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HOW ARE TAX RESERVES FOR VAGLB DETERMINED FOR PRE-2010 CONTRACTS?

By Peter H. Winslow and Michael LeBoeuf

In March 2010, the Internal Revenue Service (IRS) issued Notice 2010-29,[1] which provided interim guidance on tax reserve issues that arise from the NAIC's adoption of Actuarial Guideline (AG) 43 relating to reserves for variable annuity contracts with guaranteed benefits. AG 43 was effective on Dec. 31, 2009, and superceded all prior NAIC actuarial guidelines for these contracts. Notice 2010-29 provides generally that, for purposes of computing the amount of federally prescribed reserves under I.R.C. § 807(d)(2), the provisions of AG 43 for determining the Standard Scenario Amount are taken into account, but not those for determining the Conditional Tail Expectation (CTE) Amount. While the interim guidance from the IRS was timely and welcome, it left open several important issues, including whether the CTE Amount is includible in statutory reserves under I.R.C. § 807(d)(6) for purposes of determining the limitation on the amount of deductible tax reserves.

Another important issue not addressed in Notice 2010-29 is how tax reserves should be computed for contracts issued prior to Dec. 31, 2009. Although AG 43 applies for statutory reserve purposes to variable annuity contracts issued on or after Jan. 1, 1981, Notice 2010-29 states that AG 43 will apply for tax purposes only to contracts issued on or after Dec. 31, 2009. For previously issued contracts, the Notice states that "the tax reserve method under § 807(d)(2)(A) and (d)(3) is the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43." Presumably, the IRS would conclude that the relevant guidance is AG 34 for guaranteed minimum death benefits (GMDB) provided under variable annuities, at least for contracts issued after AG 34's effective date. But what about guaranteed minimum living benefits?

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Prior to AG 43, the applicable NAIC guidance for variable annuity contracts with guaranteed minimum living benefits (VAGLB) was AG 39 adopted by the NAIC in 2002. AG 39 was intended to be temporary and by its terms (as amended) was scheduled to sunset no later than Dec. 30, 2009. AG 39 prescribes aggregate reserves for variable annuities with VAGLB as the sum of two components: (1) aggregate reserves for the contracts ignoring both the future revenues and benefits from the VAGLB and after comparison to the cash values of the contracts (Base Reserve); plus (2) the "VAGLB reserve," which is equal to the sum of the aggregate charges for VAGLB in force to the valuation date (Charge Accumulation Reserve) and subject to an asset adequacy analysis. AG 39 requires that the actuary perform the asset adequacy analysis on an aggregate basis that reflects all VAGLB and related expenses, all VAGLB charges and the assets supporting the VAGLB reserve (Asset Adequacy Reserve).

IRS AUDIT POSITION

In current audits, some IRS agents have taken the position that neither portion of the AG 39 statutory VAGLB reserve, component (2) described in the previous paragraph, qualifies to be included in the federally prescribed reserves for tax purposes. This IRS audit position has little impact with respect to the Asset Adequacy Reserve because few companies have attempted to treat the reserve as part of federally prescribed reserves in recognition of the IRS's concerns with the deductibility of principle-based stochastic reserves first expressed publicly in Notice 2008-18.[2] As a result, the audit disputes have focused on the Charge Accumulation Reserve.

IRS auditors who have challenged AG 39 tax reserves have made two basic arguments to disallow the Charge Accumulation Reserve portion. First, they contend that the AG 39 reserves are not life insurance reserves as defined in I.R.C. § 816(b) because they are not computed on the basis of recognized mortality tables and assumed rates of interest. The IRS generally takes the position that a reserve computed on the basis of gross premiums is not a life insurance reserve unless the premiums themselves expressly reflect a recognized mortality table and discount rate.[3] The second argument made by these IRS auditors is that the tax reserve method required by I.R.C. § 807(d) is CARVM and the Charge Accumulation Reserve is not a CARVM reserve because there is no attempt in AG 39 to compute the greatest of the present values of future annuity benefit streams. In support of this contention, the IRS agents have pointed out that AG 39 itself does not specifically refer to CARVM.

