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Accountant/Tax Attorney Dialogue on the History and Purpose of Internal Revenue Code Section 811(a)

By Richard Bush, Art Schneider, Mark Smith and Peter Winslow

Note from the Editor:

Two years (and a major tax bill) have passed since *Taxing Times* completed a four-part series of dialogues on Internal Revenue Code deference to the National Association of Insurance Commissioners (NAIC). Part I of the dialogue discussed tax reserves;[1] Part II discussed policyholder tax issues;[2] Part III discussed insurance classification tax issues;[3] and Part IV discussed insurance tax accounting issues.[4] Together, the dialogue formed a basis for understanding the relationship between NAIC regulatory concepts on the one hand and Federal income taxation of insurers and policyholders on the other.

Recent developments—specifically, the enactment of the Tax Cuts and Jobs Act ("TCJA")[5] and resulting efforts of life insurers and their advisors to implement that legislation—have drawn renewed attention specifically to Internal Revenue Code section 811(a), which provides rules for methods of accounting of a life insurance company. This dialogue discusses the history and purpose of section 811(a) and its historic role in the computation of life insurance company taxable income and, in particular, reserves.

We would like to thank our panel of highly experienced tax professionals. Peter Winslow of Scribner, Hall & Thompson LLP developed the concept for the original series and moderated all four parts; he graciously agreed to participate in this conversation as well. Mark Smith of PricewaterhouseCoopers LLP conceived of this dialogue and agreed to moderate it; Art Schneider, a consultant for both the American Council of Life Insurers and Transamerica, and Richard Bush of Ameriprise Financial, both have practiced in this area for decades. Combined, the participants in the dialogue have more than a century of experience in Subchapter L, dating back to years before the Deficit Reduction Act of 1984 ("the 1984 Act").[6]

We hope you enjoy the conversation!

Mark Smith: Richard, Art, Peter, many thanks for joining.

We probably should start this conversation by pointing out the simplicity of section 811(a) itself. Labeled "Method of Accounting," the section provides a general rule that all computations that are part of the tax calculation for a life insurance company are made under an accrual method of accounting, or a hybrid method to the extent permitted under regulations. It then goes on to provide something very important. Here, let me read it:

> To the extent not inconsistent with the preceding sentence or any other provision of [the Subchapter L provisions that apply to life insurers] all . . . computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the [NAIC].

"Made in a manner consistent with the manner required for purposes of the annual statement." That's a mouthful, and maybe a little confusing. Nearly identical language has been in the Code since before some of our readers were born. Let's talk about where it came from. Peter? Art? Who'd like to start?

Art Schneider: Before we jump into the legal analysis, I think it's worthwhile to put section 811(a) in the context of tax accounting methods generally. The Internal Revenue Code, besides providing tax law, could also be viewed as providing financial accounting standards—in that sense operating similar to GAAP, statutory and IFRS financial accounting standards. That is, the determination of taxable income—and tax computations generally—could be viewed as just another set of financial records. These tax basis financial records are reconcilable to book-basis financial statements. For most corporate taxpayers, tax basis is reconcilable to GAAP financial statements. For life insurance companies, by virtue of section 811(a), tax basis financials are reconcilable to NAIC statutory basis financials. So, tax basis balance sheets can be reconciled to statutory basis balance sheets, the change in tax basis balance sheets can be reconciled to taxable income, and taxable income can be reconciled to statutory income. For life insurance companies, section 811(a) truly makes the NAIC annual statement basis of accounting the foundation of all tax basis computations, except to the extent provided elsewhere in Subchapter L or in other provisions of the income tax law. This includes tax reserves, as well as other liabilities and assets.

Peter Winslow: You are right, Art. I think the scope of section 811(a) is probably most important for tax reserves and a little history may be helpful. The predecessor of section 811(a) was former section 818(a) enacted in the Life Insurance Company Tax Act of 1959. Section 818(a), and now section 811(a), contained tax accounting provisions that were necessary for the first

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time because, immediately prior to the 1959 Act, life insurers were taxed only on their investment income. Expansion of the base to underwriting income required recognition that accounting methods for unique insurance items were needed because the usual accrual method of accounting based on the "all-events test" could not apply to every element of underwriting income, particularly reserves.

