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Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves

By Peter H. Winslow

I n Notice 2010-29,[1] the Internal Revenue Service (IRS) provided "interim" guidance on the treatment of tax reserves for variable annuity contracts computed under Actuarial Guideline (AG) 43.[2] The Notice announced the IRS National Office's interim conclusion that only the Standard Scenario Amount portion of AG 43 reserves, and not the Conditional Tail Expectation Amount (CTE Amount), should be included in federally prescribed reserves under I.R.C. § 807(d). No rationale for this conclusion was offered. The Notice did not say whether the CTE Amount should be included in "statutory reserves" as defined in I.R.C. § 807(d)(6) for purposes of capping a contract's deductible federally prescribed reserves by the amount of statutory reserves allocable to the contract. Instead, the reserve capping issue, left unresolved by the Notice, was added to the IRS' Priority Guidance Plan where it has remained an open project for several years. Recently the scope of the uncompleted project was updated and revised in the 2015–2016 Priority Guidance Plan to refer more generally to the tax treatment of stochastic reserves (including VM-20 principle-based reserves (PBR) for life insurance and possibly VM-22 for fixed annuities) and to other tax reserve matters related to stochastic reserves, and not just the statutory reserves cap. This expansion of the issues being considered by the IRS for guidance is beneficial for several reasons. Guidance will be needed on PBR issues when, and if, VM-20 for life insurance policies becomes effective—commonly expected to be for 2017. More importantly, the interim conclusion of Notice 2010-29 that the CTE Amount cannot qualify as federally prescribed reserves needs to be further examined, especially in light of recent court decisions that call into question the Notice's interim guidance to the extent it departs from National Association of Insurance Commissioners (NAIC) reserve requirements.[3]

This article presents legal analysis of the issues relating to whether the CTE Amount in AG 43 and the stochastic component of PBR under VM-20 are included in federally prescribed reserves and concludes that, in this author's opinion, they are. The article also presents options for giving effect to the tax adjustments required by I.R.C. § 807(d) to the extent they are relevant to stochastic reserves.

BASIC TAX RESERVE RULES

The computation of life insurance reserves under I.R.C. § 807(d) involves a three-step approach. First, an actuarial reserve—the federally prescribed reserve—is computed on a contract-by-contract basis. Then, this reserve is compared to the net surrender value of the contract. The larger amount is the tax reserve, except, under the final step, the deductible tax reserve for a contract is capped at the amount of statutory reserves. "Statutory reserves" for this purpose generally refers to the aggregate amount of reserves with respect to the contract that are set forth in the company's annual statement.[4]

The computation of the federally prescribed reserve begins with the company's statutory reserve and modifies that reserve to take into account three requirements of I.R.C. § 807(d): (1) the tax reserve method applicable to the contract; (2) the prevailing state assumed interest rate or the applicable federal interest rate (AFIR), whichever is larger; and (3) the prevailing commissioners' standard tables for mortality or morbidity. Other related Internal Revenue Code ("Code") sections require further adjustments, eliminating from the federally prescribed reserve any portions attributable to net deferred and uncollected premiums, excess interest guaranteed beyond the end of the taxable year, and deficiency reserves. Except for these prescribed adjustments and several other miscellaneous adjustments applicable to specific types of contracts, the methods and assumptions employed in computing tax reserves should be consistent with those used in computing the company's statutory reserves.[5]

STOCHASTIC RESERVES IN THE TAX RESERVE METHOD[6]

Section 807(d)(3) defines the applicable tax reserve method for the federally prescribed reserve of a life insurance or annuity contract to be the Commissioners' Reserve Valuation Method (CRVM) or the Commissioners' Annuity Reserve Valuation Method (CARVM), respectively, as prescribed by the NAIC in effect on the date of the issuance of the contract. Therefore, by its terms, the literal language of I.R.C. § 807(d) requires the federally prescribed reserve to include the CTE Amount of AG 43 and the stochastic component of PBR under VM-20. The background section of AG 43 makes clear that the entire reserve is the NAIC's interpretation of CARVM as described in the Standard Valuation Law (SVL). Similarly, Section 1 of VM-20 states that the entire PBR, including the stochastic component, is the NAIC-prescribed CRVM. Even if it could be argued that AG 43 and VM-20 are not CARVM and CRVM, respectively, it does not matter; the tax reserve method would be the same. That is because if a contract is not covered by CARVM or CRVM, I.R.C. § 807(d) nevertheless provides that the method prescribed by the NAIC for that type of contract at the date of issuance must be used. Thus, according to the statute, AG 43 in its entirety became, and PBR in its entirety will become, the

applicable NAIC-prescribed methods for tax purposes for contracts issued after the NAIC adoption date (note that AG 43 was applied for statutory reserves retroactively to all contracts issued on or after 1981).

