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WATCH OUT! THE THREE-YEAR TRANSITION PERIOD FOR ADOPTING PRINCIPLE-BASED RESERVES MAY NOT APPLY TO TAX RESERVES

By Peter H. Winslow

In 2009, the National Association of Insurance Commissioners (NAIC) adopted a comprehensive revision to the Standard Valuation Law (SVL). Section 11 of the new SVL provides that minimum reserve standards are those required by a new NAIC Valuation Manual for policies issued on or after the "operative date" of the Valuation Manual. Changes to the Valuation Manual, therefore, can result in an automatic change to the reserve method specified by the NAIC for newly issued policies. This in turn can directly impact the amount of life insurance reserves for tax purposes. Under I.R.C. § 807(d)(3), the tax reserve method for a life insurance contract is the Commissioners' Reserve Valuation Method (CRVM) which is in effect on the date of issuance of the contract. If CRVM does not apply, the tax reserve method is the method prescribed by the NAIC which covers the contract as of the date of issuance. Because the Internal Revenue Code defers to the NAIC for the applicable tax reserve method as of the issue date of the contract, the "operative date" of any Valuation Manual change to the SVL method also can determine the effective date of a corresponding change to the tax reserve method. This will become an important issue when, and if, the NAIC amends the Valuation Manual to adopt Principle-Based Reserves (PBR) in VM-20 for individual life insurance.[1]

Section 11 of the SVL provides that, after the NAIC has adopted a reserve method change to the Valuation Manual, the operative date of the change will be January 1 following the date when states with 75 percent of direct premiums written have adopted the change.[2] This provision of the Valuation Manual creates an interesting cascading rule for the issue-date provision for tax reserves. Although I.R.C. § 807(d) defers to the NAIC for the applicable tax reserve method as of the issue date of the contract, the NAIC itself defers to states having at least 75 percent of direct written premiums for the implementation of its own reserve method changes. The result should be that PBR will not become effective as the tax reserve method when the NAIC initially adopts it because the NAIC's "operative date" will not yet be triggered. For contracts issued prior to the "operative date," the NAIC-prescribed method will still be the pre-PBR method until a sufficient number of states have adopted PBR.

As of the time of drafting this Tidbit, the earliest possible operative date of PBR is 2013 and in all likelihood will be much later. At its Summer 2010 Meeting, the NAIC Life and Health Actuarial Task Force formed a Regulatory Testing Subgroup which has commissioned a PBR Impact Study Report with a March 2011 deadline. Regulators will need time to consider the report and make any necessary fine-tuning to VM-20. State legislatures probably will not begin to consider possible adoption until 2012, at the earliest, and the 75 percent threshold is unlikely to be reached until 2013, 2014 or later. As currently drafted, there is a three-year transition period that would allow a life insurance company to elect not to adopt PBR for up to three years from the operative date of the Valuation Manual, meaning that companies may not need to adopt PBR until at least 2016.

Any election to delay implementation of PBR after the operative date in the Valuation Manual could cause unanticipated tax issues. Regardless of whether an election is made, once PBR becomes effective for NAIC SVL purposes, it will become the tax reserve method. Therefore, if an election is made by a company that thinks that an earlier adoption of PBR would create a hardship, the electing company may be surprised to learn that at least some of the difficulty cannot be avoided for tax reasons.

There may be some relief, however. Full implementation of PBR for tax purposes may not be necessary for those companies that elect to defer adoption of PBR for statutory reserves. VM-20 defines PBR as the aggregate net premium reserve (NPR), plus the excess, if any, of the greater of the aggregate deterministic reserve and the stochastic reserve over the aggregate NPR. At this point, it appears doubtful whether the IRS will agree that the stochastic reserve component qualifies as part of federally prescribed reserves deductible under I.R.C. § 807(d). The IRS rejected such treatment in interim guidance

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for the stochastic CTE Amount component of Actuarial Guideline 43 (AG 43) reserves for variable annuity contracts, and is likely to take the same position for PBR.[3] Similarly, the IRS has raised concerns over whether the deterministic reserve based on a gross premium valuation methodology can be included in federally prescribed reserves for tax purposes.[4] As a result, it is possible that the IRS will recognize only the NPR portion of PBR as the federally prescribed reserve that qualifies for recomputation for tax purposes under the rules of I.R.C. § 807(d). Therefore, companies faced with implementation difficulties that elect to defer adoption of PBR for statutory reserves may obtain some relief and may need to compute only the NPR portion of PBR for tax purposes.

Another interesting tax issue could arise relating to the interplay of the statutory reserves cap in I.R.C. § 807(d)(6) with the 10-year spread rule for tax reserve changes in I.R.C. § 807(f). Reserves must be computed for tax purposes using the NAIC-prescribed method in effect as of the time the contract is issued regardless of the method used to determine statutory reserves. The amount of tax reserves, however, is capped by statutory reserves as defined in I.R.C. § 807(d)(6).[5] It is possible that statutory reserves capping could apply to a company that elects to defer adoption of PBR. Tax reserves for contracts issued after the operative date of the Valuation Manual would be computed on the basis of the NPR portion of PBR, but they could be capped by statutory reserves determined using the pre-PBR method if that method yields smaller reserve amounts. Suppose that this company, when it ultimately adopts PBR, decides to restate its statutory reserves to PBR for all of these contracts issued after the operative date. In such circumstances, the statutory reserves cap on tax reserves can shift from the pre-PBR smaller limit to the larger PBR statutory reserves. This "uncapping" potentially could bring consideration of I.R.C. § 807(f) into play.