After the enactment of the 1959 Act, it was generally understood that section 818(a) meant that tax reserves were required to be determined on the basis of statutory reserves computed in accordance with NAIC statutory accounting. Statutory reserves had been the basis of the tax calculations of life insurance companies since 1913, even during the periods when life insurers were only taxed on investment income. In 1977, the Supreme Court in the *Standard Life* case[7] reconfirmed this principle pretty forcefully. At issue in *Standard Life* was the proper accounting treatment of deferred and uncollected premiums. The Court took as a given that state insurance law governed the computation of tax reserves and, therefore, tax reserves must take into account the assumption that deferred and uncollected premiums had been received. The issue, then, was whether the related unaccrued deferred and uncollected premiums should be included in income and assets, and, if so, whether on a gross or net basis. And, if gross, should they be offset by premium acquisition costs? The Supreme Court's answer was that, because symmetry between premiums and reserves was required to clearly reflect income, accrual accounting concepts were not relevant. Reserves reflected unaccrued deferred and uncollected premiums and symmetry required at least some premium recognition on the income side whether or not the premiums had actually satisfied the all-events test. The Supreme Court held that section 818(a) required the use of the NAIC method "to fill the gap," and required deferred and uncollected premiums to be included in income and assets, but only the net premiums reflected in reserves.

This was the state of play just before the 1984 Act. Section 818(a) required NAIC statutory accounting not only for tax reserves, but also for premiums and assets at least to the extent necessary to achieve accounting symmetry with the reserves.

Mark: But Congress reversed *Standard Life* in the 1984 Act, didn't it?

Peter: Yes, but also in an important respect, no. The 1984 Act amended former section 818(a), which became what is now section 811(a). This amendment is interesting because, you are right, it legislatively reversed *Standard Life*. In *Standard Life*, as I said, the Supreme Court started with reserves and held that to achieve symmetry, NAIC accounting was necessary to override accrual accounting for premiums. But, in the 1984 Act, Congress basically said: We want accrual accounting to apply first to items that are susceptible to the all-events test—that is, to premiums and other similar items such as policyholder dividends; this is so even though NAIC accounting still applies for tax reserves—as it has since 1913. But, Congress went further and provided that we are now going to achieve symmetry between premiums and tax reserves by adding to section 811(a) special rules to make surgical adjustments to statutory reserves to the extent necessary to match premium income, which is now to be included in income on an accrual basis.

So, in the 1984 Act, there was a change to reverse the ultimate holding of *Standard Life*, but not for its application of NAIC accounting to tax reserves. NAIC accounting for tax reserves was retained in section 811(a).

Mark: What do you mean by surgical adjustments?

Peter: The treatment of deferred and uncollected premiums in the 1984 Act is the best example. Section 811(a) now says, in effect, that NAIC accounting applies only if it is not inconsistent with accrual accounting or another statutory provision governing taxation of life insurance companies. This means that accrual accounting now applies to premiums, but not to reserves, which are specifically allowed as deductions by the Code. To maintain symmetry with unaccrued deferred and uncollected premiums that are now excluded from income under the all-events test, section 811(c)(1) provides that a reserve cannot be established unless the related premium is included in income. Although this rule does not mention deferred and uncollected premiums, this is the provision that excludes net deferred and uncollected premiums from tax reserves.

Mark: That makes perfect sense. It's interesting, at least to me, that under the 1984 Act, section 807(d)(6)—now, section 807(d)(4)—likewise made a "surgical" adjustment to the statutory reserves cap for deferred and uncollected premiums, unlike what it did for deficiency reserves, which are included in the cap but excluded from the Federally prescribed reserve. So, the broader point, I think, is Art's point earlier, one would expect to look to the Code to find what reconciling differences there are between statutory accounting and tax accounting, generally.

Is there something to be learned here from tax-prescribed factors other than deferred and uncollected premiums? Richard, how would one historically have looked at the relationship between the composition of the Federally prescribed reserve on the one hand and the assumptions incorporated by section 811(a) on the other?

