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FROM THE EDITOR
TO OUR READERS

By Christian DesRochers

In this issue, we present articles on a variety of topics, with a particular focus on reserve-related issues. We welcome Kristin Norberg as a first-time author, an informative discussion of the tax issues related to the ever-evolving reserve standards under Actuarial Guideline 38 (AG 38). We also present an exchange of views between Ed Robbins and Peter Winslow on the *American Financial* case, as well as a continuation of our ongoing series on discussions related to principle-based reserves. I am joined in that conversation by Mark Smith and Peter Winslow.

As reserve standards continue to evolve, it is becoming increasingly difficult to reconcile the developments in statutory reserves with the standards for federally prescribed reserves under section 807. It has long been recognized that a key problem in determining an equitable tax base for life insurance companies was clearly related to reserve deductions. This tension was expressed in the 1958 legislative history:

> Various methods have been used, or suggested, as devices for measuring the appropriate size of the reserve deduction. Probably the most obvious would be to permit each company to deduct its own additions to reserves…. The experience with varying formulas for determining reserve requirements has suggested to many that an individual company basis for determining needs is desirable, but only if some method is determined which for tax purposes does not vary additions to reserves depending on whether a company has established its reserves on liberal or conservative basis.[1]

Under the 1959 Act, Code Section 810(c) (Phase II) permitted a deduction for "life insurance reserves (as defined in section 801(b)." The 10-year spread (now section 807(f)) was included as a control over changes in reserve assumptions.

In congressional testimony in 1983, John E. Chapoton, assistant secretary (Tax Policy) explained that the use of state law reserves allowed "life insurance companies to accelerate deductions for additions to reserves." He went on to comment:

> We [Treasury] suggest that for tax purposes, the highly conservative state regulatory assumptions result in an undue acceleration of deductions. Moreover, we question whether life insurance companies should ever be allowed to compute reserves under assumptions more pessimistic than the state regulators require to be used.[2]

The system that was ultimately adopted was the current section 807 system, which introduced the concept of federally prescribed reserves, provided a parallel tax reserve system to the statutory reserve system as it existed in 1984, using prescribed interest and mortality and the reserve method (as of the date of issuance). The introduction of the applicable federal interest rate (AFIR) in 1988 resulted in tax reserves that were less than the statutory minimums because of the higher interest rates. However, under the current AFIR rates, tax reserves and statutory minimum reserves are generally equal. Arguably, the most significant difference

between statutory and tax reserves are items that are generally considered non-deductible, including asset adequacy and stochastic reserves. Although as we address our discussion of PBR, Congress looked to the National Association of Insurance Commissioners (NAIC) for reserve method, the basic structure of section 807 is "frozen in time" at the reserve method in effect in 1984 based on an individual policy model of formulaic reserves, with specific parallel statutory and tax assumptions.

Given recent developments, including the proliferation of actuarial guidelines and the emergence of principle-based reserves as well as the recent litigation that has been well documented in *Taxing Times*, this is an opportunity to reflect on the current tax reserve system. Some thoughts to consider:

- Do the limitations imposed on statutory reserves based on the method by which the reserves are calculated reflect congressional intent under the 1984 Act?
- To the extent that the reserve deduction is a revenue measure, does the cost to administer the system from the perspective of both the government and the life insurance industry justify the additional revenue that is raised?
- Would a return to the 1959 Act system of permitting the deduction of statutory reserves, combined with a section 807(f) spreading of changes in reserve basis, simplify the system for both the taxpayers and the government?
- Would the section 832 approach that reserves for unpaid losses must be "a fair and reasonable estimate of the amount that the company will be required to pay" be workable for life insurance reserves?[3]

One thing that is certain is that this will not be the last time we address tax issues related to life insurance reserves.

As always, I'd like to thank all of the authors and support staff who worked on the issue. Without their support, *Taxing Times* would not be possible, and we appreciate their efforts.

END NOTES

1 Report on the Taxation of Life Insurance Companies, Subcommittee on Internal Revenue Taxation, Committee on Ways and Means, Dec. 31, 1958, 4-5.

2 Tax Treatment of Life Insurance, Hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 98th Cong. 1st Sess., Serial 98-39, 50 (1984).

3 See Treas. Reg. § 1.832-4(b).

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