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ATTORNEY—ACTUARY DIALOGUE ON NOTICE 2010-29

By Peter Winslow and Christian DesRochers

On March 25, 2010, the Treasury Department (Treasury) and the Internal Revenue Service (IRS) issued Notice 2010-29. The new Notice follows-up Notice 2008-18, in which the Treasury and the IRS identified concerns regarding proposed Actuarial Guideline VACARVM and suggested approaches that might be taken to address those issues. Actuarial Guideline VACARVM was effective, as AG43, beginning on Dec. 31, 2009. In response, the Treasury and the IRS issued Notice 2010-29 providing interim guidance on company tax issues related to AG 43. This discussion is the fourth in a continuing series of interdisciplinary dialogues in *Taxing Times* on selected tax issues related to proposals regarding principle-based reserves. This dialogue features Peter Winslow, a tax attorney, and Christian DesRochers, a tax actuary and current chair of the Society of Actuaries Taxation Section.

Peter: Chris, on April 21, Mark Smith [Treasury], you and I did a webinar discussing Notice 2010-29. After saying the usual caveats that his views are solely his and not necessarily those of the IRS or Treasury, Mark summarized four key points at the beginning of the session.

First, Mark said that the Notice is in the nature of a safe harbor. It does not represent a final determination of the IRS's or Treasury's legal conclusions, but it does provide audit protection for taxpayers until further guidance is issued. Mark's second point was that no inference should be drawn from the Notice as to IRS/Treasury position on any other issue. Third, Mark said that there are no subtle messages in the Background section of the Notice; it was intended to be a straightforward recitation of existing law, breaking no new ground. Finally, Mark said that no request for comments was made because IRS/Treasury would like to monitor the impact of the Notice for a time before deciding whether changes to the interim guidance are warranted.

With these comments in mind, Chris, can you generalize about the industry's reaction to the Notice?

Chris: Mark and Sheryl Flum of the IRS also participated in a panel discussion sponsored by the Taxation Section at the Society of Actuaries' Life and Annuity Symposium in Tampa in which they echoed the comments you noted above. Their willingness to discuss the Notice is much appreciated and very helpful in creating a dialogue between IRS and Treasury and the industry. As to the Notice itself, the reaction has been positive, although as we will discuss, some issues remain unresolved. We all understand that as the industry gains more experience with AG 43, additional issues are likely to arise, but the Notice seems to have accomplished its goal of providing timely guidance to enable companies to file their tax returns for 2009.

Peter, to begin our discussion of the substance of Notice 2009-19, a good starting point is Notice 2008-18, in which the Treasury and the IRS raised issues related to the transition to VACARVM, or AG 43, as it was ultimately adopted by the National Association of Insurance Commissioners (NAIC). With respect to qualification as a life insurance company under section 816(b), they expressed the view that it was preferable for life insurance companies to continue to be taxed under Part 1 of Subchapter L. *i.e.,* as life insurance companies, so that the enactment of AG 43 should not affect the status of a company as a life insurance company. One of the approaches suggested in Notice 2008-18 was to "require the use of only the standard scenario amount (in the case of Proposed AG VACARVM.)" Notice 2010-29 includes the Standard Scenario Amount (SSA) in both life insurance reserves and total reserves under the qualification test, but provided no comment on the treatment of the Conditional Tail Expectation (CTE) amount. While recognizing the SSA as a part of life insurance and total reserves, Notice 2010-29 does not include the limitation to "require the use of only the standard scenario amount." Do you see any significance in the position in Notice 2010-29?

Peter: I think the Notice's silence on the proper characterization of the CTE amount is very significant, but not for

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section 816(b) purposes. Your question specifically relates to whether the CTE amount is a life insurance reserve or an insurance reserve to be included in numerator and/or denominator of the 50-percent reserve ratio test in section 816(b) for purposes of determining qualification as a life insurance company. Resolution of this issue standing alone is not particularly important because tax status is unlikely to change regardless of how the CTE amount is treated in the reserve ratio test. Remember, under AG 43 the CTE amount is only the excess over the SSA. But, whether the CTE amount qualifies as a life insurance reserve or an insurance reserve can be very important for other reasons, particularly with respect to the question of whether the CTE amount should be included in the statutory reserves cap. So, let's turn to that issue.

Section 3.02 of Notice 2010-29 concludes that the SSA is included in the statutory reserves cap, but, as in the case of the reserves ratio test, the Notice is silent as to whether the CTE amount also is included. This is potentially an important issue for contracts issued prior to Dec. 31, 2009, which will have tax reserves on a different basis than statutory reserves. Chris, do you have any thoughts about this issue?

