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ACTUARY/ACCOUNTANT/TAX ATTORNEY DIALOGUE ON NOTICE 2013-19 AND THE STATUTORY RESERVES CAP

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Note From the Editor:
As we have in past issues, we are presenting a dialogue on a current life insurance company federal income tax issue, in this case the guidance issued earlier this year on the treatment of deficiency reserves with respect to the "statutory reserves cap" of Internal Revenue Code section 807(d)(1), which limits the federally prescribed reserve to be no greater than the statutory reserves for the contract. The guidance is in response to an item in the Department of the Treasury 2012-2013 Priority Guidance Plan calling for a Notice clarifying whether deficiency reserves should be taken into account in computing statutory reserves under section 807(d)(6). The discussion is among three individuals who are familiar to readers of TAXING TIMES*: Edward Robbins of Ernst & Young LLP; Peter Winslow of Scribner, Hall & Thompson, LLP; and Mark Smith of PricewaterhouseCoopers, LLP. Mark, please start us off with some background on the statutory reserves cap issue.*

Mark: The statutory reserves cap has received more attention in the past three or four years than perhaps any time since 1984. In addition to the activity related to Actuarial Guideline (AG) 43 and life principle-based reserves (PBR), which has been the subject of much discussion in these pages, on Feb. 27 of this year the Internal Revenue Service (IRS) released Notice 2013-19.[1] Notice 2013-19 concludes that the statutory reserves cap of section 807(d)(1) includes deficiency reserves, acknowledging that deficiency reserves are included in "the aggregate amount set forth in the annual statement" with respect to life insurance reserves. The fact that deficiency reserves are excluded from the federally prescribed reserve does not affect this conclusion. The Notice thus resolved an issue for which guidance had been promised for several years. We'd like to talk about that Notice, and also about the statutory reserves cap more generally. To begin, though, it would be useful to talk through some of the history of life insurance reserves and where the statutory reserves cap came from.

From 1959 to 1984, a life insurance company's taxable income was computed under a complex, three-phase system that baffled many who were not privy to the mysteries of insurance tax accounting. Ironically, one of the less complex elements of that system was the calculation of underwriting income, or at least the determination of the amount of life insurance reserves. Under the Life Insurance Company Tax Act of 1959, the starting point for computing life insurance reserves was simply the company's statutory reserves.

In 1984, Congress scrapped the three-phase system in favor of a single-phase system that bore a closer resemblance to that which applies to taxpayers in other industries. For life insurance reserves, section 807(d)(2) sets forth rules for computing a federally prescribed reserve, which is generally based on National Association of Insurance Commissioners (NAIC) prescribed valuation methods, prevailing mortality tables, and the greater of tax-prescribed or prevailing state assumed interest rates. Under section 807(d)(1), the federally prescribed reserve for a contract is bounded by a floor, which is the net surrender value of the contract, and a cap, which is the amount taken into account with respect to the contract in determining statutory reserves.

For purposes of applying the statutory reserves cap, the definition provided in section 807(d)(6) is straightforward: The term "statutory reserves" means the aggregate amount set forth in the annual statement with respect to items described in section 807(c), other than certain reserves attributable to deferred and uncollected premiums. Based on this definition, many believe that the statutory reserves for purposes of applying the cap, or limitation, of section 807(d)(1) are simply the statutory reserves set forth in the NAIC annual statement.

Some amounts that are included in statutory reserves with respect to a contract are explicitly not deductible in computing the federally prescribed reserve. For example, in interim guidance, the IRS asserts that the Conditional Tail Expectation (CTE) Amount of AG 43 is not included in the federally prescribed reserve for a contract under section 807(d).[2] In addition, section 807(d)(3)(C) provides that no reserve deduction is permitted for deficiency reserves, that is, amounts that arise because the net premium exceeds the actual premiums and other consideration charged for benefits under the contract.[3]

The issue, therefore, arises whether the statutory reserves cap may include a reserve amount that is explicitly not included in the federally prescribed reserve. The issue also can arise when the statutory reserves are computed on a different basis than the federally prescribed reserve.

Notice 2013-19 is deceptively simple. That is, it recites no facts, and acknowledges what most of us would have regarded as already clear based on the language of the statute and legislative history directly on point: The statutory reserves cap includes deficiency reserves. Yet, the guidance was pending for quite a long time, and I know the issue has generated considerable attention over the years, including in *Taxing Times*.[4] Peter, what issues do you see in the new Notice?