Taxpayers have made several arguments to counter these IRS audit positions. In response to the argument that mortality and interest factors are not considered, it has been argued that the Charge Accumulation Reserve qualifies for tax reserve treatment because it is merely a portion of a larger reserve that includes the Base Reserve which is computed using mortality and interest assumptions. Also, the Charge Accumulation Reserve may implicitly take into account mortality and interest factors to the extent they are considered in the mortality and expense charges, or because the Charge Accumulation Reserve was intended by the NAIC to be a temporary estimate of a reserve computed on a tabular basis.[4]

In response to the IRS auditors' argument that AG 39 does not refer to CARVM, taxpayers have pointed out that the guideline states that it is an interpretation of the Standard Valuation Law, which is what specifies CARVM as the prescribed reserve method for variable annuities. So, by definition, however approximate the AG 39 reserve calculation, it is an NAIC-sanctioned interpretation of CARVM.

For post-2009 tax years, the position of the IRS auditors is much stronger if the company continues to use AG 39 for tax purposes for contracts issued prior to Dec. 31, 2009. At the time pre-2010 contracts were issued, AG 39 itself (as amended) provided that it would sunset no later than Dec. 30, 2009. Therefore, the IRS could argue that, although AG 39 was prescribed by the NAIC, it was only prescribed for pre-2010 years. As a result, other actuarial guidance necessarily applies for post-AG 39 tax years. Presumably, this guidance must be a

reasonable interpretation of CARVM at the time the contract was issued. The best pre-2010 guidance is AG 33, which is directly applicable to all variable annuity contracts, and AG 34 may be indirectly applicable by analogy.

AG 33

In recognition that the implementation of CARVM for annuity contracts with multiple benefit streams was not uniform within the industry, especially with respect to elective benefits, the NAIC adopted AG 33.[5] Noting that CARVM requires that reserves be based on the greatest present values of all potential future guaranteed benefits, AG 33 requires that an integrated benefit stream approach be used as follows:

> Under the integrated benefit stream approach, any potential benefit stream must be considered, including blends reflecting the interaction of more than one type of benefit. Such potential benefit streams include all types of benefits for which the greatest present value concept is required. Additionally, adjustments must be made to all such potential benefit streams to reflect those benefit types for which prescribed incidence tables are required (*e.g.,* death benefits).[6]

AG 33 then says the following with respect to determining the greatest present value:

> All guaranteed benefits potentially available under the terms of the contract must be considered in the valuation process and analysis and the ultimate policy reserve held must be sufficient to fund the greatest present value of all potential integrated benefit streams, reflecting all guaranteed elective and non-elective benefits available to the contract owner. Each integrated benefit stream available under the contract must be individually valued and the ultimate reserve established must be the greatest of the present values of these values. . . .[7]

AG 33 is intended "to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams," specifying three sets of integrated benefit streams that must be considered—cash value streams, annuitization streams and other elective benefit streams—each to be considered in a possible blend of future partial and full withdrawals and surrenders, annuitization elections, or combinations of guaranteed elective benefits, and with appropriate recognition of all guaranteed non-elective benefits available under the contract.[8] AG 33 applies to all annuity contracts subject to CARVM where any elective benefits are available to the contract owner under the terms of the contract.

By its terms, AG 33 is an interpretation of CARVM. AG 33 provides that, while it applies to all annuity contracts, "in the event an actuarial guideline or regulation dealing with reserves is developed for a specific annuity product design, the product specific actuarial guideline or regulation will take precedence over [AG 33]."[9] VAGLB are guaranteed elective benefits that would be covered by AG 33, but for the development of AG 39. Thus, at least for contracts after AG 33's effective date, the tax reserve method for annuities with VAGLB, which is required by I.R.C. § 807(d)(3), presumably is CARVM as interpreted by AG 33, except to the extent AG 39 applies.

Another way to consider the issue of what is a valid tax reserve computation for pre-2010 variable annuity contracts with VAGLB is to assume that AG 39 must be ignored completely. Where tax reserving requires the use of CARVM, if AG 39 is not CARVM for tax purposes, the existence of AG 39 should not supplant the application of AG 33 for tax purposes with respect to any guaranteed benefits under an annuity contract with VAGLB. Thus, AG 33 would be the applicable NAIC guidance for computing the CARVM tax reserve for VAGLB provided under these contracts.

