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The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System

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I. Introduction

The Life Reserve Working Group of the American Academy of Actuaries (the Academy) is developing a new, principles-based reserve valuation standard for life insurance contracts. The Academy recently presented to the National Association of Insurance Commissioners (NAIC) a draft model regulation (the Draft Model Reg) setting forth the fundamental principles and methodologies of a principles-based reserve system.¹ If the NAIC were to adopt some form of the Draft Model Reg, a key issue would be the manner in which such a system would interact with the federal income tax rules governing the deductibility of reserves held by life insurance companies. The adoption by the NAIC, and ultimately by the states, of a new reserve system that contained features in conflict with the federal income tax rules could well prompt the Treasury Department (the Treasury) to ask Congress to revisit and revise those rules, in turn leading to unpredictable and potentially adverse consequences for the life insurance industry. Indeed, the Treasury or Congress on its own initiative, could re-examine the life insurance company tax rules at any time, for any reason,

and in times past Congress has rewritten those rules when faced with a significant decline in tax revenues from the industry.

However, the ultimate goal of the Academy's working group appears to be a definition of reserves that represents a more accurate statement of the policyholder liabilities of life insurance companies. Washington tax policymakers share that goal. As shown by the 1984 and 1987 changes in the tax law's reserve rules, the objective of Congress is to allow life insurers to deduct reserves that capture the economic risks associated with their contracts but not to allow a deduction for any excess or redundant reserves that insurers choose to hold.² Moreover, a review of those rules demonstrates that both flexibility and resiliency were imbedded into their operation. Hence, barring a significant decline in tax receipts from the industry, neither the Treasury nor Congress should feel compelled to rewrite the federal tax rules on account of the adoption of principles-based reserves. Nevertheless, there are certain items that must be considered in crafting the details of a

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¹ Accompanying the Draft Model Reg were three draft actuarial guidelines: one addressing valuation assumptions, one concerning documentation and disclosure requirements and one setting forth requirements for establishing assumption margins. These draft actuarial guidelines, along with the Draft Model Reg, were presented to the NAIC Life and Health Actuarial Task Force on November 11, 2005, and on December 1 the proposal was presented to the NAIC's "A" Committee. In this article, the concepts in the Draft Model Reg are used as the basis for analyzing the operation of the federal income tax law under a principles-based reserve system.

² See generally STAFF OF JT. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 596-99 (Comm. Print 1984).

principles-based reserve system to help preclude any conflict between that system and the federal income tax rules. Further, one of these items—the mortality assumptions used in the reserve computation—has an important effect beyond the reserve rules of the tax law, reaching into the definition of the premium and cash value limits for life insurance contracts under sections 7702 and 7702A of the Code.³ In any event, guidance will be needed from the Treasury to assure a smooth, uniform transition from today’s “formulaic” reserve system to the principles-based system of tomorrow.

The purpose of this article is twofold. First, it seeks to identify the key issues raised for the federal income tax system by the Draft Model Reg. Second, it offers our views on how these issues can be successfully addressed. These issues and their possible resolutions are considered in three groups. The article first examines four very technical, but nonetheless important, issues involving the section 807(d) rules. It then considers transitional issues raised by the adoption of principles-based reserve rules. And finally, the article considers the effect of such rules on the taxation of life insurance contracts under sections 7702 and 7702A.

II. The Federal Income Tax Rules Governing Life Insurance Reserves

The congressional intent to allow a deduction for no more than “economic” reserves first manifested itself in the 1984 enactment of section 807(d), which sets forth specific rules for computing the deductible amount of life insurance reserves.⁴ As originally enacted, section 807(d) defined this deductible amount, with respect to any contract, as the greater of (1) the contract’s “net surrender value”—basically, its cash value less any surrender charge – or (2) the contract’s reserve specially computed as prescribed in the tax law, which is informally called the “federally prescribed reserve.”⁵ This federally prescribed reserve was determined in accordance with a

method, interest rate, and mortality or morbidity tables specified in the Code. More specifically, to compute the federally prescribed reserve for a life insurance contract, the insurer began with its annual statement reserve and adjusted it as necessary to take into account the tax law’s prescribed method and interest and mortality assumptions.⁶ In 1987, Congress revised, and generally increased, the interest rate assumed in this computation because it considered the state law-based interest rate previously used to be too conservative (*i.e.*, too low), producing what Congress thought to be redundant federally prescribed reserves.⁷

In addition, according to section 807(d), in no event may the deductible reserve for a contract exceed the amount of the annual statement reserve for that contract.⁸ Colloquially, this is called the “annual statement cap.” Since the annual statement reserve for a contract is required under uniform state law to equal or exceed the contract’s surrender value, it is important to focus on the relationship of the annual statement reserve, or “cap,” to the federally prescribed reserve: if the annual statement cap falls below the federally prescribed reserve as a result of the move to principles-based reserves, the cap becomes the deductible amount.