Peter: Notice 2013-19 is more notable for what it doesn't say than for what it does say. Beyond merely concluding that the legislative history requires deficiency reserves to be included in the statutory reserves cap, it does not provide useful guidance as to the factors that are important to consider for other types of reserves. Statutory reserves are defined in section 807(d)(6) as the aggregate amount set forth in the annual statement with respect to items defined in section 807(c). In its original version in the 1984 Act, this definition appeared in the now-repealed section 809 dealing with the add-on tax for mutual companies.

The definition of statutory reserves raises several important issues that we should explore in this dialogue. I can break down some of these issues into the following questions that we can discuss.

1. Are non-formulaic reserves included in statutory reserves?

2. Can aggregate or stochastically computed reserves be included and allocated back to particular contracts?

3. In determining the scope of statutory reserves, what relevance does pre-1984 Act law have as to the qualification of a reserve as an insurance reserve?

4. When is a reserve held "with respect to" a section 807(c) item?

Perhaps, the ultimate question is: What are the most important factors to consider in determining whether a liability reported on the annual statement should be included in the statutory reserves cap?

These questions should be more than enough for us to tackle.

Since the 1984 Tax Act, several types of statutory reserves have been required beyond historical deterministic net premium reserves. Ed, can you please give us some background on these non-formulaic reserves and tell us whether you think they belong in the statutory reserves cap?

Ed: Yes, you're primarily talking about "economic liability" estimates using entity-specific assumptions, commonly referred to as "asset adequacy testing" (AAT) reserves. If those economic liability estimates are greater than the formulaic reserves for those risks, the actuary is required to put up those extra amounts as reserves. Let's first give examples of those types of reserves. First came the Actuarial Opinion and Memorandum (AOM) Regulation, which required AAT for the company as a whole. The list of required AAT calculations has been growing over the years. Subsequent to the AOM requirement, several product-specific requirements have been published by the NAIC. Examples of such requirements are AG 34 (now superseded by AG 43) for guaranteed minimum death benefits, AG 38 for secondary guarantee universal life, and AG 43 for variable annuities. I would also add the gross premium valuation requirement in the health insurance statutory guidance, specifically SSAP 54. So the question of whether Notice 2013-19 will affect the ability of AAT reserves to enhance the statutory reserves cap when those reserves exceed the corresponding formulaic reserves for their respective products is an interesting one.

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The meaning of the flush language of Code section 807(d)(1) is the question. It specifies: "*In no event shall the [federally prescribed reserve] for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves.…*" This is a rather definitive statement, which would appear to include all statutory reserves allocable to the contract. One implication is that statutory reserves, whether or not they are part of the minimum statutory standard, or whether or not they are voluntary, strengthened, or formulaic reserves, still belong in the statutory reserves cap. Further, it would appear to include AAT reserves as well. That also appears to be the implication of the 1984 Act Blue Book language, which spoke to the inclusion of deficiency reserves.

Peter: I agree with you, Ed, that there is no reason why non-formulaic reserves should be excluded from statutory reserves for purposes of the tax reserves cap. But, there must be some basic set of principles that apply to make the determination. I believe that some of the criteria for what types of reserves are, or are not, included in statutory reserves can be found in regulations and case law interpreting pre-1984 law. Do you agree, Mark?

Mark: Well, Peter, I think the starting point requires an appreciation of just how straightforwardly Congress intended the cap to apply. Section 807(d)(6) defines "statutory reserves" for this purpose as the aggregate amount set forth in the annual statement with respect to items described in section 807(c), other than certain reserves attributable to deferred and uncollected premiums. The answer in the Code itself seems to be that the amount set forth in the annual statement is generally what governs.

Notice 2013-19 and the Committee Reports that it cites are fascinating on this point. The Report language that is cited in the Notice was written to explain provisions that *excluded* deficiency reserves from federally prescribed reserves and from the life insurance company qualification ratio. Yet, the Reports make it clear that deficiency reserves—which were not deductible life insurance reserves under pre-1984 law either—are *included* in the statutory reserves cap. For me, this is pretty strong evidence that Congress knew and intended the statutory reserves cap to mean the amounts set forth in the annual statement, period, and as a general matter not to be limited by pre-1984 law authorities.