Thus, AG 33 would be the applicable NAIC guidance for computing the CARVM tax reserve for VAGLB provided under these contracts.

The IRS has recognized AG 33 as applying for tax purposes under I.R.C. § 807(d)(2) and has disallowed only its retroactive application to reserves on contracts issued prior to the effective date of AG 33.[10] Therefore, if AG 39 does not apply, the IRS presumably would agree that AG 33 is applicable although the IRS has not said so formally.

AG 33 RESERVES FOR VAGLB

If AG 33 is the applicable guidance for pre-2010 contracts with VAGLB, the important question remains: how are these tax reserves to be computed? Clearly, when it was published AG 33 did not directly address how long-tailed liability struc-

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tures such as VAGLB fit into the integrated benefit stream approach; however, with respect to GMDB, AG 34 introduced a methodology to value such integrated long-tailed liability structures. Therefore, AG 34 can be said to provide by analogy NAIC guidance as to how AG 33 is to be interpreted.

The key assumptions that AG 34 introduced to value GMDB that have direct relevance to VAGLB are the deterministic drop and recovery scenario used to project future account values and utilization of the greatest present value of the worst case results into the integrated benefit streams. These basic principles would seem to be required in developing a tax-basis AG 33 reserve for VAGLB, but they do not provide specific guidance as to the assumptions needed for VAGLB to fit within the AG 34 methodology. For example, because of the nature of the guarantees, the appropriate drop and recovery scenario for GMDB and VAGLB could be much different. Moreover, AG 34 was developed and adopted in the late 1990s and the world has changed much since then. In order to implement a comprehensive, up-to-date tax reserve methodology we also should look to recognized actuarial practice at the time the contracts with VAGLB were issued—typically in the late 2000s. In doing this, guidance from AG 43 for establishing assumptions and methodology for valuing VAGLB may be useful, particularly in light of the IRS's acceptance of the Standard Scenario Amount for determining tax reserves, at least on an interim basis.

Specifically, it seems appropriate to refer to the assumptions underlying the Standard Scenario in AG 43 for VAGLB, with appropriate modifications in order to determine AG 33 tax reserves. This reliance on AG 43 is not the same as applying it retroactively for tax purposes, which is prohibited by Notice 2010-29. AG 43 principles should be considered only to the extent they reflect AG 33 methodology and are consistent with recognized actuarial practice under AG 33 (and AG 34 by analogy) as of the time the contracts were issued. Moreover, for tax years beginning in 2009, reliance on AG 43 Standard Scenario assumptions used for statutory reserves may be required, when they are relevant, to the extent they are not inconsistent with a specific interpretation of AG 33 by 26 state regulators at the time the contracts with VAGLB were originally issued.[11]

Some of those modifications to the AG 43 Standard Scenario to arrive at a tax basis AG 33 reserve might include:

- In establishing the Accumulated Net Revenue under AG 43, only the VAGLB components of the contracts should be considered;
- The account value margin assumptions in the Standard Scenario should be ignored, and only VAGLB fees should be used;
- Only VAGLB claims should be included;
- The value of hedges should be ignored;
- Partial surrenders should be considered; and
- Lapse assumptions should not be used.

Also, it appears that the drop and recovery assumptions under AG 43 are more appropriate for VAGLB than the AG 34 assumptions. That is, because a GMDB typically is available in early contract durations, the larger drop and more rapid recovery assumptions under AG 34 may be less appropriate than the AG 43 assumptions when dealing with VAGLB that are not effective until later contract durations.

Another very important assumption modification from the AG 43 Standard Scenario would be to expand the testing for the greatest present value of the worst case scenario beyond assuming a formula-driven structure for VAGLB election rates. For example, AG 43 would include such assumptions as the exercise of an in-the-money guaranteed minimum withdrawal benefit only at the earliest possible future projection interval. Consistent with AG 33 and the integrated benefit stream approach, the exercise of the VAGLB at all possible future projection intervals should be tested. There are VAGLB designs that exist today where an assumed exercise of an in-the-money guaranteed minimum withdrawal benefit at the earliest possible future projection does not produce a greatest present value. Therefore, following this assumption in the Standard Scenario of AG 43 is a departure from traditional CARVM and would not comply with AG 33 requirements.