There are four technical requirements in these section 807(d) rules that should be examined in connection with a principles-based reserve system for life insurance contracts like the one being developed by the Academy’s working group:

1. the annual statement reserves and the federally prescribed reserves must be determinable on a contract-by-contract, or “seriatim,” basis;
2. the federally prescribed reserves must be computed under the “method” specified in the Code;

³ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

⁴ The Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 211, 98 Stat. 494, 727-29 (1984).

⁵ Section 807(d)(1).

⁶ See *supra* note 2, at 599.

⁷ See H.R. REP. NO. 100-391, pt. 2, at 1106 (1987).

⁸ Section 807(d)(1).

3. that computation must use the Code's prescribed interest rate; and
4. it also must use the "prevailing commissioners' [mortality] standard tables" as defined in the Code.

A. Contract-by-Contract Reserves

As just noted, section 807(d) requires two comparisons to be made on a contract-by-contract basis to determine the deductible amount of life insurance reserves: (1) a contract's net surrender value must be compared with its federally prescribed reserve, and (2) the greater of those amounts must be compared with the contract's annual statement reserve, or cap. These requirements imply that each of these amounts can be determined for each life insurance contract.

According to the Draft Model Reg, the amount of principles-based reserves for a particular block of contracts would be the greater of the deterministic reserves and the aggregate stochastic reserves. If the aggregate stochastic reserves represent the greater value and thus determine the amount of the annual statement reserves for the block, the first tax-related issue presented is how the two contract-by-contract comparisons required by section 807(d) can be made in the absence of a per-contract annual statement reserve.

One way to resolve this issue would be to include an appropriate allocation formula in the rules of state law implementing a principles-based reserve system. The deterministic reserves are capable of contract-by-contract computation, while the aggregate stochastic reserves are not; the latter, by definition, are computed in the aggregate for a block of contracts. Accordingly, when the aggregate stochastic reserves exceed the deterministic reserves for the block, per-contract reserves may be established by allocating the excess amount to specific contracts within the block. To accomplish this, the relevant state law rules could include a formula for apportioning (when necessary) the amount of the principles-based reserves to each contract covered in the overall calculation. This type of allocation would seem necessary, quite apart from tax considerations, in order to implement existing state law rules governing life

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insurance company insolvencies, which require identification of reserves attributable to specific contracts.⁹

If such an allocation formula enabled the determination of a per-contract annual statement reserve in all events, then the two comparisons mandated by section 807(d) could be made regardless of whether the amount of the annual statement reserves was measured by the deterministic or aggregate stochastic computations. Since the net surrender value for a given contract is independently known, it could be compared with the federally prescribed reserve for that contract, as usual. The latter would be computed by adjusting the annual statement reserve for the contract—including the formula-apportioned excess amount when necessary—to take account of the tax law's prescribed method and interest and mortality assumptions to the extent they differed from the basis of the annual statement reserve computation. The greater of the net surrender value or federally prescribed reserve for the contract would then be compared with, and capped by, the per-contract annual statement reserve (again including any allocated excess amount) to determine the deductible amount of the reserve.