Richard Bush: The 1984 Act for the first time prescribed a tax method, interest rates and mortality tables, when applicable. But the committee reports and Blue Book make it clear that to determine tax reserves under the 1984 Act, except to the extent otherwise required, a company should begin with its statutory or annual statement reserve, and modify that reserve to take into account the prescribed method, the prevailing interest rate, the prevailing mortality or morbidity table, as well as the elimination of any net deferred and uncollected premiums and the elimination of any reserve in respect of excess interest. Thus, except for the Federally prescribed items, the methods and assumptions employed in computing the Federally prescribed reserve (for example, whether to use a continuous or curtate function) should be consistent with those employed in computing a company's statutory reserve.

That statutory reserves are the starting point for tax reserves is made clear by the case of *American Financial Group v. United States*.[8] The IRS appears to have argued that where tax reserves are based on statutory reserves, the company may not change its tax reserve method even if it changes its statutory reserve method. The Sixth Circuit correctly rejected the IRS position. The Court pointed to Rev. Rul. 94-74[9] as support, noting the ruling accepts that changes from one acceptable valuation method (for example, curtate to continuous) to another are permissible, even if it results in larger reserves. The case makes clear, for example, that if there is no prevailing State interpretation of CARVM or CRVM prior to the adoption of a new guideline, and a company computes its statutory reserves using the new guideline, a company should compute tax reserves using the statutory reserve method (adjusted for tax interest rates and mortality). That is, a company that changes its statutory reserves to conform to the new guideline should likewise calculate its tax reserves using the guideline in the event there was no previous NAIC method or prevailing State method. The company is simply applying the rule that tax reserves must follow statutory reserves unless there is a prescribed method. A company may use the method prescribed by the guideline as the tax reserve method for contracts issued prior to its adoption where there is no prior guidance but would not be required to do so unless it changed its statutory reserve method to conform to the new guideline.

Consistently, in Rev. Rul. 89-43,[10] a life insurance company issued level premium, guaranteed renewable, group long-term care policies. The IRS held that the use of the company's own experience met the requirement that life insurance reserves must be computed using a "recognized mortality or morbidity tables." Thus, the company's tax reserves were computed using the mortality table used for its statutory reserves.

Art: I like Richard's point about how the legislative history of the 1984 Act continued to link the tax reserve computation to the statutory reserve computation, and it reinforces how section 811(a) underlies this result. The tax reserve computed under section 807(d) after the 1984 Act was often referred to as the "Federally prescribed reserve," and I think people sometimes lose sight of how much of it was really NAIC-prescribed as opposed to Federally prescribed. As Richard notes, except for the five enumerated differences (four if you consider that the Federally prescribed method was generally the NAIC method), tax reserves under the 1984 Act followed statutory reserves. In this sense, the changes made by TCJA could be viewed as walking the tax reserve computation back even closer to statutory reserves by eliminating the requirements to use the prevailing interest rate and mortality or morbidity table in determining tax-basis life insurance reserves. In other words, while the 1984 Act was generally meant to allow companies the minimum reserve that most states would require to be set aside, TCJA has relaxed those minimum standard assumption requirements for reserves computed under section 807(d), so long as the assumptions are not inconsistent with the NAIC-prescribed method.

Peter: Before we get into how section 811(a) now applies to tax reserves under the new law, I think it's important to point out a potential ambiguity in section 811(a). That section refers to the manner required for purposes of the annual statement approved by the NAIC. Does this mean the reporting required by a company's domiciliary state regulator or does it mean the method required by applicable NAIC accounting guidance? In

my experience, prior to the 1984 Act, it was generally assumed that the reserves actually reported on the annual statement governed for tax reserves. Two events changed this result, however. For the Federally prescribed reserves (not the statutory reserves cap), the 1984 Act prescribed use of the NAIC method, which is not necessarily the method prescribed by a specific state regulator. More generally, the second event that occurred is the codification of the SSAPs in the early 2000s. Codification of NAIC statements of statutory accounting principles created uniformity in accounting and, as a consequence, at least in my view, when there is a conflict, the tie should be broken in favor of the guidance provided by the NAIC in implementing the accounting rules in section 811(a) over a single state regulator's views. By the way, there has been some litigation on this point under somewhat analogous provisions relating to taxation of property/casualty companies. An appeals court in a *State Farm*[11] case relied heavily on codification and NAIC guidance to hold that reserves for extra-contractual obligations are properly deductible as part of reserves for incurred losses.