Peter: I agree with you too, Mark. Congress must have intended statutory reserves to be a broad concept. Under the 1984 Act, statutory reserves served two functions. The excess of statutory reserves over tax reserves served to increase a mutual company's equity base, and thereby taxable income, in the add-on tax imposed by section 809, which has since been repealed. Statutory reserves also served the purpose which we are discussing now—a limitation on the amount of deductible tax reserves. For the mutual company "add-on" tax, the equity base started with statutory surplus and capital and was increased by, among other items, any excess of statutory reserves over tax reserves. Congress evidently was concerned that mutual companies would artificially reduce their equity base by reporting a portion of what otherwise could be section 807(c) reserve items as some other type of liability on the annual statement. The broad statutory language ensured that all reserves for the contract would be taken into account as long as they are connected to a deductible reserve item.

For the statutory reserves cap, an expansive definition of statutory reserves served the tax policy objective of a level playing field. Congress' goal was that all life companies should obtain comparable tax reserve deductions for the same products, but only if the company did not hold smaller reserves on its annual statement. But, to prevent an unfair result, statutory reserves were broadly defined so that the cap would come into play only where the company does not have sufficient reserves on the annual statement for the contract. That way, a company would not obtain a competitive advantage by deducting tax reserves without taking a hit to surplus. But, if a company holds sufficient reserves for the contract somewhere in the annual statement, there is no tax policy reason to give that company a smaller tax reserve deduction than its competitors.

Mark: Well, the Code requires that statutory reserves be "the aggregate amount set forth" in the annual statement "with respect to" items described in section 807(c), such as life insurance reserves. The reference to "the aggregate amount set forth" in the annual statement seems simple enough, and refers to statutory reserves. Section 1.801-5(a) of the regulations under the 1959 Act clarifies that in computing total reserves, a company is permitted to use the highest aggregate reserve "required" by any state or territory, and that the amount must be "actually held."[5] Reserves that are not required, or are not held, would presumably not pass muster.

Amounts are presumably "with respect to" items described in section 807(c) if they relate to amounts that account for obligations to policyholders. Thus, for example, contingency reserves, like the 5 percent add-on reserve in Rev Rul. 67-435,[6]

are arguably not "with respect to" because they do not account for the company's obligations to its policyholders. Arguably amounts are not with respect to items described in section 807(c) if they account for a company's assets or business risks rather than its obligations to policyholders.

The complete phrase—"with respect to items described in section 807(c)"—is noteworthy for a couple of reasons. First, it suggests that a reserve need not be a section 807(c) item itself, but simply "with respect to" a section 807(c) item. Second, it appears not to be limited to section 807(c)(1) (describing life insurance reserves), but rather refers more generally to section 807(c).

I'm intrigued by Ed's observation about AAT, because this implicates all these sub-issues. Are asset adequacy reserves "with respect to" amounts described in section 807(c), or are they with respect to the company's assets and the sufficiency of those assets to meet obligations to policyholders?

Peter: There is a lot to consider in what you just said. I think that our analysis needs to start with the term "statutory reserves" and put it in the context of what Congress was trying to accomplish in the 1984 Act and how it thought the term would be interpreted in light of the state of the law at that time. Prior to 1984, life insurance companies were generally entitled to a deduction for their reserves as reported on the annual statement. They could make an adjustment under former section 818(c) for life insurance reserves computed on a preliminary term basis, and life insurance reserves had to be "required by law;" but, by and large, insurance reserves reported on the annual statement were deductible. Although the term "statutory reserves" was not in the Code prior to the 1984 Act, as a practical matter, the same concept applied.

Because the concept of statutory reserves was implicitly embedded in pre-1984 Act law, it follows that clues as to the scope of statutory reserves under current law can be found in the pre-1984 law that dealt with whether a particular reserve reported on the annual statement was deductible or not. Under pre-1984 law, a deduction generally was allowable for reserves that were properly classified as insurance reserves, but not for so-called surplus or contingency reserves or for reserves held for expenses. Whether a reserve technically qualifies as a life insurance reserve, as opposed to some other type of insurance reserve, should be irrelevant in resolving this issue because it is clear that statutory reserves is a broader concept, and because reserves that failed to qualify as life insurance reserves were still deductible under pre-1984 law if they otherwise were insurance reserves reported on the annual statement.