If the statute is so clear that the stochastic reserve component of AG 43 is included in CARVM as prescribed by the NAIC, how did the IRS reach a contrary tentative conclusion in Notice 2010-29 that the federally prescribed reserve is limited to the Standard Scenario Amount? The IRS has long held the view that absolute deference to NAIC accounting and reserves requirements is not how the tax law should be interpreted. From the IRS' perspective, the NAIC has a different goal in setting reserve standards from Congress in enacting tax statutes. The NAIC is concerned with solvency whereas the federal tax regime attempts to provide a set of rules to provide a measure of annual income that should be taxed. As a result, in litigation and rulings, the IRS has asserted that it is entitled to place an interpretative gloss on the provisions of Subchapter L of the Code applicable to insurance companies and depart from deference to the NAIC where such deference would be inconsistent with Congress' perceived goals. As the IRS stated in Notice 2008-18,[7] in which it expressed concern with allowing tax deductions for stochastic reserves:

> Notwithstanding the deference accorded statutory accounting under Subchapter L, the Treasury Department and IRS do not anticipate changes to existing guidance that requires that tax principles override statutory accounting principles in appropriate cases.

In light of recent court decisions, this position of the IRS probably should be reconsidered. Perhaps the most basic rule of statutory construction is that the plain language of the statute must be followed; if the statute is clear, courts should not examine legislative history in an attempt to discern congressional intent.[8] In order to go beyond the statutory language, it is first necessary for the court to find that there is an ambiguity in the statute. This fundamental principle was recently reconfirmed by the Supreme Court in a case upholding the tax provisions of the Affordable Care Act, although the justices could not agree on whether that statute, in fact, is ambiguous.[9] For the tax reserve method, the plain language of the statute is clear—deference to the NAIC-prescribed method is required. This conclusion is supported by three recent cases. In *American Financial*,[10] the Sixth Circuit stated definitively:

The point is that, when it comes to the federal-tax consequences of increasing or decreasing their annuity reserves, insurance companies must follow the reserve-valuation method (the CARVM) "prescribed" by the National Association in effect on the date the company issued the annuities.

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In that case, in order to resort to legislative history in a case involving an interpretation of AG 33, the IRS argued that the meaning of the word "prescribed" to ascertain the NAIC-prescribed tax reserve method is ambiguous. The court disagreed, but went further to point out that even if this "glimmer of ambiguity" permits review of the legislative history, it does not supersede the statute. In other words, the court found that the statute's deference to the NAIC in the tax return method is much clearer and more definitive than the general principles of perceived congressional intent that could be gleaned from the legislative history.

This same deference to the NAIC has been followed in two other cases in analogous circumstances dealing with reserves for property/casualty insurance companies.[11] Like the provisions applicable to reserves for life insurance and annuity contracts, the comparable provisions of Subchapter L for nonlife claim reserves defer to NAIC annual statement accounting.[12] In *State Farm*, the Seventh Circuit held that estimates of compensatory extracontractual obligations are required to be included in deductible loss reserves because NAIC accounting requires that treatment. The court rejected the IRS' attempt to depart from NAIC reserve accounting merely because extracontractual obligations may not be unpaid losses "on" an insurance contract. Similarly, the Tax Court in the *Acuity* case involving the reasonableness of a taxpayer's loss reserve estimates, cited the *State Farm* case and quoted the case of *Sears, Roebuck*,[13] reconfirming that deference to state regulators' reserve requirements "are not some intrusion on federal tax policy; using their annual statement is federal tax law."

