SOCIETY OF ACTUARIES

Article from:

Taxing Times

February 2013 – Volume 9 Issue 1

WHAT DOES "PREVAILING INTERPRETATION OF THE STATES" MEAN?

By Edward Robbins

In the October 2012 issue of *Taxing Times,* Peter Winslow wrote an article titled, "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."

While the Winslow article was excellent, this article expands somewhat on one item that article discussed: TAM 200448046. The Internal Revenue Service (IRS) had taken a position in the *American Financial* case with respect to how actuarial guidelines should be considered, relative to other guidance.

The Winslow article states: "In TAM 200448046 (30 August 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 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.[1]"

Contrary to what is implied above, the TAM was likely correct in its conclusion denying the use of the Connecticut approach, even though, as discussed in the Winslow article, the reasoning utilized was not appropriate. While there is a requirement in the Internal Revenue Code (the Code) to pick the mortality assumption that results in the lowest reserve among the explicit NAIC-based mortality options available [Section 807(d)(5)(e)], there is no need to choose the "method" that results in the lowest reserve. Indeed, where there is an explicit choice of method given in the NAIC guidance, the taxpayer can choose among them, the only requirement being that the tax-basis method must follow the statutory-basis method. The TAM implied that the company must adopt the method that yielded the smallest reserve permitted by 26 states, and it took the position that the Connecticut requirement was not the "prevailing interpretation of the states." The TAM apparently took the term "interpretation" to include passive acceptance[2] by a state of a reserve methodology. Further, the TAM cited an excerpt from the 1984 Tax Act legislative history: *"The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more, unless the net surrender value is greater."* It is questionable whether such an "intent" would be controlling, given that Code section 807(d) does not mention this concept in the reserve calculation requirements. Indeed, the courts apply the language of the Code rather than the legislative history when the Code is clear.

Further, there are two elements of guidance in particular that pertain when the NAIC has not defined the tax reserve "method" for a contract or benefit, inasmuch as, in the instant case, there was no NAIC guidance for the guaranteed minimum death benefit (GMDB, sometimes referred to as MGDB) reserve at the time of promulgation of the Connecticut requirement.

First, Code section 807(d)(3)(A)(iv)(II) stipulates the following:

> *If no reserve method has been prescribed by the [NAIC] which covers such contact, a reserve method which is consistent with the reserve method required under clause (i), (ii), or (iii) or under subclause (I) of this clause as of the date of the issuance of such contract (whichever is most appropriate).*

For the instant case, we will refer to the above as the "consistent with CARVM" requirement.

Second, the 1984 Tax Act legislative history contains the following language:

> *If specific factors are not prescribed by the NAIC recommended reserve method, the* ***prevailing state interpretation*** *of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes.*[3] *[Emphasis added.]*
>
> This begs the question of what a prevailing state interpretation is. There has been general agreement that the word "prevailing" means agreement among at least 26 states. The meaning of the word "interpretation" is less clear. Should it include a state administrative act, such as a letter from a state insurance department to one company only, or would it have to be a public announcement (circular letter, regulation, etc.)? The former might be correct, but administratively impossible to research. The latter would be the more pragmatic approach to such a definition. If one subscribes to the position that passive acceptance by a state does not constitute a "state interpretation," then it appears that there was no prevailing interpretation of the GMDB reserve method requirement prior to AG34. (See references at the end of this article.)

The TAM indicates that the fact that many states *permitted* the Connecticut requirement (which, the TAM stipulates, was a higher reserve requirement than any other state requirement at the time) was not a compelling reason to validate the Connecticut requirement for federally prescribed tax reserve purposes. Indeed, speaking in general terms, statutory regulatory policy at most *requires* a minimum reserve standard and *permits* a method that yields a higher reserve. The TAM was likely correct in rejecting the Connecticut method, but the approach taken should have been that the Connecticut method was not incontrovertibly a method "consistent with CARVM," especially in light of the fact that, as the TAM stated, it was an unusually onerous requirement. The IRS should have challenged the taxpayer to support a "consistency with CARVM" position. However, that may have been difficult for the taxpayer to support, in part since, according to our understanding, the reserve requirement included an immediate one-third drop assumption on the account value, ***including any elements of the account values invested in the general account.***

There has been general agreement that the word "prevailing" means agreement among at least 26 states.