So, now to the hard part. Is an asset adequacy reserve or stochastic reserve in the nature of a surplus or contingency reserve or is it more in the nature of an insurance reserve? I believe the correct answer is: It depends. Some of the main factors to be considered may be found in what Ed outlined earlier—that is, the distinction between an asset adequacy reserve required by the Actuarial Opinion for the company as a whole and an asset adequacy reserve required by an actuarial guideline interpreting the Standard Valuation Law (SVL) for a particular product.

Ed: I think the answer to that question needs to consider that even many (or most) required insurance liabilities contain some provision for adverse deviation. Thus, from a purely actuarial perspective, it seems to be the ***degree*** of conservatism that can dictate whether a particular liability should be treated as a contingency item or an insurance reserve. Actuaries generally agree that a reserve should provide only for moderately adverse deviations from expectations, in order not to unduly distort statutory earnings. Peter, to your point, whether a liability is treatable as an insurance reserve or a contingency can possibly be seen as a function of how great the degree of conservatism is. An explicit example can be found for variable annuities, in the relationship of the RBC (C-3 risk) calculation to the CTE Amount. The structure is equivalent, but the degree of conservatism is far greater in the former item. Specifically, the CTE Amount threshold is CTE 70, whereas the RBC contribution uses CTE 90. The former is a reserve, while the latter is an element of "required surplus." At the one extreme, the statutory risk-based capital (RBC) requirement could clearly be categorized as a contingency reserve by practitioners in general. Its purpose is to assure that the probability of a company insolvency is very small. It is part of statutory surplus, as opposed to being a statutory liability. The excess of total statutory surplus over a "grossed up" Company Action

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Level RBC is generally considered "free surplus." The RBC requirement would appear clearly to be a contingency fund. It is not a deductible liability. But, by its nature, and considering that a company not satisfying the RBC requirements will be insolvent, it could be classified as an "effective liability," despite its inclusion in company surplus.

Next down the chain might be the asset valuation reserve, which would appear to be a contingency reserve on assets, but which is part of statutory liabilities nevertheless. However, changes in the asset valuation reserve go directly to surplus as opposed to statutory earnings. It is not a deductible liability. Its nature would appear to be that of a contingency fund, and, to Mark's point, it is only indirectly (if at all) with respect to "liabilities to contractholders."

Jumping to the other extreme, statutory formulaic insurance reserves according to minimum standards are clearly includable in the statutory cap. Note that the required assumptions generally provide for some adverse deviation, as would be necessary to run a viable insurance operation. Deficiency reserves, which form part of the statutory minimum formulaic reserves, would fall into this category.

Under the Code section 807(d)(1) language, voluntary changes to formulaic reserves to increase them, such as decreases in valuation interest rates, clearly should be included in the statutory reserves cap.

Then we have various AAT reserves applicable to particular product lines. These are all "evidential" items. That is, AAT reserves are compared to their respective formulaic reserves, and only when the AAT reserve exceeds the latter does the AAT reserve become the final reserve for the product line. I would view these as insurance reserves rather than contingencies, since they purport to contain the same levels of margins on the assumptions (by and large) as do the formulaic reserves. The fact that generally current assumptions, rather than at-issue assumptions, are used for AAT reserves is not pertinent, as long as the required level of margins thereon is comparable.

The degree of conservatism is not the only issue here. AAT reserves in total are primarily calculated in the aggregate over all contracts in a product line (or, in the case of the AOM requirement, over all contracts in force in the company), as opposed to being seriatim (individual contract) calculations. The issue of allocation down to the policy level is an important one.

Mark: Although I don't disagree with anything either of you has said, I do wonder what it means to distinguish among the various reserves according to the degree of conservatism. The statutory reserves cap of section 807(d)(6) prevents a company from deducting amounts on its tax returns (as a federally prescribed reserve) that exceed the amounts the company actually set aside. Whether those amounts are conservative or not is not an issue for the statutory reserves cap, and not a matter the IRS and Treasury need to concern themselves with. What matters is whether amounts were required to be set aside, and were actually set aside, by the company. "Stat equals stat."

Of course, you are correct that reserve amounts that are determined with regard to the company as a whole, or with regard to a company's assets as opposed to its obligations to policyholders, logically would not belong in the statutory reserves cap. In fact, it would be almost unnatural to apportion those kinds of reserves contract by contract, and section 807(d)(6) requires that reserves included in the cap be "with respect to" items described in section 807(c) (that is, reserves).

