SOCIETY OF ACTUARIES

Article from:

Taxing Times

October 2012 – Volume 8 Issue 3

SOCIETY OF ACTUARIES Taxation Section

Taxing TIMES

VOLUME 8 | ISSUE 3 | OCTOBER 2012

THE SIXTH CIRCUIT GETS IT RIGHT IN *AMERICAN FINANCIAL*—AN ACTUARIAL GUIDELINE CAN APPLY TO PRIOR CONTRACTS WHEN THE INTERPRETATION WAS A PERMISSIBLE OPTION AT THE TIME THE CONTRACT WAS ISSUED

By Peter H. Winslow

In *American Financial*,[1] the Sixth Circuit held that a life insurance company subsidiary of American Financial Group could compute its tax reserves by using Actuarial Guideline (AG) 33 once its statutory reserves were conformed to AG 33. Providing a breath of fresh air, the court got it exactly right. The court said that if a reserving method prescribed by the National Association of Insurance Commissioners (NAIC) permitted several reserving approaches at the time a contract was issued, then tax reserves can follow statutory reserves when the company changes to another interpretation specified in a new AG. The change is permitted as long as the new AG adopts an approach that was one of the prior permissible options. The court did not say that actuarial guidelines always have retroactive effect, however. For example, the court left open whether a new AG can apply to prior contracts where the NAIC changes its mind and issues an actuarial guideline that adopts a previously impermissible interpretation. Before discussing the *American Financial* case in more detail, it may be useful to provide some background on what the statute requires and the Internal Revenue Service's (IRS's) ruling and litigating positions.

BASIC TAX RESERVE RULES

Under I.R.C. § 807(d), life insurance reserves are required to be computed in accordance with the "tax reserve method" (CRVM for life insurance and CARVM for annuities) prescribed by the NAIC which is in effect on the date of the issuance of the contract. After

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the CRVM or CARVM reserve is computed, using the federally prescribed interest rate and mortality table, the reserve is capped by the statutory reserve and floored by the net surrender value on a contract-by-contract basis.

Where there are state-by-state variations on the interpretation of CRVM and CARVM as of the contract issue date, the legislative history provides some general rules as to which interpretation to use for tax reserves. First, the company is required to use the method prescribed by the NAIC as of the date of issuance of the contract, and take into account any factors recommended by the NAIC for the contract. The NAIC-recommended factors to be taken into account are those generally addressed in model regulations or actuarial guidelines prescribed by the NAIC. Second, where no such factors are recommended by the NAIC, or for contracts issued prior to the NAIC's adoption of a regulation or actuarial guideline, companies are to look to the prevailing interpretation of the Standard Valuation Law (SVL), *i.e.*, the interpretation that has been adopted by at least 26 states. The 1984 Blue Book[2] states that, in general, life insurance reserves are computed by starting with the assumptions made for statutory reserves and then making the adjustments required by I.R.C. § 807(d), indicating that, absent an NAIC actuarial guideline or a prevailing interpretation of the states, the tax reserve method should follow the interpretation of the SVL used by the company for its statutory reserves.

26-STATE RULE

Most of the disputes between the IRS and companies over these rules have centered on the meaning of legislative history explaining that a prevailing state interpretation can apply when the NAIC has not issued a specific interpretation of CRVM or CARVM. There is no 26-state rule contained in the I.R.C. § 807(d) definition of "tax reserve method." Instead, the statute unambiguously defers to the NAIC's interpretation of CRVM or CARVM. The legislative history, therefore, provides a gloss on the statute and is consistent with the statute only if it is construed to mean that, when a majority of NAIC members have formed a uniform position as to the correct interpretation of an NAIC-prescribed method (*i.e.,* 26 states have adopted the same interpretation of the SVL thus making it prevailing), then the NAIC will be presumed to have adopted that interpretation. In such a case, because the NAIC will be deemed to have prescribed the view of a majority of its members, it governs for the tax reserve method. This construction of the legislative history has important implications. Specifically, it means that when considering an interpretation of CRVM or CARVM where there is no applicable NAIC interpretation on point, then a uniform view of 26 states can be applied, but only in the same way as if the NAIC had issued an actuarial guideline setting forth the majority states' view. There is no separate 26-state rule for the tax reserve method that applies independently from the NAIC-prescribed method the statute requires.

Let's apply this basic principle to a situation where the NAIC, directly by an actuarial guideline or indirectly by a majority of states, allows several optional approaches to implement CRVM or CARVM. Can the company choose any optional interpretation or must it choose the option that yields the smallest reserve permitted by the NAIC guidance or by 26 states? It so happens that the legislative history addresses this question. The Blue Book at page 599 states that when "methods and assumptions" are not prescribed by I.R.C. § 807(d), the ones actually used for statutory reserves should apply for tax reserves. The specific example used in the legislative history is the choice between continuous or curtate functions. The legislative history states that either assumption is permissible for tax reserves as long as it is consistent with the assumption used for statutory reserves.