There are, of course, no guarantees that the Treasury would find such an allocation approach acceptable in administering section 807(d). The need for allocation of any excess of the aggregate stochastic reserves over the deterministic reserves to contracts within a block for insolvency law purposes provides a substantial, non-tax justification for the allocation. However, it is conceivable that the Treasury, knowing that life insurance reserves were based on today's formulaic approach during the framing of section 807(d) in 1984, could

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⁹ See LIFE AND HEALTH INSURANCE GUARANTY ASSOCIATION MODEL ACT, § 14.C., reprinted in NAIC MODEL LAWS, REGULATIONS AND GUIDELINES, Vol. III, p. 520-30.

view the advent of principles-based reserves as entailing enough of a change to warrant a re-examination of the section 807(d) rules. Alternatively, the Treasury could view only the deterministic reserve as the logical heir of the formulaic reserve known to Congress two decades ago, at least for purposes of the federally prescribed reserve computation; the annual statement cap would seem a different matter, as it would track the requirements of state law, including the allocation of any aggregate stochastic excess, in determining the amount of the annual statement reserve for any contract. But even Congress recognized that section 807(d) indulged in a bit of fiction when it assumed the existence of contract-by-contract reserves, observing in the legislative history that the computation of reserves on an aggregate basis was much more practical.¹⁰ If the applicable state law rules were to include a suitable apportionment formula, there would be no apparent technical or tax policy reason for the Treasury to propose legislative change on account of the shift to principles-based reserves—or for Congress to spend valuable time addressing a non-problem.

B. The Reserve “Method”

The balance of part II of this article is concerned with whether a principles-based reserve system can co-exist with the determination of the federally prescribed reserve under section 807(d). (The reserve computation “method” and the interest and mortality assumptions dictated by section 807(d) have nothing to do with the determinations of the net surrender value and the annual statement cap used in the statutory comparisons.) As already noted, computation of the federally prescribed reserves involves adjusting annual statement reserves, as necessary, in respect of the method, interest rate, and mortality tables that section 807(d) says must be used in the computation.

Focusing first on the reserve computation method, section 807(d) provides that the method to be used is the Commissioners’ Reserve Valuation Method (CRVM) “in the case of a contract covered by the CRVM,”¹¹ a phrase intended to address most life insurance contracts without specifically saying so. The statute goes on to

identify methods applicable to annuity contracts¹² and noncancellable accident and health insurance contracts, all of which, together with life insurance contracts, give rise to “life insurance reserves” within the meaning of the Code.¹³ In the case of any other contract, according to section 807(d), the method to be used is “the reserve method prescribed by the National Association of Insurance Commissioners which covers such contract (as of the date of issuance),” and if there is no NAIC-prescribed method with respect to a contract, and only in that case, the method to be used is whichever of the foregoing methods “is most appropriate” for the contract involved.¹⁴

It should be clear to anyone reading the “method” portion of section 807(d) that Congress was endeavoring to defer to the NAIC’s determination of the appropriate reserve method for a contract. This was necessary because the calculation of the federally prescribed reserve required the specification of something beyond the interest and mortality assumptions that were rather easily defined. The specification of the reserve method was intended as the instruction of “everything else” that needed to be known to enable the new, tax law-specific reserve to be calculated. While the reference to the CRVM in the method rule had a particular purpose in 1984—to require the federally prescribed reserve to be computed on a 1-year preliminary term basis—in all other respects the rule was purely residual in nature: if one method does not apply, default to the next one, and so on until a method can be found that does apply, always deferring to the NAIC.

The Draft Model Reg describes the principles-based reserve system set forth in it as the CRVM for life insurance contracts. Therefore, if the Draft Model Reg were adopted in its present form by the NAIC, under section 807(d), the federally prescribed reserve would be required to be calculated using it. Further, if the Treasury were to consider the Draft Model Reg’s system to be sufficiently distinguishable from the CRVM known to Congress in 1984 (*e.g.*, see the following discussion) that it should not be deemed the CRVM, section 807(d) still would mandate the use of that system in computing the

¹⁰ See *supra* note 2, at 599.

¹¹ Section 807(d)(3)(A)(i).

¹² Section 807(d)(3)(A)(ii).

¹³ Section 807(d)(3)(A)(iii).

¹⁴ Section 807(d)(3)(A)(iv).

federally prescribed reserve, since it would be the NAIC-prescribed method. Thus, there is no technical reason why the Treasury should seek to upset the NAIC's prescription of a principles-based reserve system as the CRVM.

From a tax policy perspective, a noteworthy change to the method that the Academy's working group is proposing is the use of a gross premium valuation method.

Specifically, the reserve (whether deterministic or aggregate stochastic) is computed prospectively as the present value of future benefits less the present value of future premiums. Importantly, for this purpose the future premiums are not net premiums (determined based on interest and mortality assumptions) as in the past, but rather equal to the gross premiums for the contracts being valued less related expenses.