The "consistent with CARVM" requirement can be read in two ways. The narrow reading is that this section would apply when a contract is not covered by CRVM/CARVM. A broader reading, as suggested by the Committee reports, is that this section applies when CRVM or CARVM is not defined by the NAIC for a particular contract or benefit. The fact pattern under this TAM fits the latter interpretation, as CARVM had not been defined for GMDBs at that time.

The issue then is, "When one state alone requires a very high statutory reserve for a contract or benefit for which the NAIC has not prescribed a method, does this give a company the right to hold a tax reserve on that very high method?" It would seem that an affirmative conclusion would open the floodgates for companies with substantial surplus that would like to reduce taxable income. There are numerous instances in which one state's unusually high requirement does not necessarily become the applicable tax reserve. Failing a "prevailing interpretation," the "consistent with CARVM" requirement should have been invoked by the IRS. This would have correctly placed on the company the burden of demonstrating that this requirement had been met.

So much for the case in which a reserve method has not been defined. The next question is, "How far does the *American Financial* decision go in providing guidance where there are 'two or more permitted methods'?"

One logical criterion is whether a method is permitted *by NAIC prescription.* According to the language of the Court

CONTINUED ON **PAGE 44**

Edward Robbins, FSA, MAAA, is an advisor, Insurance and Actuarial Advisory Services with Ernst & Young LLP and may be reached at *Edward.Robbins@ey.com.*

of Appeals decision, it is neither individual states nor the IRS, but the NAIC that defines the permitted methods. For example, there are several NAIC pronouncements that speak to continuous versus curtate functions on life insurance.[4] Moreover, when there are multiple explicit options prescribed in an NAIC actuarial guideline, such as in Actuarial Guideline XXXV,[5] there is no question that the company has a choice of method, as long as the tax basis method is consistent with the statutory method.

In sum, it goes too far as to say that whatever a state "permits" should, in and of itself, provide sufficient grounds for tax reserve purposes. In the absence of NAIC guidance, if a particular method is supportable as a method "consistent with CARVM," and there is no prevailing state interpretation, then there would be sufficient support for such "consistent" tax reserve calculations. In the case of an existing prevailing state interpretation, it appears that the "consistent with CARVM" approach might still apply, although the burden of proof then would be on the IRS to take the position that the prevailing state interpretation is not consistent with CARVM.

In the case of both regulatory requirements and company practice in reserving for MGDBs prior to the advent of AG34, some history does exist which to some extent contradicts the fact pattern expressed in TAM 200448046. The only data that we found readily available with respect to MGDB reserving practice pre-AG34 is an excerpt from Mr. Stephen Preston, FSA, at the Society of Actuaries 1997 Montreal Spring Meeting. He stated:

> *The SOA MGDB survey is somewhat dated, so I won't dwell on it, but in 1995 the Task Force completed a survey of MGDB and I think it is still basically up to date. The survey identified various types of MGDBs, contract charges, reinsurance, and methods used to quantify MGDB risk. The SOA Task Force also identified variable annuity reserving practices for the base contract, ignoring any MGDB. Most of the companies that were surveyed used some type of CARVM approach based on a projection of the account value, based on the valuation rate less some combination of asset charges. As far as current reserving practices on MGDB, there were two approaches commonly used. First, the prospective method is typically a one-year term reserve, typically with a drop in account value assumed. Second, some companies use a retrospective approach, similar to the one required by New York, where you put a target amount into a fund and remove claims as they're incurred.*

In that session, Preston also spoke to the state of MGDB reserve regulation pre-AG34 as follows:

> *In the absence of specific NAIC regulations governing MGDBs, some states have tried to apply the NAIC* Variable Life Model Regulation*. There are two variations of this Model. The variation most commonly used requires a one-year term reserve with a one-third drop in account value, with life insurance valuation interest and mortality. Additionally, the Connecticut Circular latter requires companies to apply their* Variable Life Regulation *to variable annuity MGDBs. It uses an approach similar to the NAIC Variable Life Model Regulation. It also requires mirror reserving. New York Regulation 47 provides different requirements, depending on whether the MGDB is incidental or not. New York defines incidental as return to premium or account value, and possibly ratchet MGDBs. For incidental death benefits, New York permits an accumulation type of reserve where a reasonable target is determined, and then the target is placed into a fund, less claims. For non-incidental MGDBs, New York requires compliance with their* Variable Life Model Regulation*, which requires a method similar to the NAIC V*ariable Life Model Regulation*. Also many companies have begun to use the requirements in drafts of Actuarial Guideline MMM, and many regulators have been accepting those requirements.*

This language suggests that there was no prevailing interpretation of the states in the CARVM requirement for MGDBs if one eliminates a state's passive acceptance of a reserve method as a "state interpretation." Thus, premised on the lack of a prevailing state interpretation, the TAM could have invoked the "consistent with CARVM" requirement if it chose to deny the Connecticut method. This would have placed on the company the burden of demonstrating that that criterion had been met. ◂

END NOTES

[1] 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 (September 2005).

[2] "Passive acceptance" is herein defined as a state taking no action with respect to a company's filing of a statutory annual statement. To hold that such passive acceptance constitutes a state "interpretation" leads in part to the anomaly that annual statement filings can consist of many different reserve approaches among companies. If a state passively accepts all of them, this renders the term "interpretation" difficult if not meaningless. Indeed, the IRS would never extend the concept of passive acceptance to its audits of taxpayers.

[3] 1984 Act Senate Committee Reports, CCH page 951; see also Blue Book page 601.

[4] This was true to some extent even prior to Actuarial Guideline XXXII, which prohibited the use of curtate functions without an Immediate Payment of Claims adjustment.

[5] The Application of the Commissioners Annuity Reserve Method to Equity Indexed Annuities.

AUTHOR'S RESPONSE TO ROBBINS' ARTICLE

By Peter H. Winslow

Ed Robbins' analysis of TAM 200448046 helpfully advances the discussion of when statutory reserves are an acceptable basis for tax reserves. Although I generally agree with the thrust of Robbins' comments, several additional comments may be useful.

First, as a technical matter, I do not believe TAM 200448046 implicates the "consistent with CARVM" requirement of I.R.C. § 807(d)(3)(A)(iv)(II). Actuarial Guideline 33 made it clear that all benefits provided in an annuity contract must be considered in the CARVM reserve, including guaranteed minimum death benefits. Therefore, TAM 200448046 presents a case where the National Association of Insurance Commissioners' (NAIC's) general requirements of CARVM actually apply and there is no need to resort to the "consistent with CARVM" provision of I.R.C. § 807(d). Having said that, I generally agree with how Robbins frames the issue. The validity of the Connecticut reserve method for tax purposes turns on a determination as to whether the one-third drop assumption is a permissible interpretation of CARVM at the time the contracts were issued or, instead, whether the drop assumption is so onerous that it goes beyond a reasonable interpretation of CARVM. In court the burden of proof to establish that the one-third drop assumption was permissible would be on the company.

Robbins' article suggests that the TAM's conclusion could be correct apparently because the Connecticut requirement to apply the one-third drop assumption to elements of the account values invested in the general account is inconsistent with CARVM. Let's assume that Robbins' article is correct on this point (a debatable point). That does not mean that TAM 200448046's conclusion was correct. The proper approach should have been to start with the company's statutory reserves and adjust any factors that are not a permissible interpretation of CARVM. If the problem is the application of the one-third drop assumption to the general account assets, then tax reserves should be computed by using the Connecticut method, including the one-third drop assumption for separate account assets only, thereby adjusting the reserves to eliminate the factor that was an unreasonable (not permissible) interpretation of CARVM. In summary, I continue to believe that the tax reserves computed using the Connecticut method should have been allowed, possibly as adjusted, and the TAM was wrong to conclude otherwise.

Peter H. Winslow is a partner with the Washington, D.C. law firm of Scribner, Hall & Thompson, LLP and may be reached at *pwinslow@scribnerhall.com.*