Thus, based on the legislative history, the following basic rules can be said to apply when there are several permissible interpretations of CRVM or CARVM.

Rule No. 1 – When the NAIC through a model regulation or AG provides for more than one approach to computing CRVM or CARVM reserves at the time the contract was issued, then the approach used for statutory reserves should be used for tax reserves. This is so regardless of whether another permissible approach would have yielded smaller tax reserves.

Rule No. 2 – When the NAIC issues a new model regulation or an AG which mandates a single approach that was one of several approaches previously permissible, then tax reserves should conform to statutory reserves computed using the new NAIC requirement. This is so even if tax reserves previously were computed using another interpretation that was permissible at the time the contract was issued.

Rule No. 3 – Where the NAIC is silent on an interpretation, then the statutory reserve approach should be used for tax reserves unless it is inconsistent with a single uniform approach within the NAIC-prescribed method required to be used by 26 states at the time the contract was issued. As in the case of an NAIC guideline that allows several options, there is no requirement for tax reserve assumptions or interpretations to depart from permissible statutory reserves other than as required by I.R.C. § 807(d) even if this results in greater reserves than 26 states otherwise specifically would have allowed when the contract was issued.

CHANGING IRS POSITIONS

In its initial guidance, the IRS applied these rules correctly. In Rev. Rul. 94-74 (Situation 3),[3] the company changed its statutory reserves assumption from using curtate to continuous functions. The ruling concludes that, because the NAIC did not require either assumption to be used for purposes of determining minimum acceptable reserves under state law, the company was required to conform its tax reserves to the new statutory reserves using continuous functions. The ruling reached this result even though the new statutory reserve assumption yielded greater tax reserves. The 10-year spread rule of I.R.C. § 807(f) was held to govern because there was a change in the basis of computing tax reserves. The principle set forth in Rev. Rul. 94-74 was followed in TAM 200108002 (Oct. 24, 2000). In that TAM, the taxpayer changed its tax reserves to conform with its statutory reserves for structured settlement annuity contracts using a graded interest valuation method. The IRS upheld the conforming change in the tax reserve computation because it was one of several permissible methods that could have been adopted by the company at the time the contracts were issued.

In two subsequent technical advice memoranda, the IRS departed from its prior ruling position and created the dispute that led to the *American Financial* litigation. In TAM 200328006 (March 20, 2003), the IRS adopted the position, in a case involving AG 33, that tax reserves for contracts issued before the effective date of a new actuarial guideline cannot take the guideline into account. The TAM ignored the fact that at least some of the taxpayer's statutory reserve changes may have been permissible interpretations of CARVM when the annuity contracts were issued prior to the adoption of AG 33.

In TAM 200448046 (Aug. 30, 2004), the IRS took a similar position, but provided a more detailed explanation this time. The question in TAM 200448046 was how the taxpayer was required to compute CARVM tax reserves for variable annuity contracts with guaranteed minimum death benefits that were issued before the adoption of AG 34. For statutory purposes, the taxpayer had used the method required by the Connecticut Insurance Department which, for purposes of computing the CARVM reserves, required an assumption of a one-third drop in asset value. According to the TAM, the Connecticut asset-drop assumption was not required by any other state as of the issue date of the contracts and resulted in greater reserves than were required under the AG 34 method that subsequently was adopted. Instead of attempting to determine whether there was a single uniform prevailing state interpretation of how CARVM applied before the adoption of AG 34, the IRS concluded that the taxpayer could not use the Connecticut method because at least 26 states permitted smaller reserves for variable annuity contracts with guaranteed minimum death benefits. In doing so, the TAM seems to have reasoned that a prevailing view of the states can be gleaned from passive acceptance by state regulators of CARVM interpretations made by companies filing Annual

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Statements. The TAM also adopted a minimum reserve requirement on the prevailing-state-interpretation standard when an item is not addressed directly by the NAIC. Even though there was no single prevailing state interpretation of CARVM and even though a majority of states permitted several interpretations of CARVM, the TAM concluded that tax reserves must be computed using the method that yielded the smallest reserve permitted by at least 26 states. This was a significant departure from the IRS's previous rulings in Rev. Rul. 94-74 and TAM 200108002.[4]

AMERICAN *FINANCIAL CASE*

Not surprisingly, the IRS's position as expressed in TAM 200328006 was challenged in the *American Financial* case. American Financial's subsidiary, Great American Life Insurance Company (GALIC), issued deferred annuity contracts. After AG 33 was adopted by the NAIC in 1995, GALIC recomputed its statutory reserves for all its contracts, including those contracts issued before 1995, to comply with the new guideline. Two of GALIC's reserve changes related to interest rate assumptions and a third change was to take into account the partial surrender and partial annuitization options that had not previously been considered. GALIC conformed its tax reserves to its AG 33 statutory reserves and deducted the increase in tax reserves applying the 10-year spread rule of I.R.C. § 807(f).