It is unclear whether the Treasury would view the change to a gross premium valuation method to be a problem, in and of itself, in applying the section 807(d) rules. The Internal Revenue Service (IRS) has interpreted the predecessor to section 816(b), which generally defines life insurance reserves for purposes of taxing life insurance companies, as prohibiting the use of gross premiums in calculating life insurance reserves.¹⁵ It is highly doubtful that the Treasury would consider that position as binding in the interpretation of section 807(d), especially given that the CRVM incorporates the use of the gross premiums by requiring the use of the lower of the gross premium and the net premium for valuing reserves.¹⁶ More importantly from the standpoint of tax policy, if the inclusion of an expense element in reserves will have the effect of reducing the amount of the reserves *versus* what it would be without that element, as some actuaries believe to be the case, this would have the effect (all else being equal) of decreasing the amount of reserves that a life insurer could deduct for tax purposes. In other words, if the expense element uniformly (or virtually always) turns out to be negative, moving to

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a gross premium valuation method would result in reduced reserve deductions—a result that seemingly would not be of concern to the Treasury. Overturning the use of the NAIC-prescribed method as the section 807(d) method would require congressional action, and there would seem to be no reason, and no case, for the Treasury to seek legislative change in such circumstances.

On the other hand, the Treasury could resist acceptance of the methodology of principles-based reserves as the section 807(d) reserve method out of concern that it would increase the difficulty of auditing the federally prescribed reserves. It is true that auditing any set of numbers is simpler when the auditor merely can follow a uniform formula. However, this does not mean that federally prescribed reserves computed using a principles-based methodology, together with the prescribed interest and mortality assumptions discussed here, cannot be audited. Complex calculations that make use of historical experience and judgments exist in other areas with which the federal tax law concerns itself, and all such calculations are subject to review by IRS auditors.¹⁷ Since life insurers, like other taxpayers, are required to retain records that adequately document how they arrived at their taxable income calculation, the IRS should be able to replicate the computation of the federally prescribed reserves by reviewing those records during an audit.

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¹⁵ Rev. Rul. 77-451, 1977-2 C.B. 224.

¹⁶ See *supra* note 2, at 598 (stating that a company cannot improperly compute a reserve for a liability involving a life contingency to avoid the section 807(d) reserve computation, and for example claim treatment as unearned premiums under section 807(c)(2), in order to use statutory reserve amounts for tax purposes).

¹⁷ For example, the calculation of the section 415 limits on benefits and contributions under tax-qualified deferred compensation plans involves the use of many assumptions and constraints on assumptions. Also, property and casualty insurance companies can use their own historical claims payment patterns rather than published discount loss factors in computing discounted unpaid losses. See Rev. Proc. 92-76, 1992-2 C.B. 453.

It is, of course, possible that the Treasury could ask Congress to revise section 807(d) following adoption of principles-based reserves on the ground that the method underlying such reserves differs from what Congress contemplated when it enacted section 807(d). However, the statute itself shows that Congress did not concern itself with the specifics of the CRVM or other applicable reserve method at that time; it was content with whatever method the NAIC prescribed, as evidenced by the rule that any reserve method prescribed by the NAIC that applies to a particular type of contract is the method to be used for tax purposes. Congress's concern, rather, was with establishing a "federally prescribed" limit on the deductible amount of life insurance reserves that comported with economic reality and avoided redundancy in the deductible reserve amount. This seems entirely compatible, again, with the ultimate goal of the Academy's working group.

C. The Interest Rate

In determining the federally prescribed reserve for a life insurance contract, section 807(d) also requires the use of an interest rate, determined at the time the contract is issued, equal to the greater of (1) the "applicable Federal interest rate" or (2) the "prevailing State assumed interest rate."¹⁸ The former is an annual rate determined anew by the IRS each year, based on a five-year rolling average of the applicable Federal mid-term rates,¹⁹ while the latter is the highest assumed interest rate permitted to be used in computing reserves for the contract under the insurance laws of at least 26 states (disregarding the effect of nonforfeiture laws on valuation interest rates).²⁰

The Draft Model Reg currently contemplates that a standard, long-term yield curve based on predicted future Treasury bill rates will be prescribed by the NAIC for use in determining the annual statement reserves, with the recognition that the rates may change over the life of a given contract. The Draft Model Reg also suggests that insurers with sufficient credible investment experience could use, in lieu of the actual rates falling on the aforementioned long-term yield curve, the actual rates that each of their investments is designed to earn. It contemplates that a life insurance company's reserve

calculation could take into account dynamic, short-term rates derived from the asset base of the company and its own investment experience.