Mark: We all agree that it is the NAIC method that governs for tax reserves under the new law. But, in the context of section 811(a), what does Art mean when he says that assumptions must be "not inconsistent" with the NAIC prescribed method? Is there a difference between assumptions that are inherently part of the method (and therefore prescribed as CARVM or CRVM regardless of what a company did) and assumptions that aren't part of the method but are used in applying the method? Also, does "not inconsistent with" mean that any assumptions are OK under section 811(a) so long as they produce a reserve that passes muster under the Standard Valuation Law?

Richard: There are assumptions that are not prescribed by CARVM or CRVM. For example, CRVM allows a company to use semi-continuous or continuous reserves but not curtate assumptions, *unless an immediate payment of claims (IPC) reserve is also held*. So, if a company computed its life insurance reserves using continuous functions on the annual statement, it would use those assumptions for tax purposes. However, if a company held curtate reserves without an IPC reserve, this is not allowed under CRVM, so tax reserves would have to be supplemented with an IPC reserve or be computed using either continuous or semi-continuous functions (subject to the statutory cap). Similarly, where a guideline may give a company a choice between methods, the use of any of the prescribed methods would apply for tax (consistent with the statutory reserve). Further, it seems to me that if a company failed (intentionally or not) to follow a prescribed method or part of a prescribed method, tax would not follow statutory and would need to be recomputed. Finally, I would just note that sometimes it is not entirely clear how CRVM or CARVM should be applied in a new or unusual fact pattern. I generally agree with Peter about a single state's view of CRVM or CARVM, but I have a bit more nuanced view. Under the 1984 Act, the committee reports (and a couple of TAMs) say that the "prevailing" state interpretation of CARVM or CRVM applies in defining CARVM or CRVM for tax purposes, which I always took to mean 26 states (though this was never really defined anywhere). I think this notion probably carries over to the 2017 Act, since the reference to CARVM and CRVM carried over. So, if there was no prevailing view, a single state's interpretation of CARVM or CRVM should apply for tax purposes, so long as (in Art's words), the state's requirement was consistent with CARVM or CRVM. We are not talking about permitted practices, where a state is allowing a company to hold weaker reserves than the SVL might otherwise require.

Art: An interesting illustration of Richard's point about a guideline permitting a choice of prescribed methods could arise under the Practical Considerations section of Actuarial Guideline 33. That section notes that while the AG is intended to provide clarification and consistency in applying CARVM to annuities with multiple benefit streams, other acceptable methods of applying CARVM that are substantially consistent with the methods described in AG 33 may be used, with prior regulatory approval. While allowed by the guideline (with prior regulatory approval), such other acceptable methods are not specifically prescribed in the guideline, and therefore might fall into the category of a permitted practice. If so, the reserves would have to be recomputed for tax purposes under the NAIC-prescribed method and then haircut by the 7.19 percent factor. Of course, if a permitted practice results in a lower statutory reserve, the statutory cap could apply.

Peter: I think I will call Richard's more nuanced view and raise him an even more nuanced view, which circles back to the meaning of section 811(a). It is true, as Richard says, that the 1984 legislative history refers to a prevailing state interpretation of the NAIC-prescribed method where no specific factors have been recommended by the NAIC. But I have always interpreted this legislative history as meaning that, in searching for the true NAIC-prescribed method, we should consider a clear prevailing interpretation of the states. After all, a majority of the state regulators effectively is the majority within the NAIC. But, if a company reports statutory reserves using a permissible interpretation of CRVM or CARVM that the NAIC would accept, I think there is a strong position that section 811(a) governs and the factor used for statutory reserves should be used whether or not a majority of other state regulators would impose or allow use of a different interpretation. The critical point is that statutory assumptions govern under section 811(a) unless they are inconsistent with the NAIC-prescribed method for the contract, or more generally, NAIC accounting principles reflected in model regulations or SSAPs.

Mark: Peter, I'm confused by the point you are making here. If the standard is whether the NAIC would accept a particular interpretation of CRVM or CARVM, wouldn't any interpretation of CRVM or CARVM always pass muster if it produces reserves that are greater than the reserves that would be produced by a prevailing interpretation?