Chris: I am optimistic that at this point the Treasury and IRS have an open mind on the treatment of the CTE amount, at least with respect to qualification and the statutory cap. With respect to the 50-percent reserve ratio test, I agree with your observation that the Treasury and IRS are well aware that exclusion of the CTE amount is not likely to cause any life insurance company to lose qualification as a life company. Thus, their silence on the issue was a pragmatic solution that allowed the Notice to be issued, without the need to address the nature of the CTE amount. In that regard, while the CTE amount has elements that are consistent with the section 816 definition of life insurance reserves *(i.e.*, are set aside to mature or liquidate future unaccrued claims involving life, accident or health contingencies), there are also elements in the CTE amount that cause the Treasury and IRS concern about their inclusion as components of life insurance reserves.

However, with respect to the statutory cap, there doesn't seem to be a compelling argument against the inclusion of any CTE amount in excess of the SSA in the statutory cap. As a practical matter, for those companies with reserves based on the CTE amounts, it seems a reasonable position to include them in the statutory cap, but each company must decide that for themselves. Peter, I know you have a view on the CTE amounts and the statutory cap. Can you share it with our readers?

Peter: The question as to the meaning of "statutory reserves" under section 807(d)(6) for purposes of the tax reserves cap is currently being considered by the IRS National Office in the context of deficiency reserves, and no decision has been made. As a technical matter, statutory reserves are defined in the Code as liabilities held "with respect to" insurance reserves described in section 807(c), implying that "statutory reserves" is a broader concept than just deductible tax reserves. But, the definition also implies that there must be a nexus between the statutory liability and section 807(c). In my view, the fact that the excess CTE amount has been defined by the NAIC to be part of CARVM should satisfy the nexus requirement. This conclusion is supported by the legislative history. The concept of "statutory reserves" was intended to be broadly construed to be consistent with the policy of former section 809 to increase mutual companies equity base and of section 807 to ensure that all taxpayers obtain the same reserve deduction as long as they hold statutory reserves for the policy at least equal to the federally prescribed reserves. So, I think the better answer is that the excess CTE amount should be included in the statutory reserves cap, but the IRS National Office has not made this determination, and, as I said, whatever it concludes on the deficiency reserve issue may have a bearing on the outcome here.

Chris, you mentioned some IRS concerns with new factors taken into account in the CTE amount. Are there similar concerns with the SSA?

Chris: Section 3.03 of the Notice provides that "for purposes of determining the amount of the reserve under section 807(d)(2) with respect to a contract falling within the scope of AG 43 and issued on or after Dec. 31, 2009, the provisions for determining the Standard Scenario Amount are taken into account, and the provisions for determining the CTE amount are not taken into account." One effect of the Notice is that it provides a clear safe harbor for the SSA as the federally prescribed reserve. The recognition of the SSA as the basis for the federally prescribed reserve is one of the very positive aspects of the Notice, as there are components of the SSA that could have been problematic, although for different reasons. First, the Accumulated Net Revenue element of the SSA covers more than just assumed interest and mortality, but also contains account drop and recovery assumptions, as well as projections of assumed lapses and partial withdrawals. While there is precedent for recognition of factors other than mortality and interest in the calculation of life insurance reserves,[1] the treatment of the drop assumption under AG 34 has been an issue in the CIGNA case. Second, the recognition of value of hedges in the SSA, while not creating a particular reserve issue, seems to me to require that a company should think about how it might affect their tax accounting for hedges generally. Peter, any thoughts on either of these issues?

Peter: As to the SSA, I agree that it is comforting to know that the nonmortality and interest aspects of AG 43, such as consideration of lapses, reinsurance, hedging, account value drop assumptions and margins, will be accepted without a need to carve out portions of the reserves or adjust these assumptions. But, I also think it is important to caution our readers that in our webinar, Mark Smith reiterated that the Notice is only an interim safe harbor with no inference to be drawn on these issues for prior years' audit issues or for future guidance having prospective affect.

As to the CTE amount that will not qualify as part of the federally prescribed reserve, the Notice does not explain the rationale for the disqualification. I think there could be at least four possible rationales. The CTE amount could be considered at least in part, a "surplus" reserve and not an insurance reserve. Second, it could be considered to fail, as a "life insurance reserve" and such qualification may be considered a prerequisite to a deduction under section 807(d). Third, the Notice could be saying that the CTE amount is not a deterministic reserve and only this type of reserve can qualify for a deduction under section 807(d). Or, fourth, it could be that the CTE amount is not capable of being recomputed under section 807(d) in a manner that yields an appropriate tax reserve amount. The rationale for the disqualification matters, for example, to the conclusion as to whether the CTE amount is included in the statutory reserves cap and as to how principle-based reserves will be treated. I personally disagreed with the first three potential rationales and hope that the fourth rationale was the theory relied upon to conclude that the excess CTE amount is not part of federally prescribed reserves.