Even if it were to be assumed that there is some "glimmer of ambiguity" in I.R.C. § 807(d) as to what the NAIC-prescribed method actually is, it is unlikely that a court would limit the federally prescribed reserve to AG 43's or PBR's net premium portion of the reserve—which, standing alone, is not the NAIC-prescribed method. Certainly, Notice 2010-29 is not entitled

to deference simply because the IRS has stated its position publicly. For a court to grant this type of "Skidmore"[14] deference to an IRS publication of its position, the IRS must provide persuasive reasoned analysis for its conclusion.[15] This required reasoning is lacking in Notice 2010-29.

A court would need to rely on some clear congressional intent revealed in the legislative history to arrive at this result. It has been suggested that the following quote from the legislative history supports the exclusion of stochastic reserves from federally prescribed reserves.

> 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. To avoid State-by-State variations, the rules prescribed in the bill are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.[16]

The inference apparently gleaned from this quote, coupled with the statutory provisions designed to require adjustments to net premium reserves, is that stochastic reserves are not allowable because they permit too much discretion to companies to increase reserves above the "minimum reserve that most States would require," and that company-specific assumptions, such as lapse rates, are inconsistent with a perceived congressional intent to avoid reserve variations so that companies do not receive varying tax reserve deductions for similar products.

This argument is reading too much into the legislative history, and a court would be reluctant to rely on this committee report statement to override the plain language of the statute. The quote from the legislative history says that Congress intended to avoid state-by-state variations in minimum tax reserve standards; it does not say that the law requires company-by-company conformity in tax reserve amounts. Moreover, there are several instances in the statute and legislative history that actually do permit company-specific assumptions to govern,[17] as well as other statements in the legislative history that reinforce the required deference to the NAIC-prescribed tax reserve method.[18]

Another rationale sometimes offered in support of this conclusion is hinted at in Notice 2008-18. The possible rationale is based on a rule of statutory construction that the IRS sometimes has referred to as the "Cambridge Doctrine"[19] because it is derived from an early Supreme Court case that incorporates that name.[20] Under this rule of statutory construction of tax statutes, Congress is presumed to have used a term of art according to its legal significance at the time the tax statute was enacted. In the case of tax reserves for annuity contracts, the argument goes,

Congress must have intended that only reserves computed using a deterministic net premium reserve methodology would qualify as NAIC-prescribed tax reserves because that was the understanding of the meaning of CARVM under the SVL's definition in 1984 when I.R.C. § 807 was enacted. Further support for this interpretation of the statute is that the other adjustments to statutory reserves required by I.R.C. § 807 (*e.g.*, mortality, interest, deficiency reserves) contemplate a 1984-era deterministic net premium reserve methodology.

There are significant problems with application of the Cambridge Doctrine to tax reserves, but the most important problem is the plain language of I.R.C. § 807(d) itself. The statutory construction principle referred to by the IRS as the Cambridge Doctrine potentially could have application here if the statute merely had required use of CRVM or CARVM without more, but that is not what the statute says. Rather, I.R.C. § 807(d) explicitly defers to the method prescribed by the NAIC. Congress understood that the NAIC could adopt new reserving methodologies and specifically referred to this possibility in the legislative history.[21] To resolve what happens if the NAIC adopts a new reserve method, the statute requires use of the NAIC-prescribed method in effect at the time a contract is issued. Thus, I.R.C. § 807(d) mandates deference to the NAIC even if the NAIC changes its prescribed reserve method for a particular class of contracts. Moreover, I.R.C. § 807(d)(3) requires taxpayers to use the NAIC-prescribed method even if the NAIC specifies something other than CRVM or CARVM. Simply put, the Cambridge

Doctrine is of little help in interpreting I.R.C. § 807(d) and determining the proper tax reserve method required to be used.

Although the Cambridge Doctrine should not apply here, another rule of statutory construction probably does. That rule is that all parts of a statute, if possible, should be given effect; courts avoid statutory interpretations that would render a provision superfluous.[22] On the one hand, this rule of statutory construction provides further support for the conclusion that the NAIC-prescribed method must be used. Otherwise, the requirement in I.R.C. § 807(d) to use the NAIC-prescribed method is ignored. On the other hand, by applying this statutory construction principle, the conclusion of Notice 2010-29 possibly could be defended by saying that the IRS is deferring to the NAIC-prescribed AG 43, but only to the extent of the net premium reserve portion (the Standard Scenario Amount) in order to give meaningful effect to the other required tax reserve adjustments that contemplate a deterministic net premium reserve calculation. The problem with relying on this rationale is that the Standard Scenario Amount, standing alone, simply is not the method prescribed by the NAIC in the SVL; in many situations the Standard Scenario Amount is not an adequate reserve and does not satisfy any reasonable interpretation of the SVL definition of CARVM, which is the tax reserve method required by I.R.C. § 807.