It is unclear how this proposal could be construed as containing a "prevailing State assumed interest rate." Conceivably, the Treasury could conclude that a prevailing State assumed interest rate within the meaning of section 807(d) no longer exists under a principles-based reserve system. However, it does not automatically follow that Congress would need to re-examine the section 807(d) rules. Quite to the contrary, section 807(d) could readily be interpreted to provide that in the absence of a prevailing State assumed interest rate, the computation of federally prescribed reserves must use the "applicable Federal interest rate" exclusively. Indeed, Congress and the Treasury may well be satisfied with such a result. The relevant applicable Federal interest rate will continue to exist, and in fact it was the rate that Congress added to the tax reserve calculations in 1987 because, as noted previously, it viewed the prevailing State assumed interest rate as being too conservative and thus as producing redundant federally prescribed reserves. More often than not in recent years, the prevailing State assumed interest rate applicable to life insurance contracts was lower than the applicable Federal interest rate under section 807(d). Further, to the extent that even higher interest assumptions (and/or more liberal mortality assumptions) are utilized in determining principles-based reserves, the tax law will give recognition to such assumptions via the annual statement cap. In any event, it appears that any issue involving the interest assumption under section 807(d) should be capable of a satisfactory resolution without legislation.

D. Mortality Tables

As a final matter where the federally prescribed reserves are concerned, the computation of such reserves is required by section 807(d) to use the "prevailing commissioners' standard [mortality] tables." Section 807(d) defines these tables, with respect to any contract, as the most recent commissioners' standard tables prescribed by the NAIC and permitted to be used in computing

¹⁸ Section 807(d)(2)(B).

¹⁹ Section 807(d)(4)(A)(i), referencing the rate under section 846(c)(2).

²⁰ Section 807(d)(4)(B).

reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued.²¹ Currently, the prevailing commissioners' standard tables for life insurance contracts are the 2001 CSO tables.²² Section 807(d) further provides that if no standard mortality table applies to a given contract, the Treasury Department can promulgate one for use in determining the contract's federally prescribed reserve.²³

The Academy working group's draft actuarial guideline setting forth valuation assumptions contemplates that standard mortality tables would be prescribed by the NAIC for use in determining the annual statement reserves for life insurance contracts under a principles-based reserve system. Under a principles-based reserve system like the one being developed, the standard mortality experience reflected in the prescribed tables could be adjusted by a company in determining its annual statement reserves if the company possessed sufficient experience to warrant such an adjustment.

For section 807(d) to work in its current form, avoiding disruption in the tax treatment of life insurers, it is important that standard mortality tables continue to be prescribed by the NAIC and approved by the states for use in determining annual statement reserves for life insurance contracts, along the lines indicated in the Academy's proposal. Further, as discussed here, it is important that the tables so prescribed are the ones also used in determining the minimum nonforfeiture values for life insurance contracts under state law.

The Treasury might disagree that the tables so prescribed meet the definition of prevailing commissioners' standard tables under section 807(d), perhaps on a theory that the annual statement reserve computations would not be wholly dependent upon the tables. Such a determination would necessitate either the promulgation of mortality tables by the Treasury or reference

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of the matter to Congress. However, if the NAIC continues to approve standard mortality tables that could be employed to compute federally prescribed reserves for life insurance contracts, there should be little incentive for the Treasury to go to such trouble. Again, to the extent that more liberal mortality assumptions (perhaps in combination with higher interest assumptions) were to be employed in any company's principles-based reserve computations, the tax reserve rules would recognize the use of such assumptions via the annual statement cap.

Finally in respect to mortality tables, one other tax provision should be discussed. As stated previously, the life insurance reserves that are subjected to the deduction limits imposed by section 807(d) are themselves defined in section 816(b). Section 816(b), in turn, defines such reserves (in relevant part) as amounts "computed or estimated on the basis of recognized mortality or morbidity tables." This rule has a lengthy history, but what constitutes "recognized" tables has been liberally construed by the IRS in recent times.²⁴ Reserves based, in whole or part, on NAIC-prescribed standard mortality tables should meet the section 816(b) definition. Indeed, were the Treasury to disagree, it would effectively be authorizing a wholesale escape of reserves from the limits of section 807(d) and

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²¹ Section 807(d)(5)(A).