Peter: What the NAIC would accept as allowable statutory reserves, and what the NAIC would permit as reserves computed according to CRVM or CARVM, may be two different things. What I am saying is that, if you can prove that statutory reserves are computed in a manner that the NAIC would agree is CRVM or CARVM, then there is no need to make an adjustment to the statutory reserve method. The problem is the proof. Where there is a single demonstrable prevailing state interpretation, it may be very difficult to show that statutory reserves computed in a different manner are also permissible under NAIC guidance. So, what I am saying is that, by reason of sections 807(d) and 811(a), it is the method used for statutory reserves that governs for tax as long as it is an interpretation of CRVM or CARVM that is permitted by the NAIC. It is not the prevailing state view as to what the NAIC-prescribed method should be. But, to repeat, if there is a prevailing state view, the legislative history points out that it should be considered in the absence of any other guidance from the NAIC.

Mark: Shortly before I left the insurance branch, a technical advice memorandum[12] rejected the "Connecticut Method" of reserving for variable annuities with guaranteed minimum benefits. According to the TAM, a prescribed assumption that the underlying assets experienced an immediate one-third drop in value was not part of CARVM because Connecticut was an outlier state in requiring it. The issue no longer exists because AG 43 now would apply, but is this the right way to approach a "method" question?

Richard: I think the TAM's approach was wrong, but it is not clearly so. First, it is not clear that the one-third drop method used actually met the definition of CARVM (the tax years at issue predated AG 34, so there was not a uniform interpretation of how to apply CARVM to these benefits). Connecticut did not think CARVM applied to variable annuities, so that could have been a way to get to the answer the IRS got to, though that is not what they relied on. My problem with the TAM is that the IRS seemed to define the "prevailing view" as the minimum reserve that would be required by 26 states, even if the states all had different views. I think the prevailing view means that 26 states must have a particular view of how to apply CARVM or CRVM before it becomes required for tax, not that the minimum reserve required by 26 states is the prevailing view, even if there is no standard interpretation.

Peter: But, we still are looking for an NAIC-prescribed method, not necessarily a prevailing state view. For tax reserves, we are going through a two-step process. First, under section 811(a), we are looking to see whether the statutory reserves reported in the annual statement are consistent with NAIC accounting generally. The second step is to see whether those statutory reserves are consistent with section 807(d), which requires use of the NAIC-prescribed method for the contract at the valuation date. In this second step, we have to see whether the reserves are part of the NAIC's definition of CRVM or CARVM. It is possible that a portion of statutory reserves may be reported in a manner that conforms with NAIC accounting, but is technically not part of CRVM or CARVM. A good example is the additional discretionary reserves required for the actuarial opinion by sections 3 and 6 of the Standard Valuation Law.

Think about Art's earlier example of AG 33. In AG 33, the NAIC specifically recognizes that the guideline is not the exclusive interpretation of the NAIC's own CARVM guidance. In effect, the NAIC is saying in AG 33 that there may be some contract benefits that AG 33 does not adequately address, and, if so, a state regulator is permitted to allow an adjustment to the specific rules in AG 33 as long as it is "substantially consistent" with AG 33 when considering that benefit; in such a case, we, the NAIC, will accept the regulator's method as compliant with the NAIC-prescribed method. It seems to me that in such a case the question that needs to be answered is whether the statutory reserve method permitted by the state regulator is substantially consistent with, or is a deviation from, AG 33 as contemplated by the NAIC.

A good illustration of the point I am making is AG 29 dealing with interpretations of CRVM and CARVM for restructured contracts issued by a company that is in court-supervised rehabilitation. AG 29 basically says that, because restructured contract provisions are fact-specific, a mechanical application of NAIC guidance may not be appropriate, and the proper interpretation of CRVM and CARVM should be left to state regulators. In other words, in these situations, the NAIC-prescribed method is whatever the state regulator decides, provided the state regulator is attempting to interpret CRVM or CARVM. Again, we get back to the basic question. Is the statutory reserve method prescribed by a single state regulator a permissible interpretation of the NAIC-prescribed method?

Mark: Can we get back to Richard's and Peter's "nuanced" and "more nuanced" views on the acceptability of a "method" under section 811(a)? It has been the case since 1984 that "method" is prescribed by section 807(d), and the manner of making "computations" follows the NAIC annual statement under section 811(a) as to items not otherwise prescribed by Subchapter L or regulations. How do we know whether an item is a "method"

and therefore prescribed by section 807(d), or whether it is instead an item for which one follows what was done for the annual statement under section 811(a)? As to the former, there has been controversy over the years on what really constitutes CARVM or CRVM in the first place.