But all that is different from the most basic question that Peter posed: Is a stochastic reserve in the nature of a contingency reserve, or is it in the nature of an insurance reserve? Peter's answer was: It depends. My answer is the same, although I might describe that slightly differently. It might be a matter of semantics, but the distinction between an insurance reserve and a contingency reserve is sometimes hard to draw (perhaps because even an insurance reserve accounts for an insured contingency). I would ask whether the factors that are taken into account in performing the stochastic determination are factors that are, historically, inherently part of the determination of an insurance reserve. That is, are they factors like interest rates, mortality tables, even asset values to the extent they bear on the measurement of the company's guarantees to policyholders? Are they factors that drive policyholder behavior and hence the measurement of the company's obligations under the underlying contracts? A stochastic determination that looks to the company's assets, but not to its obligations to policyholders, likely would not qualify. For me, the fact that the calculation begins on a contract-by-contract basis, or that it begins on an aggregate basis and then is apportioned contract by contract, bears no weight. I really don't understand why that difference should make a reserve ineligible for inclusion in the statutory reserves cap.

I also worry what the alternatives are. Would the IRS exclude an entire reserve—or part of a reserve—from the cap even though the entire amount was required to be set aside by the company and was part of the economic measurement of the company's obligations to policyholders? Would its actuaries attempt to bifurcate that reserve, element by element and company by company? Even if that could be done—a very big "if"—I'd be concerned whether the result would produce a clearer reflection of income than what the NAIC prescribed after years of careful study.

Peter: Let's get down to the basics. The basic characteristic of an insurance reserve is that it starts with the present value of future benefits and subtracts the expected revenue that is available to fund those benefits. In a deterministic net premium reserve calculation, the assumptions in making the reserve calculation are formulaic and fixed at issue, including the receipt of future premiums and investment income. In my opinion, a reserve will qualify as an insurance reserve if it has these basic characteristics. It can be a stochastic reserve, a gross premium reserve or a rule-of-thumb estimate, but as long as it is intended to be a liability held for the present value of future benefits less future available funding for the benefits, it should be an insurance reserve and included in the statutory reserves cap. By the way, there has been some confusion about the role of expenses in insurance reserves. There is nothing inconsistent with the nature of an insurance reserve to take into account expenses in the portion of the formula that subtracts the present value of future receipts available to fund future benefits. Expenses are an appropriate consideration as a reduction of future available funding. In a net premium calculation expenses are taken into account implicitly; there is nothing wrong with a more robust reserve method that takes expenses into account explicitly.

Ed: What about the issue of conservatism?

Peter: The issue of conservatism is tricky. Obviously, the inclusion of some conservatism does not mean that a reserve, or portion of a reserve, fails to be in the nature of an insurance reserve. Conservatism is fine. In fact, a proper insurance reserve should have an element of conservatism. Otherwise, profits would emerge upfront rather than over the period of the risk exposure, and income would not be clearly reflected. That's why the proposals for accounting for insurance contracts from IASB and FASB contain a risk margin. The key is whether the conservatism is in the assumptions used to estimate the present value of future benefits and/or is needed to reflect the proper emergence of profits or whether the reserve is held primarily for another purpose. For example, a 5 percent margin in the reserve assumptions to provide for moderately adverse conditions would be just an integral part of a basic insurance reserve, but a separate reserve equal to 5 percent of total reserves across the board imposed by a state law for solvency objectives may not qualify as an insurance reserve if the actuarial reserves held by the company otherwise satisfy the SVL and already contain an element of conservatism.

Mark: I anticipate an objection that there's little real difference between a margin for conservatism that might be inherent in a reserve calculation and a margin for conservatism that is equal in magnitude but applied across the board, independent of actuarial reserves that otherwise satisfy the SVL. In the computation of the federally prescribed reserve, I believe that Congress implicitly wrung out that conservatism in at least three respects. First, it required that mortality tables be prevailing (that is, mortality tables required by at least 26 states); Second, it required that the interest rate used be the higher of the Applicable Federal Rate or the prevailing state assumed rate. Third, it defined the relevant CRVM or CARVM by ref-

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erence to prescription by the NAIC. Thus, for all three elements—mortality tables, interest rate and methodology—the federally prescribed reserve includes safeguards against a particular state requiring excess conservatism in computing its reserves. There is no requirement for "tax equipoise" in life insurance reserves. Congress instead explicitly relied on 26-state standards as the measurement for appropriate conservatism.