Section 807(f) applies where there is a change in basis of computing tax reserves of a life insurance company. When applicable, it requires that the difference between the deductible insurance reserves computed under the new method and the reserves computed under the old method as of the end of the year of the change be reflected ratably over 10 years (the "10-year spread"). An unresolved issue is whether a change in annual statement reporting of reserves (that occurs without a corresponding change in federally prescribed tax reserves) is a change in basis of computing reserves or whether it is a mere change in facts to which section 807(f) does not apply. Legislative history suggests that a change to the net surrender value ordinarily will not be subject to section 807(f) presumably because the change is a mere change in facts relating to contract benefits. Many tax practitioners believe that this legislative history applies by analogy to the change in the statutory reserves cap. It is arguable, however, that the computation of statutory reserves is a tax reserve method to the extent the statutory reserves cap is applicable and a change in that method gives rise to the application of the 10-year spread rule of section 807(f). A similar issue arose when AG 43 was adopted. Unlike PBR, AG 43 has retroactive effective for statutory purposes and applies to policies issued before its effective date. As a result, statutory reserves for contracts issued prior to Dec. 31, 2009, are computed using AG 43, but tax reserves are not. In Notice 2010-29,[6] the IRS provided interim guidance that concluded that a 10-year spread would apply to any statutory reserves capping change arising from the transition to AG 43. But, the IRS and Treasury Department also have made it clear that the 10-year spread in Notice 2010-29 is not identical to what would have been required under I.R.C. § 807(f) and that no inference should be taken from the notice as to whether I.R.C. § 807(f) applies to other capping or uncapping situations.[7] Resolution of this issue will have to wait for another day.

END NOTES

1. Changes to the net premium reserve in Section 3 of VM-20 will apply only to term policies and universal life insurance with secondary guarantees.
2. *See also* Valuation Manual VM-00; VM-20, Section 1.
3. IRS Notice 2010-29, 2010-15 I.R.B. 547.
4. IRS Notice 2008-18, 2008-5 I.R.B. 363.
5. Statutory reserves are defined in I.R.C. § 807(d)(6) as the aggregate amount set forth in the annual statement with respect to items described in I.R.C. § 807(c). Statutory reserves do not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserves is not permitted under I.R.C. § 811(c).
6. 2010-15 I.R.B. 547.
7. *Attorney-Actuary Dialogue on Notice 2010-29*, 6 *Taxing Times* 23 (Sept. 2010).

PLR201045019: ADDING INVESTMENT OPTIONS TO IN-FORCE CONTRACTS

By Kory J. Olsen

In a recent Private Letter Ruling (PLR201045019), the Internal Revenue Service (IRS) ruled that under the facts presented, the addition of Investment Options to in-force life insurance contracts is not a deemed exchange and there is no new "issue date" for purposes of IRC Sections 7702, 7702A and 807, nor would it require an adjustment in the computation of the Section 7702 or 7702A limits.

The PLR request was based on an Indexed Universal Life Insurance contract with multiple Investment Options. The Investment Options determine the interest crediting rate

based on the change in an external equity index. The contract entitles taxpayer to add or cease to offer Investment Options at any time. It was represented that the addition of the Investment Option will not change any benefits provided under the contract.

Essentially, the request was for three issues: a) does the addition of the Investment Option produce a "deemed exchange"; b) is it an "adjustment event" under Section 7702(f); and c) is it a "material change" under Section 7702A(c)?

To answer the "deemed exchange" question, the ruling looked at the legislative history of Section 7702 contained in the Senate Committee Report, the legislative history of Section 7702A contained in the Conference Report, "Cottage Savings Assoc. v. Commissioner," Rev. Rul. 2003-19 and Notice 2006-95. Specifically, the PLR referenced the determination of "issue date" for Section 7702, "entered into" for Section 7702A, the "materially different" criteria and the example provided in *Cottage Savings*. The PLR noted that in Rev. Rul. 2003-19 demutualization had no effect on the issue date for the policy for Sections 7702 and 7702A. The conclusion was that when these authorities are "read together," the addition of the Investment Option did not produce a deemed exchange.

The IRS did not use this opportunity to elaborate on the important factors to use to identify a "deemed exchange" as applied to life insurance, leaving continued uncertainty in this area.

In the determination of whether there was an adjustment event under Section 7702(f)(7), the PLR looked at the policy benefits. The addition of the Investment Option does not change any benefits provided under the contract. Also, the guaranteed rate under the Investment Option did not exceed the statutorily prescribed rates of 4 percent or 6 percent. Based on these factors, the conclusion was that the addition of the Investment Option would not be an adjustment event.

Regarding the "material change" under Section 7702A, this ruling looked to what was changing on the contract compared to what was used in the previous determination of the 7702A limits. With the addition of the Investment Option, there would be no change in benefits or other terms of the contract that were not previously reflected in the calculation of the 7702A limit. Hence, there was not a material change.

In summary, the IRS ruled:

1. The addition of the new Investment Option will not create a new "issue date" for Section 7702.
2. The addition of the new Investment Option will not cause a deemed exchange for purposes of determining limits under Section 7702A.
3. The addition of the new Investment Option will not create a new "issue date" for Section 807, nor cause the company to recompute its tax reserves.
4. The addition of the new Investment Option will not require an adjustment in the guideline single or level premium limits under Section 7702(f)(7)(A).
5. The addition of the new Investment Option will not require an adjustment in the computation of the cash value accumulation test limits under Section 7702(f)(7)(A).
6. The addition of the new Investment Option will not require a recomputation of the Section 7702A limits under Section 7702A(c)(3)(A).

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