Turning to hedging, my initial reaction is that it is the adoption of AG 43 generally that probably will have the greater impact on tax accounting for related hedges, rather than the treatment of hedges in the AG 43 formula itself. But, this question raises very complicated issues well beyond what we are here to discuss today.

Chris, tell us about the Notice's discussion of the effective date of AG 43 for tax purposes.

Chris: The application of AG 43 differs with respect to contracts that it covers for statutory and tax purposes. For statutory reserves, AG 43 affects all contracts issued on or after Jan. 1, 1981, effective as of Dec. 31, 2009. However, where the application of AG 43 produces higher reserves than the prior method, an insurer may request a permitted practice for a grade-in period of three years. For tax reserves, Notice 2010-29 applies AG 43 to "taxable years ending on or after Dec. 31, 2009" for purposes of Section 3.01 Reserve Ratio Test and 3.02 Statutory Reserve Cap. In determining the amount of the reserve under section 807(d)(2), Notice 2010-29 applies different rules based on a contract's issue date, as follows: a) for a contract issued before Dec. 31, 2009, the tax reserve method is "the method applicable to such contract when issued, as prescribed under relevant actuarial guidance in effect before the adoption of AG 43:" and b) for a contract "falling within the scope of AG 43 and issued on or after Dec. 31, 2009," the tax reserve method is the method prescribed in AG 43 as adjusted by the Notice.

The Notice is based on the IRS and Treasury view of section 807(d)(3)(A)(ii) which sets the tax reserve method as "CARVM in the case of a contract covered by the CARVM," while section 807(d)(3)(B)(ii) in turn defines CARVM as "the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract." The view implicit in Notice 2010-29, as well as other IRS guidance, is that actuarial guidelines, including AG 43, are effective for tax reserves prospectively for new issues even though as in the case of AG 43 the guideline itself applies retroactively to both in force and new issues. This creates a situation in which statutory and tax reserves are in some cases computed in significantly different ways. This would particularly be the case for variable annuity living benefits (VAGLBs) if the tax reserve method for contracts issued before Dec. 31, 2009, is based on AG 39, in which reserves are computed as an accumulation of fees. As a result,

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there are now instances where the statutory reserve under AG 43 exceeds the tax reserve and other cases in which the AG 43 reserve may be less than the tax reserve, resulting in statutory capping. This is an important reason that the treatment of the statutory cap has emerged as a significant issue under AG 43.

Peter, the effective date of actuarial guidelines was one of the issues in the recent American Financial case, which is discussed in another article in this issue of *Taxing Times*. There are also people who believe that that AG 39 was an interim guideline that was never intended by the NAIC to create a permanent reserve method. The argument is that AG 39 sunsets as of Dec. 31, 2009, so it is no longer a proper interpretation of "the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract" and is therefore no longer the appropriate tax reserve method for policies issued before Dec. 31, 2009. Do you think that view has any merit?

Peter: I do. In several audits of returns for pre-AG 43 tax years, IRS agents have taken the position that AG 39 is not CARVM for tax reserve purposes because it does not seem to conform with CARVM methodology as set forth in the Standard Valuation Law and because nowhere in the text of AG 39 is there a reference to CARVM. The IRS's current audit position is stronger now that AG 39 has expired. Is a reserve measured by undiscounted accumulated charges for the duration of the contract really the NAIC-prescribed CARVM after 2009? If neither AG 43 nor AG 39 is CARVM for pre-AG 43 contracts, what is? The answer probably is AG 33, but that guidance does not tell us specifically how to compute reserves with guaranteed living benefits. The legislative history of the 1984 Act tells us that, in general, we are supposed to compute the federally prescribed reserve by starting with the statutory reserve and making the adjustments required by section 807(d). Therefore, I think the correct approach probably is to start with the SSA under AG 43 and retain the methodology and assumptions that are not inconsistent with CARVM (as interpreted by AG 33) as of the date the contract was originally issued. Other AG 43 assumptions that are new would have to be modified. These may include such things as the treatment of lapses, partial withdrawals, hedging, reinsurance, continuous functions, and maybe other items I have not thought about. Another way to state this is that for contracts issued before the tax effective date of AG 43 the federally prescribed reserves may equal AG 33-type reserves computed using the same assumptions used for the SSA statutory reserves except to the extent AG 43 assumptions would not have been permitted by the NAIC, or a majority of states, or considered an appropriate interpretation of the Standard Valuation Law at the time the contract was issued. By the way, it is likely that this AG 33-type tax reserve would be greater than AG 43 statutory reserves and, therefore, the tax reserves would be capped.

