17] Usually, changes in assumptions in life insurance reserve calculations are subject to section 807(f) because the method of accounting adopted from the outset contemplates that the reserve assumptions will remain static until the contract matures. The same is not true for other types of reserves, particularly claim reserves.[18] In analyzing whether a change in health insurance reserves is subject to section 807(f), the operative issue is whether the reserve method itself assumes that periodic updates to assumptions will be made (as may be the case for claim reserves) or whether the method assumes that assumptions will not change. For example, for IBNR disability claim reserves, the method for calculating termination rates in the first 24 months from disablement may assume that assumptions will be continuously updated as experience emerges. When such assumptions are routinely and periodically adjusted, the change in reserves should not be subject to section 807(f). For other changes in assumptions, however, it may be more difficult to resolve whether the ten-year spread rule applies.

CONCLUSION

Health insurance tax reserve issues may receive less attention from the IRS, and even from *TAXING TIMES'* authors and readers, than tax reserves for life insurance and annuity contracts. Moreover, providing guidance on health insurance tax reserves is unlikely to be a major focus of the IRS in the near future relative to other issues. However, the tax reserve issues health actuaries must deal with are no less complex. ◂

END NOTES

1 All references to "section" or "Code section" are to the Internal Revenue Code of 1986, as amended.
2 *See* Notice 2010-29, 2009-16 I.R.B. 849.
3 Section 807(d)(2)(C).
4 PLR 8601013 (Sept. 30, 1985).
5 Ordinarily, only health insurance contract and claim reserves that are computed using morbidity and interest rate assumptions qualify as life insurance reserves. However, Treas. Reg. § 1.801-3(d) requires that, in order to be classified as a guaranteed renewable contract, a reserve in addition to the unearned premium must be held. Therefore, premium reserves generally qualify for life insurance reserve treatment only if an additional reserve also is held for active lives.
6 NAIC Accounting Practices and Procedures Manual, Appendix A-010, Exhibit 1, Paragraph 4.
7 TAM 200108002 (Oct. 24, 2000).
8 Under this analysis, there may be more than one "issue date" for tax purposes for a health insurance contract – an issue date for contract reserves and another issue date for claim reserves. There may even be a third issue date because the AFIR is effective only for contracts "issued" in tax years beginning after 1987. Pub. L. 100-23, Section 10241.
9 Section 807(d)(5)(A).
10 Authority is given to Treasury to prescribe such tables under section 807(d)(5)(C).
11 Section 807(d)(4)(B)(i) contains similar language for the interest assumption. Thus, if the APPM mentions a statutory interest standard, it generates issues similar to those discussed above relating to tables.
12 NAIC Accounting Practices and Procedures Manual, Appendix A-010, Paragraph 29.
13 H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1416 (1984).
14 S. Rep. No. 169 (Vol. I), 98th Cong., 2d Sess. 542 (1984). *See also,* FSA 1992 WL 1466112 (Aug. 28, 1992), which considered adjustments to the prevailing tables in the context of structured settlement annuities and annuities and advised the IRS agent that a company *may* be required to adjust the mortality factors from the prevailing table for purposes of computing its tax reserves even though the company did not make an adjustment to the table in computing its annual statement reserves for the contracts.
15 TAM 9251005 (Sept. 9, 1992).
16 TAM 200416009 (Dec. 15, 2003).
17 *American General Life & Accident Ins. Co. v. U.S.*, 90-1 U.S.T.C. 50, 010 (M. D. Tenn. 1989); Rev. Rul. 94-74, 1994-2 C.B. 157. For a complete discussion of section 807(f) *see, Winslow & Jones, Change in Basis of Computing Reserves – Is It or Isn't It? 6 TAXING TIMES 9 (Feb. 2010).*
18 *E.g.*, TAM 200115002 (Dec. 21, 2000).

Edward L. Robbins, FSA, MAAA, is a senior managing director, Insurance Actuarial Services with LECG and may be reached at *erobbins@lecg.com.*

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.*