GIVING EFFECT TO THE REQUIRED I.R.C. § 807(d) ADJUSTMENTS

As indicated above, the computation of federally prescribed reserves starts with statutory reserves and makes certain adjustments for the tax reserve method, interest and mortality or morbidity. The principle of statutory construction that disfavors interpretations that render statutory provisions to be superfluous would seem to suggest that some operative effect should be given to these tax reserve adjustments even in the context of an NAIC-prescribed method that includes a stochastic component, at least to the extent they are relevant and appropriate in implementing the method. But, this principle only applies to the required tax reserve adjustments. Because the Code does not address other assumptions, such as those related to policyholder behavior and prudent estimates, no adjustments to statutory reserves should be made for these assumptions in computing federally prescribed reserves.[23]

The difficult interpretative issues that need to be addressed involve implementation of the requirements to "use" the discount rates and mortality tables prescribed by I.R.C. § 807(d). As explained below, it is questionable whether the I.R.C. § 807(d) adjustment for the discount rate is required to be made for stochastic reserves computed in a manner similar to the CTE Amount or PBR. But, if it is determined an adjustment is required, there are several ways this could be accomplished, some of which were offered as possibilities, without elaboration, in Notice 2008-

18. The inclusion of this issue in the IRS' 2015–2016 Priority Guidance Plan provides an excellent opportunity for the IRS to work with insurance industry representatives and the actuarial profession to develop an approach that is administrable and integrates the I.R.C. § 807(d) tax reserve adjustments into the NAIC-prescribed method in a reasonable manner. There are at least three general approaches that could be considered, which for simplicity are discussed below in the context of AG 43. There are parallel concepts used in PBR and VM-20 with somewhat different terminology (net premium reserves, deterministic reserves and stochastic reserves).

Option 1. One option is a simple two-step approach. The first step would be to make all the adjustments required by I.R.C. § 807 to the net premium components of AG 43 and then, in the second step, add to that reduced net premium reserve the amount of the excess of the statutory stochastic component over the statutory net premium component. The result would take into account all the adjustments required by I.R.C. § 807 and would result in an appropriate tax/statutory reserve differential. An example of Option 1 is provided below.

The legal argument for this approach is based on the fact that I.R.C. § 807(d) provides that the federally prescribed reserve should be computed "using" the greater of the AFIR or the prevailing state assumed interest rate as well as the prevailing commissioners' standard table, but the statute does not specify how the interest assumption is to be used. Because federally prescribed reserves are determined by the NAIC-prescribed reserve method, it follows that the interest and mortality assumptions must be "used" under I.R.C. § 807(d) in a manner consistent with that method. For stochastic reserves the NAIC-prescribed method requires discount rates that are market-based and regularly updated to achieve a more accurate statutory reserve level. It is reasonable to conclude that imposition of a fixed discount rate assumption in stochastic reserves is incompatible with the tax reserve method and, to avoid doing violence to the method and to avoid an inappropriate tax reserve level, should not be substituted for the discount rates in the stochastic component of reserves. That is, fixed assumptions for interest should be used in the NAIC-prescribed method only in those instances where the tax reserve method based on the NAIC-prescribed method specifies a comparable assumption locked-in at contract issuance.

The nature of the discount rates in stochastic reserves provides further support for limiting the discount rate adjustment to the net premium reserve component of AG 43. In theory, the discount rate in life insurance reserves is "used" as an estimate of the earnings rate on assets held to support the reserve reduced by the spread element for corporate profits and investment expenses. Because the discount rates in the stochastic component of AG 43 are directly tied to the actual anticipated asset-earnings rates in each scenario and expenses are considered elsewhere in the

computation, the NAIC-prescribed method uses the proper discount rate in the stochastic component of the reserve without the need for a further I.R.C. § 807(d) adjustment.