Chris: Peter, it is interesting to note that section 3.03 of the Notice speaks in terms of "relevant actuarial guidance in effect before the adoption of AG 43" in the context of the federally prescribed reserves, but does not specify what the relevant guidance actually is. As a consequence, Notice 2010-29 certainly does not preclude the approach that you have described above. This is a topic that should continue to receive some additional discussion as companies develop positions relative to their tax reserves on pre-Dec. 31, 2009 issues.

Now, I'd like to turn to section 3.04 of the Notice which provides that any difference in the amount of tax reserves "determined with regard to AG 43 and the amount determined without regard to AG 43 (*i.e.,* under prior actuarial guidelines) must be spread over 10 taxable years, using the method prescribed by section 807(f)(1)(B)." In discussions, Mark Smith cautioned that the term "the method prescribed by section 807(f)(1)(B)" should be read carefully, as it did not reflect the position that section 807(f)(1)(B) specifically applied to the change in tax reserves resulting from AG 43, but that any change should be spread over 10 years. This seems to be a practical approach to dealing with a change in reserves on business issued before Dec. 31, 2009. Reserves under AG 43 vary by company, depending on the types of products sold, and the time period in which they were sold. For some companies, reserves increased, while for others reserves declined as a result of AG 43. Without guidance, the IRS appears to have been concerned that companies whose reserves increased would take the deduction immediately, while companies whose reserves decreased would spread the income over 10 years. However, they did not seem to bring the change under section 807(f)(1)(B) specifically, perhaps because most commentators do not view a change in the statutory cap as a change in reserve basis which is subject to a 10-year spread.

Peter: Before we wind down, I would like to address one point made by Mark Smith in our webinar. He said that even though the Notice does not necessarily reflect the final views of the IRS or Treasury, complete reliance can be placed on the Notice until further guidance is issued. If this is really the intent, it is important that the safe harbor protection be interpreted to mean that tax reserves for contracts are locked in place forever and that the protection not be limited to taxable years prior to any changes. Otherwise, there could be no true protection that could be relied upon for pricing purposes.

Also, although the Notice does not ask for comments, the IRS and Treasury have encouraged further comments particularly on the nature of the CTE amount, because they would like to better understand how the CTE amount is driven by the various factors taken into account in the computation.

Chris, I know that the Notice says that its conclusions should not have any precedential effect, but are there any lessons to be learned as we go forward on PBR? Any other final thoughts?

Chris: As I noted at the outset, overall the industry reaction to the Notice has been positive, although as we have discussed, there are questions that remain to be answered. The IRS and Treasury appear to have gone as far as they feel comfortable in accommodating changing statutory reserve requirements. I'd like to think this is in part a result of communication between industry and government, including the previous dialogues that have been presented in *Taxing Times*. I also believe that there has been a great effort made to arrive at the "right answer" within the limitations of the Internal Revenue Code. As we move forward in the development of principle-based reserves for life insurance, the comments of IRS and Treasury in both Notice 2008-18 and 2010-29 are generally helpful, but also contain a warning. They are positive in the sense that the IRS and Treasury appear to be willing to accept a broad definition of life insurance reserves, including elements other than strictly interest and mortality. At the same time, the discussions of the factors included in CTE amount indicate a view that there may be limits to what can be in a deductible life insurance reserve. That is, the definition of federally prescribed reserve under current law can only be stretched so far, and efforts to make life principle-based reserves more "tax friendly" continue to be important.

One of the frustrations that Mark Smith expressed relative to the process of developing Notice 2010-29 was the lack of data that was available to IRS and Treasury relative to the effect of AG 43. I believe this reflected the difficulty of implementing AG 43, and the timing of system changes needed to bring the calculations on line. If additional discussions are going to occur relative to the makeup of the CTE amount, and its resulting tax treatment, access to data will be a key element for IRS and Treasury to come to a decision.

Peter, on behalf of the Taxation Section, I'd like to thank you for participating in the webinar, as well as your willingness to engage in yet another dialogue. Your insights are much appreciated. There are a number of issues that we have addressed that should generate additional discussions. Any of our readers that have thoughts or comments are welcome to share them with us. We hope to hear from some of you.

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END NOTES

[1] *See*, for example, Union Mutual Life Insurance Company v. United States of America, 570 F.2d 382, 397 (1st Cir. 1978) and Mutual Benefit Life Insurance Company v. Commissioner, 58 T.C. 679, 688 (3d Cir. 1972), 488 F.2d 1101, 1107 *See also* Lincoln National Life v. United States, 217 Ct. Cl. 515, 585 F.2d 579 (1978).