Peter: All reserves take into account contract-related future cash flows explicitly or implicitly. A reserve method simply sets forth how the assumptions as to those future cash flows are arranged together and whether the assumptions are explicit or implicit. An NAIC-prescribed method may specify prescribed assumptions or ranges of assumptions or leave the assumptions to actuarial discretion. So, the distinction between an NAIC-prescribed method that must be used and permissible assumptions that follow statutory reserve assumptions can be thought of as determining whether the statutory reserve assumptions for particular future contract-related cash flows are arranged in, and consistent with, the manner required and permitted in the NAIC-prescribed method. If so, those assumptions should be used for tax reserves even if other permissible assumptions would yield lower reserves.

Mark: What constraints might apply under section 811(a); that is, are there limits to simply following for tax purposes what assumptions are applied for stat?

Art: Richard can address the more technical aspects of your question, but I'd like to make a general observation. That is, contrary to what some people in the government seem to think, it is extremely rare that tax considerations are the primary, or even a leading, driver in determining statutory reserving assumptions in a company's NAIC annual statement. Instead, the level of statutory capital is nearly always the utmost concern. This is particularly true since the financial crisis. As our CFO used to say—his three principal concerns were "capital, capital and capital." I think most any tax director at a domestic life insurance company would tell you that if they went into the CFO's office with an idea to increase statutory reserves (and reduce statutory capital) by $1 with the idea of getting a tax deduction that, after TCJA, might get back 92.81 percent of 21 cents, they'd instantly get the boot. And, strange though it may seem, the initial effect of TCJA's corporate tax rate cut puts additional stress on capital levels. NAIC risk-based capital (RBC) ratios compare available capital to required capital, and a company's available capital consists primarily of its statutory capital. Statutory capital includes a limited amount of admitted deferred tax assets (DTAs) for future tax benefits, including reversal of statutory reserves in excess of tax reserves. The corporate tax rate reduction reduced the tax benefit of these future reversals, thereby decreasing the already limited amount of admitted DTAs and also decreasing available capital—the numerator of the RBC ratio. To add to the effect, required capital—the denominator of the RBC ratio—has been increased. The reason is that required capital is based on extreme loss events and determined on an after-tax basis—like the Federal government is a partner (a limited partner because of potential tax law limitations on loss utilization) in the loss. The corporate tax rate cut reduces the government's loss-sharing percentage, thereby increasing required capital. Companies are finding that this double whammy has the effect of decreasing RBC ratios by 10 percent or more compared to pre-TCJA levels. Whether stakeholders—*i.e.*, shareholders, policyholders, regulators, rating agencies, investment analysts, etc.—will expect RBC ratios to be built back up remains to be seen. But the point is, there is a natural lid on annual statement reserving assumptions that almost inevitably outweighs tax considerations.

Richard: I do not think there is a "reasonableness" test for life insurance reserves, as there is for section 807(c)(2) reserves or for unpaid losses of property and casualty companies. The Code defines the method (and under the 1984 Act, mortality tables and interest rates) and there is no basis for the IRS to challenge a reserve computed using the prescribed assumptions because the reserve is "unreasonable" in relation to actual experience.

In *USAA Life Insurance Company v. Commissioner*,[13] the Fifth Circuit stated that a taxpayer does not need to show a tax-independent purpose in the calculation of reserves. In *UNUM Life Insurance Company v. United States*,[14] the First Circuit held that the way a taxpayer actually calculates reserves determines whether the reserves qualify as "life insurance reserves," at least where the method is reasonable, accepted by the regulators and where the calculation was not made (to avoid life insurance reserve treatment) purely for tax reasons. In an old TAM,[15] the taxpayer had strengthened reserves from curtate functions to semi-continuous functions. This resulted in higher reserves. Actual mortality and interest experience of the taxpayer had been favorable. The IRS agent had maintained that in view of the underlying favorable experience, the taxpayer could not strengthen reserves. The National Office ruled that, "[t]he fact that the change in assumptions made in computing reserves . . . follows the practice of the taxpayer in paying death benefits but runs counter to favorable mortality and interest experience which the taxpayer has actually experienced is not relevant to a determination as to whether the taxpayer's reserves qualify as life insurance reserves. . . . Section 801(b) of the Code [now section 816(b)] does not prohibit reserve strengthening in the face of favorable experience on insurance risks." In *Lincoln National Life Insurance Company v. United States*,[16] the Court stated that a company is entitled to strengthen reserves "where deemed necessary by the company in its business judgment." In *United Fire Insurance Company v. Commissioner*,[17] the Seventh Circuit, in rejecting the Service argument that no additional reserve is required to be held during the two-year full preliminary term