The Government argued that, when new AGs are issued by the NAIC, they change CARVM and, therefore, AGs cannot apply to contracts issued before they are adopted by the NAIC. Because there was no previous AG on point, following the reasoning of TAM 200448046, the Government argued that the 26-state rule should apply. The Government acknowledged in its briefs, however, that there was no single prevailing view of the states on the details of computing CARVM reserves for GALIC's contracts at the time the contracts were issued. Nevertheless, it argued that GALIC was required to continue using its prior reserving approach because it had been accepted by state regulators and yielded a smaller reserve that was permissible by the states when the contracts were issued. The District Court for the Southern District of Ohio rejected these arguments.[5] It noted that AG 33 did not amend the definition of CARVM and is only an interpretation of the SVL. The district court concluded that the statute defers to the NAIC for the tax reserve method. As a result, the court found that when the NAIC specifies that an AG is an interpretation of the SVL in effect at the time the contract was issued, I.R.C. § 807(d) requires that interpretation to apply for tax purposes to that contract.

The district court's opinion was a big win for the taxpayer and was read by some to mean that AGs always should be accorded "retroactive" effect because they are merely interpretations of the SVL. But, at least one commentator questioned whether this broad interpretation is correct.[6]

The Government appealed the district court's decision, but the Sixth Circuit affirmed in an opinion issued on May 4, 2012.[7] Simply stated, the Sixth Circuit's opinion effectively placed us back to where we were under Rev. Rul. 94-74 and TAM 200108002 before the IRS went off course by applying its own version of the 26-state rule in TAMs 200328006 and 200448046. The court held that GALIC's use of AG 33 was proper because it was a permissible interpretation of CARVM at the time the contracts were issued. Relying on Rev. Rul. 94-74, the court adopted the following rule when the company makes a change to its statutory reserves:

> The parallel to this case is unmistakable: (1) the reserving method prescribed by the Commissioners in effect at the time the contracts were issued permitted either of two approaches; (2) the taxpayer permissibly applied on approach for several years; (3) the taxpayer then changed to the other permissible approach in calculating its state-law reserves, leading to higher reserve figures. As Revenue Ruling 94-74 demonstrates, § 807 permits the taxpayer to make the identical change for federal tax purposes.[8]

The Government relied on legislative history of the 1984 Act explaining that tax reserves under I.R.C. § 807(d) generally will approximate the smallest reserve that would be required under the prevailing law of the states. From this observation in the legislative history, the Government contended that any time a state insurance department accepts a company's calculation for one year, the company can never increase its tax reserve based on a change in statutory reserves regardless of whether a new AG is prescribed and regardless of whether the new approach was permissible when the contract was issued. The Sixth Circuit squarely rejected this argument.

Importantly, the Sixth Circuit did not say that AGs always will apply to previously issued contracts. The court left open the possibility that the NAIC itself can change its mind and, by an AG, change its own prior interpretation of CRVM or CARVM. In such a case, the court left open whether the new AG would apply to contracts issued before the AG was adopted by the NAIC.

IMPLICATIONS OF *AMERICAN FINANCIAL*

The *American Financial* case has many ramifications on pending (and potential) disputes between the IRS and taxpayers. In the short-term, it seems that the IRS's position that AG 34 cannot be applied to prior contracts has been rejected. This may not make much of a difference, however. In the case of *CIGNA Corp. v. Commissioner,*[9] the IRS in oral argument and in a reply brief filed on Dec. 21, 2011, represented to the Tax Court that the IRS "had no intent to raise the AG 34 issue with legal position other taxpayers."[10]

The *American Financial* case also confirms indirectly that where an actuarial guideline provides for several reserve options, the option used for statutory reserves should be followed for tax reserves (for example, AG 35 applicable to equity indexed annuity contracts provides for several optional approaches). There is no requirement to use the AG option that yields the smallest reserve.[11]

Further, the *American Financial* case can be read to confirm that where statutory reserves are changed from an interpretation that was permissible at the time the contract was issued to another permissible interpretation, tax reserves can (or even should) likewise be changed to conform to the new statutory reserve approach. As in Rev. Rul. 94-74, this is so whether or not the change to statutory reserves was prompted by the NAIC's adoption of a new AG.