Once the AG 33 reserve for VAGLB is computed, the remaining tax reserve requirements would still need to be followed. The AG 33 reserve would need to be aggregated with any other federally prescribed reserves for the contract (AG 34

reserves for GMDB) and then capped by the statutory reserves for the contract. The initial transition to an AG 33 tax reserve could end up producing higher or lower tax reserves for individual policies as compared to AG 39 reserves. The amount of the difference will depend on how close or far to an in-the-money position the VAGLB happens to be in the transition year. It is not out of the question for an out-of-the-money VAGLB to have a near zero additional tax reserve attributable to the VAGLB. This would be unthinkable under AG 39. Conversely, an in-the-money VAGLB may have an appropriately higher tax reserve than under AG 39. Following AG 33, however, will result in a tax reserve approach that is more intuitive and responsive to movements in the market than the simple accumulation of fees under AG 39. Additionally, as part of the transition to AG 33, the increase or decrease in the tax reserve could be incorporated into the AG 43 change in basis under Notice 2010-29.

For insurance companies, this approach to VAGLB tax reserves has several advantages. First of all, there should be an administrative advantage because there is the potential ability to leverage off existing models and processes that currently develop AG 43 reserves to the extent they are consistent with AG 33 and AG 34. Also, companies would have a tax reserve that will move with market conditions, much like AG 43 reserves. This result, where tax and statutory reserves move similarly year to year, will help reduce the company's deferred tax asset, unlike the situation that can exist in an AG 39 tax reserve environment.

CONCLUSION

In an environment where the IRS on audit is rejecting insurance companies' reliance on AG 39 to set tax reserves for VAGLB, the industry is left with a void in its tax compliance that must be filled with an alternative tax reserve method that fits in with the principles of CARVM as of the time the contract was issued. Assuming the IRS's audit position is correct, it seems that the best course of action is to look to our past, AG 33 and AG 34, as well as AG 43 to the extent it is consistent with AG 33 and AG 34, to develop a tax reserve method that is grounded in CARVM principles previously recognized by the NAIC and incorporates the integrated benefit approach that NAIC guidance requires. The authors believe that the method outlined in this article does just this and companies and the IRS should consider this to be a reasonable alternative approach to CARVM as a substitute for AG 39 in the event of an IRS audit, as well as into the future so long as pre-2010 variable annuity contracts remain on the books. ◂

END NOTES

1. 2010-15 I.R.B. 547. *See* Peter Winslow and Christian DesRochers, *Attorney-Actuary Dialogue on Notice 2010-29*, 6 Taxing Times 24 (Sept. 2010).
2. 2008-5 I.R.B. 363.
3. Rev. Rul. 77-451, 1977-2 C.B. 224; Rev. Rul. 69-302, 1969-1 C.B. 186.
4. *See Central National Life Ins. Co. of Omaha. v. United States,* 574 F.2d 1067 (Ct. Cl. 1978).
5. Guideline effective 12/31/1995 for all contracts issued after 1/1/1981. Revisions to guideline effective 12/31/1998 for all contracts issued after 1/1/1981.
6. National Association of Insurance Commissioners, *Accounting Practices and Procedures Manual,* vol. II, at C-83 (Mar. 2008) ("AP&P 2008").
7. AP&P 2008 at C-85.
8. AP&P 2008 at C-85.
9. AP&P 2008 at C-83 to C-84.
10. *See* TAM 200328006 (Mar. 20, 2003). *But see American Financial Group v. United States,* 726 F. Supp. 2d 802 (S.D. Ohio 2010), *appeal docketed,* No. 10-3991 (6th Cir. Aug. 16, 2010).
11. Staff of the Jt. Comm. On Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Tax Reform Act of 1984 599 (Comm. Print 1984).

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