reserve to qualify a contract as noncancelable during the first two years, stated: "We might find greater merit in the Commissioner's position if it appeared that the preliminary term method of reserving were purely and simply a tax avoidance device. . . . But the preliminary term method has been widely adopted by insurance companies primarily for sound business reasons. It has been accepted and approved by the National Association of Insurance Commissioners and by all fifty states. The Commissioner does not suggest that the preliminary term method is merely a tax avoidance device, and we find nothing in the record to support such a conclusion." In *Equitable Life Insurance Company of Iowa v. Commissioner*,[18] the Tax Court rejected the IRS's argument that reserves for annuity guarantees for death benefits payable as a settlement option under its life insurance policies were overstated because the original reserve assumptions used to compute the additional reserve were not updated with available current information. The Tax Court noted that under Iowa law, an insurance company was allowed to adopt a standard for computing reserves that produced aggregate reserves greater than the minimum standard provided in the statute. The insurance company did not request or obtain the approval of the Insurance Commissioner of Iowa to adopt a standard for computing its additional reserves lower than the standard using the 1959 data. The Tax Court stated: "There is nothing in the Iowa law which requires a continual updating of the assumption on which reserves are based as long as the standard used by an insurance company results in reserves in excess of the reserves computed under the minimum standard. The reserves as computed by petitioner were included in its annual statement and were not questioned by the Iowa Insurance Commissioner even though there were three audits made of petitioner during these years." And in *Lamana-Panno-Fallo Co. v. Commissioner*,[19] the Service had argued that reserves that were less than the amount required by state law did not qualify as life insurance reserves. Louisiana industrial insurers were not required to maintain reserves. The Louisiana Supreme Court later held that such companies were required to hold reserves, and the insurance companies were given several years within which to make up their reserve deficiencies, so for several years the reserves were deficient. The Fifth Circuit stated that it was not the function of the Service to question the sufficiency of the reserves but merely to ascertain whether reserves were required by law. Since the company was required to maintain the reserves, the reserves were required by law.

Mark: That's a lot of case law authority, but does it mean that there is no reasonableness test for particular assumptions, either?

Richard: So, are there any limits? Could a company that held reserves using the 58 CSO Table or using a 1 percent interest rate get a deduction (subject to the haircut)? While Art points out that most insurance companies would not use up their capital, this may not be as true for foreign captives or for hedge funds. And based on the discussion above, a court might find that an extra reserve held purely for tax reasons or which has no basis is not deductible, or perhaps is just a solvency reserve, though one would think the reserve would have to be extreme before a court would agree.

Peter: There is another aspect of section 811(a) that relates directly to the concept of reasonableness that we have been discussing. The accounting rules in the Code that govern for tax reserves are sections 811(a) and 807. In my opinion, this means that the general accounting provisions in section 446 that apply to other taxpayers, and even for most items of insurance companies, do not apply to tax reserves. Why is this important? It means that the IRS does not have the authority to impose an accounting method for tax reserves in an exercise of its discretion to require a clear reflection of income. There is no reasonableness test for tax reserves that can be imposed under the IRS's authority in section 446; although, of course, there is an implicit reasonableness limitation to the extent statutory reserves are outside the scope of permissible assumptions that are compatible with the NAIC method.

Mark: Well, this is a lot of material to digest. Let me see if I can summarize what we've learned so far. First, section 811(a) is part of a comprehensive tax accounting regime that has started with the NAIC annual statement for many decades and made only limited, prescribed adjustments for tax. The 1984 Act legislative history reinforces this view. Second, if anything, one could view the TCJA as narrowing the differences between tax reserves and statutory reserves by reducing the number of tax-prescribed adjustments in section 807(d). In fact, if reserves are calculated in a manner consistent with CARVM or CRVM, the only adjustments one would expect to see are those that are prescribed in the Code, such as the 92.81 percent factor in section 807(d), or the rules for deferred and uncollected premiums or deficiency reserves. Third, not even the requirement that reserves be "reasonable" applies explicitly to life insurance reserves, though as Art points out, the likelihood a company would hold unreasonably high reserves is close to nil in most cases. There may be a situation where a company does so, but the standard for disallowing that for tax must be awfully high.