More broadly, both opinions of the Sixth Circuit and the district court underscore that I.R.C. § 807(d) defers to the NAIC to determine the applicable tax reserve method. There is no room in the statute for the IRS to second-guess the NAIC and select its own tax reserve method. The Sixth Circuit stated: "If the National Association of Insurance Commissioners replaces the existing model for reserves calculations (the Standard Valuation Law) or materially amends it, a company could apply that law for tax purposes only to contracts issued after its effective date."[12] This observation of the court has important implications when, and if, the NAIC changes the SVL to adopt principle-based reserves. It could be read to mean that, although a new NAIC-prescribed reserving method will not apply to previously issued contracts, it will govern for new contracts even if it is a "material" change. If this reading is correct, the IRS's ability to limit the application of a new reserving method prescribed by the NAIC to newly issued contracts may be circumscribed by the *American Financial* reasoning even if that reserve method is not comparable to current CRVM or CARVM.[13]

Finally, the Sixth Circuit's opinion in *American Financial* does not resolve the issue as to whether a new AG can apply to contracts issued before it has been adopted by the NAIC, where the new AG supercedes a prior inconsistent AG. One could argue that the new AG should apply to previously issued contracts because it is an interpretation of the SVL which has not changed; the more recent "correct" NAIC interpretation should govern for tax purposes too. On the other hand, it could be argued that if, at the time

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the contract was issued, there was a clear NAIC-prescribed AG, the statute requires its use as the tax reserve method even if the NAIC later changes its mind and supercedes its prior interpretation.

Under the latter view, a further complication can arise when the NAIC adopts a new AG that requires the use of some assumptions or interpretations that were permissible prior to the adoption of the new AG and some that were not. AG 43 is a case in point. Prior to the adoption of AG 43 several of the new requirements in computing the Standard Scenario Amount were permissible for variable annuity contracts with guaranteed minimum benefits, but some were not (*e.g.,* lapse assumptions were not permitted under AG 33 or AG 34). Thus, assuming that AG 43 cannot be applied wholesale to previously issued contracts, the proper approach for pre-AG 43 contracts would be to conform tax reserves to the new AG 43 statutory reserves, but only to the extent the statutory reserve assumptions would have been permissible under prior NAIC guidance at the time the contracts were issued. A recent article in *Taxing Times* suggests in detail how this approach can be implemented for AG 43.[14]

END NOTES

1 *American Financial Group v.* U.S., No. 10-3991, 2012 WL 1560393 (6th Cir. 2012).
2 Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provision of the Deficit Reduction Act of 1984 (Comm. Print 1984).*
3 1994-2 C.B. 157.
4 *See* Peter H. Winslow & Susan J. Hotine, *IRS Requires Use of Prevailing State Minimum Reserve Standard Where There is No Specific NAIC Guidance at Issue Date,* T3: *Taxing Times* Tidbits, 15, *Taxing Times*, Vol. 1, Issue 2 (Sept. 2005).
5 *American Financial Group v.* U.S., 726 F.Supp.2d 802 (S.D. Ohio Mar. 15, 2010).
6 Richard N. Bush, *IRS Rules on American Financial,* 10 *Taxing Times*, Vol. 6, Issue 2 (Sept. 2010).
7 *American Financial, supra* note 1.
8 *Id. See also* Peter H. Winslow, *Common Myths in Interpreting the Company Tax Provisions of the 1984 Act,* 50 *Taxing Times*, Vol. 5, Issue 3 (Sept. 2009), explaining the same interpretation of the statute.
9 No. 013645-09 (Tax Ct. filed June 4, 2009).
10 *Id. See also* Peter H. Winslow, *What is the Tax Reserve Method "as of" the Date of Issuance of the Contract?*, 1 *Taxing Times*, Vol. 7, Issue 3 (Sept. 2011), for a discussion of the parties' arguments in the *CIGNA* case.
11 This is in contrast to I.R.C. § 807(d)(5)(E) which provides that when there are several options or tables for mortality or morbidity, the prevailing commissioners' standard table is the option or table which generally yields the lowest reserve. There is no comparable smallest-reserve requirement for the "tax reserve method."
12 *American Financial Group,* 2012 WL 1560393, *2.
13 *See* Edward L. Robbins & Peter H. Winslow, *Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM,* 1 *Taxing Times*, Vol. 3, Issue 1 (Feb. 2007); Christian DesRochers & Peter H. *Winslow, Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves (Part II),* 1 *Taxing Times*, Vol. 3, Issue 2 (May 2007); Brian G. King, Christian DesRochers, Edward L. Robbins, & Peter H. Winslow, *Tax Attorney and Tax Actuary Dialogue on IRS Notice 2008-18-AG VACARVM and Life PBR (Part III), Taxing Times* Supplement (March 2008); Peter H. Winslow, *The Tax Reserve Method Should be PBR Once It Is Adopted by the NAIC,* 24 *Taxing Times*, Vol. 4, Issue 3 (Sept. 2008).
14 Peter H. Winslow & Michael LeBouf, *How are Tax Reserves for VAGLB Determined for Pre-2010 Contracts?* 1 *Taxing Times*, Vol. 7, Issue 2 (May 2011).