With excess conservatism thus addressed in the computation of the federally prescribed reserve, the statutory reserves cap plays no role in further limiting reserves for conservatism. The statutory reserves cap merely prevents a deductible tax reserve from exceeding amounts that are set aside for regulatory purposes. The IRS and Treasury should be thankful that the regime relieves them of the responsibility for devising tax-specific reserve methodologies, a time-consuming and contentious process that on the non-tax regulatory side takes years.

But this is all very abstract. How does your analysis of conservatism apply to the real-world issues of asset adequacy reserves and the CTE Amount in AG 43?

Peter: What you are saying, Mark, is that the degree of conservatism in a reserve is not the determinative issue in deciding whether an annual statement liability is included in the statutory reserves cap. I agree, but I also agree with the basic thrust of what I think Ed is saying—the degree of conservatism is an important factor in deciding whether a liability has the characteristics of an insurance reserve in the first place. Certainly, if the NAIC or a state regulator mandates a certain level of conservatism in estimating the present value of future benefits (minus the values of funding sources) for a group of policies, then the reserve—the entire reserve—should qualify as an insurance reserve and be included in the statutory reserves cap. This should be the conclusion regardless of how conservative the mandatory assumptions may be.

The statutory reserves cap merely prevents a deductible tax reserve from exceeding amounts that are set aside for regulatory purposes.

With this consideration in mind, I think qualification of the CTE Amount in AG 43 as an insurance reserve and as part of the statutory reserves cap is clear. It meets all the criteria of an insurance reserve. Also, as part of the minimum reserve required by the NAIC to satisfy the SVL, it seems equally clear that it is held "with respect to" a section 807(c) reserve item—the basic requirement for statutory reserves in section 807(d)(6). Similarly, the asset adequacy reserve portion of AG 39 reserves should qualify. It is the only actuarially computed portion of the AG 39 reserve and, without it, there would not be a sufficient CARVM reserve in market conditions such as occurred in 2008.

An opposite conclusion could be reached for the general asset adequacy reserve that is needed to satisfy the actuarial opinion, but is not held for specific policies. This probably does not satisfy the "with respect to" requirement for statutory reserves and may not be an insurance reserve. The asset adequacy reserve required by AG 34 is a close question. You could make good arguments either way. But, because the reserve is mandated by the NAIC for a specific group of policies, it probably should be included in the statutory reserves cap.

Ed: So far we've mentioned at least two potential criteria as to whether a reserve is of deductible character: the degree of conservatism (a question of degree) or whether the reserve is "with respect to" policyholder liabilities (a possibly "brighter line"). And there are other potential such criteria. Let's examine the RBC requirement to see how it squares with these two criteria or other criteria. An RBC requirement is in part with respect to policyholder liabilities but is not deductible. It seems that the degree of conservatism is sufficiently extreme to render it non-deductible on that score. When a margin is too great, one might question whether that margin was set aside for a particular product line, or, whether it was intended to support the company as a whole.

A third criterion is simply the placement in the annual statement. The RBC requirement is not contained in either of the two annual statement reserve exhibits (Exhibits 5 and 6). Indeed, it speaks to asset issues as well as liability issues. Thus, from a technical perspective, it is not a statutory reserve at all and fails the specific test under section 807(d)(1). A fourth criterion might be the relative ease with which it is allocable down to the policy level, to enable the required contract-by-contract comparison between the federally prescribed reserve and statutory reserves.

On the other hand, let me suggest another criterion—which in fact goes the other way. Putting statutory placement aside, if a company has insufficient "Total Adjusted Capital" to cover its RBC requirement, it runs into danger of insolvency. That's a primary characteristic of a reserve. Back when Guideline 43 was first proposed, the reserve and the C-3 requirement were similar in form and different only in degree.

Peter: I believe we have identified four, and possibly five, factors so far to consider in determining whether we have a qualified statutory reserve. Let me add another question that I think should be asked, at least for asset adequacy reserves. Does the reserve arise because assets allocated to fund a block of contracts have a fair market value less than their book value? If the answer to this question is "yes," maybe we do not have an insurance reserve. Conversely, if the answer is "no," the label on the reserve is misleading because there is no asset inadequacy—something else is causing the need for an additional reserve.