²² See Notice 2004-61, 2004-41 I.R.B. 596. Under the transition rule provided in section 807(d)(5)(B), the previously prevailing 1980 CSO tables may continue to be used in determining the federally prescribed reserves for contracts issued through the end of 2007.

²³ Section 807(d)(5)(C).

²⁴ This trend is most noticeable in Rev. Rul. 89-43, 1989-1 C.B. 213, holding that certain reserves for long-term care insurance contracts are life insurance reserves. There are no standard mortality or morbidity tables for long-term care insurance, so that, as the IRS's ruling recognizes, the reserves are reflective of an insurer's own experience.

the reclassification of many life insurers into tax status as property and casualty insurance companies, entitling them to much more favorable proration and life-nonlife consolidation treatment than is currently afforded them. This is a road that presumably would not be taken.

III. The Effect of Principles-Based Reserve Rules on Pre-Existing Business

One issue not resolved in the Draft Model Reg is the prospective *versus* retroactive effect of a new principles-based reserve system, *i.e.*, whether the new rules not only would govern the valuation of contracts issued after a certain future date, but also would require a restatement of the reserves for all previously issued contracts then in force. The pros and cons of applying one treatment rather than the other will be debated within the life insurance industry and the NAIC for some time to come, as the complexity and cost of maintaining two different valuation systems (*i.e.*, prospective application of the new rules) are weighed against the complexity and cost of re-valuing the in-force book of business (retroactive application).

From a federal income tax standpoint, the applicable rules and related considerations may be stated simply enough. If the new valuation standard is accorded prospective effect, the federally prescribed reserves and (as relevant to the annual statement cap) the annual statement reserves for the pre-existing in-force business will continue on as before. Further, both types of reserves for newly issued contracts would need to adapt to the use of the new rules, as discussed above.

If, to the contrary, the new standard were made retroactively effective, there would be a sharp divergence in the computation of one type of reserve *versus* the other in respect of the in-force business on the effective date of the new rules. As noted in the description of the section 807(d) rules in part II, the computation of the federally prescribed reserve for a given contract makes use of the method and the interest and mortality assumptions applicable as of the contract's date of issuance. Hence, if the method, interest rate, and/or mortality tables change with respect to that contract after it is issued, the change is simply irrelevant in the determination of the federally prescribed reserve. On the other hand, where the annual statement reserve is concerned—as relevant to the annual statement cap—the retroactive effect given to the new valuation standard would require a restatement of that reserve as of the new standard's effective date. The restated reserve could, of course, be higher or lower than,

or the same as, what the pre-existing reserve would have been had the rules not changed. If the restatement were to result in a decrease in the amount of the annual statement reserve, and if that amount were less than the federally prescribed reserve, the annual statement cap (or perhaps a cap in a still lower amount) would take effect, reducing a life insurer's reserve deduction. And if the restatement were to produce the opposite result, it is possible that the reserve deduction would increase over the deductible amount under the pre-change rules.

In either case, the retroactivity of the new standard would likely attract increased scrutiny by the Treasury, as the immediate impact on federal tax receipts from the industry resulting from adoption of the new rules could be far more pronounced. Such retroactivity also could raise technical questions, *e.g.*, as to the applicability of the 10-year spread rule of section 807(f) to the annual statement cap, along with related tax policy questions. Further, such retroactivity could raise additional questions as to how to allocate any excess of the stochastic reserve over the deterministic reserve to contracts issued prior to the adoption of the new standard.

IV. The Product Tax Rules and Principles-Based Reserves

As noted in part II.D, section 807(d) defines the “prevailing commissioners’ standard [mortality] tables” to be used in determining the federally prescribed reserves for life insurance contracts. Further, if no such tables exist with respect to a given contract, section 807(d) leaves it to the Treasury to define the mortality assumptions to be used in determining the federally prescribed reserve for that contract. These rules also are utilized outside of section 807(d) in a manner important to life insurers: they are incorporated by reference, albeit with some significant modifications, into the calculation of the life insurance premium and cash value limits under the definitions of “life insurance contract” and “modified endowment contract” in sections 7702 and 7702A, respectively.