In short, the TCJA enhanced the role of section 811(a) in computing life insurance reserves such that one would expect fewer differences between statutory and tax reserves than under the 1984 Act regime. I know in prior *Taxing Times* Dialogues we have been cautious about using the term "deference," but here the shoe does seem to fit.

Art: I think about it less as deference but more in terms of required consistency with the basis of tax accounting set forth by section 811(a)—that is, an accrual method of accounting which, to the extent not inconsistent with specific provisions of the Code, is to follow the NAIC annual statement method of accounting. And, as pointed out earlier in this discussion, the NAIC annual statement method of accounting is particularly important for reserves, which are not subject to normal accrual accounting principles.

Richard: My last comment just reflects on Art's capital is capital is capital comment. In a low interest rate and low tax rate environment, the benefit for increasing statutory reserves (just for tax reasons) in excess of required reserves is pretty small. One can establish mathematically that the tax benefit for holding an additional reserve (assuming it is 100 percent tax deductible) is effectively to convert taxable income to tax-exempt income. Ignoring the haircut, this means that the economics of a $100 million tax reserve increase is to convert the income supporting the reserve into tax-exempt income. If a company earns $5 million on that $100 million (at 5 percent), the tax benefit is the tax savings on converting the $5 million to tax-exempt income, or just $1.05 million (21 percent of $5 million). Further, only 92.81 percent of the reserve is deductible, meaning the tax benefit is just about $975,000. A pretty expensive use of capital for a relatively small tax benefit. And, it should be remembered that the SVL generally requires a company to get permission from its domiciliary regulator to reduce reserves (other than additional reserves held under the Actuarial Opinion and Memorandum Regulation), and this may serve as another constraint.

Mark: Richard, Art, Peter, thank you so much for participating in this Dialogue. We probably need to wrap this up, but likely have not heard the last word on section 811(a). I hope this is as interesting to the readers of *Taxing Times* as it has been for the four of us.

Disclaimer: The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of their employers.

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ENDNOTES

1 Peter Winslow, *et al.*, "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part I: Tax Reserves," *Taxing Times*, Vol. 11, Issue 2, at 22 (June 2015).

2 Peter Winslow, *et al.*, "Actuary/Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part II: Policyholder Tax Issues," *Taxing Times*, Vol. 11, Issue 3, at 13 (October 2015).

3 Peter Winslow, *et al.*, "Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part III: Insurance Classification Tax Issues," *Taxing Times*, Vol. 12, Issue 1, at 13 (March 2016).

4 Peter Winslow, *et al.*, "Accountant/Tax Attorney Dialogue on Internal Revenue Code Deference to the NAIC Part I: Insurance Tax Accounting Issues," *Taxing Times*, Vol. 12, Issue 2, at 4 (June 2016).

5 More precisely, "An Act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97, enacted December 22, 2017.

6 P.L. 98-369.

7 *Commissioner v. Standard Life and Accident Insurance Co.,* 433 U.S. 148 (1977).

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

9 1994-2 C.B. 157.

10 1989-1 C.B. 213.

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

12 TAM 200448046 (August 30, 2004).

13 *USAA Life Insurance Company v. Commissioner*, 937 F.2d 606 (5th Cir. 1991).

14 *UNUM Life Insurance Co. v. U.S.,* 897 F.2d 599, 609 (1st Cir. 1990).

15 TAM 6909291310A (September 29, 1969).

16 *Lincoln National Life Insurance Co. v. U.S.*, 217 Ct. Cl. 515 (1978).

17 *United Fire Insurance Co. v. Commissioner*, 768 F.2d 164, 171 (7th Cir. 1985).

18 *Equitable Life Insurance Company of Iowa v. Commissioner*, 73 T.C. 447 (1979).

19 *Lamana-Panno-Fallo Co. v. Commissioner, 127 F.2d 56* (5th Cir. 1942).