Ed: Just to throw in a little "actuarialese" for a moment, "asset inadequacy" means that, for ***whatever*** reason, current assets together with future investment income and future premiums are inadequate to provide for future benefits plus expenses. A "fair value/book value" asset difference is not the only reason you can have asset inadequacy. But to your point, fair value/book value differences can certainly be a contributor to asset inadequacy, like in the early 1980s when interest rates were high enough to severely depress market values of assets. At that time many insurance liabilities were not particularly market-value sensitive and the values of the liabilities did not tend to be as interest-sensitive as the values of the assets.

Peter: You make a very interesting point of "actuarialese." I will add a bit of "lawyerese"—I can make a distinction between inadequate fair value/book value of assets and inadequate future investment income. One could argue that an insurance reserve starts from the premise that the value of assets is equal to the assets' book value and that the reserve measures the difference between the present values of future benefits and income. A deficiency in future premiums (net versus gross) in this calculation is a deficiency reserve and is included in the statutory reserves cap. A deficiency in future investment earnings (assumed versus actual) technically is not a deficiency reserve, but is similar in concept. Maybe an additional reserve for investment income deficiencies in a base deterministic reserve should be in the statutory reserves cap, along with traditional deficiency reserves, even though a reserve for fair value/book value deficiencies should not.

Ed: You appear to be carving out a new criterion to determine "what is a reserve" versus "what's better off as part of surplus" that speaks to the ***sources*** of inadequacy. You're differentiating a liability-based deficiency from the asset-based deficiency (which is really a pretty cool way to think about this issue!). Perhaps that could be a reason for differentiation of a reserve-type item from a surplus-type item (like the IMR and AVR, which are both asset-driven and non-deductible).

Peter: Only an actuary would describe this discussion as pretty cool. But, I do think we are on to something important here that relates back to a previous comment of Mark's and to the basic question of what types of reserves should be considered held "with respect to" a section 807(c) reserve item—the Code's definition of statutory reserves. Mark said that we should be looking at whether the reserve includes traditional insurance reserve factors. Now, I am building on Mark's point and saying that a reserve that is held primarily because there are deficiencies in the assumptions used to estimate the present value of future benefits over the present value of future funding sources clearly satisfies the Code's definition of statutory reserves—particularly if the reserve is mandated for a particular group of policies by the NAIC. Frankly, in my view, if a reserve meets this basic criterion, it should not fail the statutory reserves test simply because it is computed stochastically, or is difficult to allocate back to individual contracts, or is not reported with the base insurance reserves on the annual statement, or even has very conservative assumptions mandated by the regulators. These other factors may be important evidence that helps us determine the basic nature of the annual statement liability, but they are not really the ultimate question we are trying to answer.

Assuming I am correct that some aggregate stochastic reserves, like the CTE Amount and the asset adequacy portion of the AG 39 reserves, should be included in statutory reserves, what do we do about the contract-by-contract comparison that section 807(d) seems to contemplate?

Ed: Great question. There is a continuum here when we speak to AAT reserves. I agree that the AAT reserve associated with the AOM would probably be too far removed from the individual policies to easily come up with an equitable formula for such allocation. At the other extreme, there are at least

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two product-specific NAIC actuarial guidelines that provide explicitly for such allocation: Guideline 43 and Part 8D of Guideline 38. With respect to those two allocation approaches, those guidelines attempted to provide for such allocation in a manner that was reasonably related to the exposure associated with those liabilities. For other required, product-specific AAT reserves, the guidance does not prescribe allocation methodologies.

Peter: Perhaps to accomplish the contract-by-contract allocation of aggregate reserves, we just use the same basic actuarial principles underlying AG 43 and AG 38 as guidance and allocate to specific contracts in a similar actuarially principled way. This is easy for me to say because it is the actuaries, not the lawyers, who have to figure out the best allocation method.

Mark: Actuarialese? Lawyerese? Is there such a word as "accountantese" or perhaps "taxtuary"? The application of section 807 necessarily relies on the skills of the actuary, the tax lawyer and the accountant. But whose role is what?

Let me end this discussion with several overall observations about the ideas we have been discussing.

First, much of our conversation so far has been very theoretical. There is a practical dimension to the administration of tax reserves and a limit to what the IRS can undertake. If I were (still) with the IRS or Treasury and charged with providing guidance here, I would look for approaches that employ bright lines and clear legal authority, not for issues that rely on untested legal theories or that require a high degree of human judgment to apply. The trend in AG 43 and in life PBR to rely more heavily on company-specific data and actuarial judgment does not necessarily make this harder, and certainly does not impose any greater burden on the IRS than on state regulators. In my own mind, the trend to rely more heavily on actuarial judgment argues for, not against, deferring to the annual statement for the statutory reserves cap. I'm not confident that any other approach would be administrable and still acknowledge the Congress' clear definition of statutory reserves as "the aggregate amount set forth in the annual statement with respect to items described in section 807(c)."