More specifically, section 7702(c)(3)(B)(i) requires the “guideline premiums” for a contract under section 7702(c) to be based on “reasonable” mortality charges that “do not exceed the mortality charges specified in the prevailing commissioners’ standard tables (as defined in section 807(d)(5)).” This “reasonable mortality” rule is incorporated as well into the computation of the “net single premiums” under section 7702(b) (relating to the “cash value accumulation test”) and the determination

of the so-called 7-pay premiums under section 7702A. For all of these purposes, section 7702(c)(3)(B)(i) further authorizes the Treasury to issue regulations requiring the use of mortality assumptions that diverge from the NAIC-prescribed tables. To date, however, guidance from the Treasury has accepted the use of the NAIC-prescribed tables in all of the section 7702 and 7702A computations. In general, under the most recent Treasury guidance, the 1980 CSO tables may be used until the beginning of 2009, and the 2001 CSO tables may be used thereafter (absent promulgation of new NAIC-prescribed tables), in determining the guideline premium, net single premium, and 7-pay premium limits.²⁵

Not unlike the case with section 807(d), in order for sections 7702 and 7702A to work in their current form, it is important that standard mortality tables continue to be prescribed by the NAIC and approved by the states for use in determining annual statement reserves for life insurance contracts, along the lines indicated in the Academy working group's proposal. This would avoid potential disruption in the tax treatment of life insurance products stemming from the absence of such prescription and approval and, in their stead, the Treasury's promulgation of its own set of "reasonable mortality" assumptions to be used in the premium and cash value limits for life insurance contracts. Moreover, it is important that the NAIC-prescribed valuation tables are the ones also used in determining the minimum nonforfeiture values for life insurance contracts under applicable state law.

If the permitted valuation and nonforfeiture assumptions were to diverge, such that the mortality assumptions applicable under section 807(d) became more liberal than the assumptions underlying the minimum nonforfeiture values, the federal "ceiling" on cash values under section 7702(b)'s cash value accumulation test could well fall below the state law "floor" for those values, rendering impossible the compliance of traditional, whole life contracts issued in reliance on that test. In that event, ironically, the industry would be placed in the position of imploring the Treasury to exercise its regulatory authority under section 7702(c)(3)(B)(i) to prescribe mortality assumptions (*i.e.*, those utilized in the nonforfeiture law) in order

for companies to be able to issue traditional products. But if, on the other hand, the existing situation were to be preserved—the NAIC continues to prescribe standard mortality tables for valuation purposes and these tables also are used in determining minimum nonforfeiture values—it becomes difficult for the Treasury to diverge from those tables in implementing the "reasonable mortality" rules, not least because doing so would disadvantage the traditional product forms.

V. Summary and Conclusion

The inherent features of the principles-based reserve system for life insurance contracts now being developed by the Academy's Life Reserve Working Group are not inconsistent with the current federal income tax rules governing the deductibility of life insurance reserves. As previously described, those rules are quite flexible and resilient. However, a smooth transition to the adoption of a principles-based reserve system would be facilitated by including three specific features in any system ultimately adopted by the NAIC and the states: (1) a formula for apportioning the amount of the principles-based reserves to each contract covered in the overall reserve calculation, (2) adoption of the new system by the NAIC as the CRVM with respect to the life insurance contracts it covers, and (3) continued use of standard mortality tables that are prescribed by the NAIC and approved by the states in determining the reserves for the contracts covered by the new system.

Further, for the Code's product tax rules (sections 7702 and 7702A) to continue to function properly, the same standard mortality tables used in computing the principles-based reserves for life insurance contracts also should apply in determining the minimum nonforfeiture values for those contracts. In any event, guidance will be needed from the Treasury to assure a smooth, uniform transition from the current reserve system to a principles-based system. For its part in shepherding such a transition, the Treasury can take comfort from the fact the desire of Congress in limiting the deductible amount of life insurance reserves to "economic" reserves is well aligned with the purpose underlying the Academy working group's development of principles-based reserves. ◀

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²⁵ See Notice 2004-61, note 22, *supra*. This Notice was discussed in detail beginning on page 1 of the May 2005 issue of *Taxing Times*.