Second, on the most fundamental level, the IRS and Treasury will need to ask what tax policy is at stake in administering the statutory reserves cap. Is there agreement that the role of the cap is to limit the tax deduction for reserves to amounts actually held and reported on the annual statement? My own thoughts on this are pretty clear. Stat equals stat, and for this reason Peter is correct that the CTE Amount of AG 43 is included in the cap. But it really is important to ask at the outset whether the statutory reserves cap is just a limitation and, if not, what is its role? (In a sense, this is what was at stake for deficiency reserves, and the IRS and Treasury correctly recognized that the exclusion of deficiency reserves from the federally prescribed reserve did not mean that the statutory reserves cap—which is just a limitation—also had to be reduced.)

Third, how confident can anyone be that a reserve that is computed other than using an NAIC-prescribed methodology will still produce a clear reflection of income? When a reserve methodology is prescribed by the NAIC and is treated as an appropriate application of the SVL, it is hard to imagine that the tax administrator could make changes to that reserve and conclude with any confidence that it is still a comprehensive reserve methodology that produces a clear reflection of income. This is a judgment that, at least for regulatory purposes, entails a large number of professionals and a great deal of process. Some of the issues preceding AG 43 and life PBR have been a decade in the making.

Fourth, what are the broader costs of tax administration and litigation? The trend in recently decided cases in the reserve area, such as *American Financial*[7] and *State Farm,*[8] would not necessarily support broad departures from annual statement accounting for reserves, and the definition of statutory reserves in section 807(d)(6) is pretty straightforward. One would expect this at least argues for caution on the part of the government in applying the statutory reserves cap in a manner that entails significant departures from what is actually set forth in the annual statement.

A FINAL COMMENT FROM THE EDITOR

I would like to thank Ed, Peter and Mark for their thoughtful discussion. As they pointed out, many pages of *Taxing Times* have been dedicated to reserve issues, and we can expect that the discussion will continue. A recent Senate Finance Committee Staff paper commented:

> The rules governing insurance taxation have not been significantly reformed since 1986. Since then, many more insurance companies have become publicly traded. The federal government has become more active in overseeing the financial solvency of insurance companies through the Treasury Department's Federal Insurance Office and Dodd-Frank. And technology has enabled insurance actuaries to more accurately predict long-term liabilities.

The paper recommended that Congress consider adjusting the rules governing the amount of a life insurance company's reserves that are deductible to more closely align with statutory reserves the company is required to hold by state regulators.[9] Given that context, the discussions of the character of reserves with respect to the statutory reserves cap may also become important to discussions of the tax reserves themselves.

Stay tuned!

Note: The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP, PricewaterhouseCoopers LLP, or Scribner, Hall & Thompson, LLP.

END NOTES

1 2013-14 I.R.B. 743.

2 Notice 2010-29, 2010-15 I.R.B. 547. The correctness of this assertion has been the matter of some debate.

3 For a comprehensive discussion of the history and treatment of deficiency reserves for federal income tax purposes, see Christian DesRochers, "Deficiency Reserves: The Cicadas of the Life Insurance Industry," *Taxing Times* vol. 7, issue 3 (September 2011).

4 *See, e.g., id.*, Samuel A. Mitchell and Peter H. Winslow, "The Statutory Reserve Cap on Tax Reserve Includes Deficiency Reserves," *Taxing Times* vol. 2, issue 2 (September 2006).

5 *See also* Rev. Rul. 2008-37, 2008-28 I.R.B. 77 (concluding that the amount of the company's statutory reserves within the meaning of section 807(d)(6) is the highest aggregate reserve amount set forth on an annual statement pursuant to the minimum reserving requirements of any state in which the company does business).

6 1967-2 C.B. 232.

7 *American Financial Group v. U.S.*, 678 F.3d 422 (6th Cir. 2012).

8 *State Farm Mutual Automobile Insurance Company v. Commissioner*, 698 F.3d 357 (7th Cir. 2012).

9 *BUSINESS INVESTMENT AND INNOVATION Senate Finance Committee Staff Tax Reform Options for Discussion April 11, 2013, 12,14.*