It also is reasonable to conclude that the mortality assumptions required by the NAIC for use in the stochastic component of reserves are "prevailing commissioners' standard tables" that are acceptable for computing federally prescribed reserves. There is nothing in the Code that requires a contract to have a single prevailing commissioners' standard table; to the contrary, I.R.C. § 807(d)(5) refers to "tables" for the contract—plural. Moreover, the statute does not preclude the use of company-specific factors in developing mortality tables and having the resulting tables treated as prevailing.[24] It has been settled law since 1942 that "recognized" mortality and morbidity tables for life insurance reserve qualification under what is now I.R.C. § 816(b) include tables accepted by insurance regulators that are constructed from a single company's actual experience.[25] This rule for determining life insurance reserve qualification can reasonably apply by analogy to determine the prevailing commissioners' standard tables for the contract for purposes of computing the amount of life insurance reserves.

Even if it were to be concluded that there are no prevailing commissioners' standard tables for the stochastic portion of the reserve, I.R.C. § 807(d)(5)(C) provides in these circumstances that tables are to be prescribed by Treasury in regulations. Treasury could adopt the Option 1 approach by issuing regulations prescribing the use of the mortality assumptions in the stochastic reserves as the tax reserve tables. In the absence of regulations or IRS guidance, it would seem reasonable for companies to adopt this Option 1 approach.

It could be argued that if a discount rate and/or mortality adjustment is required only for the deterministic portion of an NAIC-prescribed reserve, the AG 43 method requires that the federally prescribed reserve be equal to the tax-adjusted Standard Scenario Amount plus the excess of the unadjusted CTE Amount over the tax-adjusted Standard Scenario Amount—in other words, the federally prescribed reserve ends up being equal to the entire statutory reserve allocable to the contract. Although this approach may follow from the legal arguments summarized above, and could be considered to yield a reasonable tax reserve amount consistent with Congress' objectives in enacting I.R.C. § 807(d), the Option 1 approach described above also represents a reasonable way to address the IRS' concerns expressed in Notice 2008-18.

Option 2. A second possible approach to I.R.C. § 807(d) compliance would be to make the interest and mortality adjustments to both the net premium reserve component as well as the stochastic reserve component of AG 43 and then follow the reserve methodology taking the greatest of the tax-adjusted reserve components as the federally prescribed reserve. Doing this would require a redetermination of both components, and with respect to the stochastic component of AG 43, alternative assumptions may need to be considered. For the mortality assumptions, it may be appropriate to substitute the prevailing table used in the net premium reserve in each scenario if the IRS does not permit the mortality assumptions in stochastic reserves to be treated as prevailing tables. A similar scenario-by-scenario substitution of discount rate assumptions required by I.R.C. § 807(d) would be difficult to implement, however, if the AFIR and prevailing state assumed interest rate are interpreted to require a contract-by-contract computation as of the time of contract issuance. The same problem likely would arise in this interpretation of I.R.C. § 807(d) in situations where there are multiple prevailing mortality tables in the net premium reserve calculations.
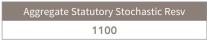
A possible approach to address this problem could be to make an aggregate adjustment to the stochastic portion of the reserves for the I.R.C. § 807(d) discount rate and the mortality assumptions. Perhaps a discount rate adjustment could be determined by first estimating a weighted average of the various discount rates used in the stochastic scenarios and then comparing that average rate to a weighted average of the discount rates used in the net premium reserve component as recomputed for tax purposes. If the average statutory discount rate in the stochastic reserve component is lower than the average discount rate used in the tax-adjusted net premium reserve component, an aggre-

gate adjustment could be made. A similar approach could be used for the mortality table adjustment required by I.R.C. § 807(d). The goal under this approach is to develop a way to make an aggregate adjustment for the discount rate and/or the mortality table that is reasonably administrable and consistent with the overall NAIC-prescribed method. If it is determined that a discount rate adjustment is required for the stochastic component of reserves, actuarial work is needed to implement this option in the best way and to prevent duplicative aggregate interest and mortality adjustments. A preliminary reaction from several actuaries expressed to this author is that it may be unduly burdensome, and not readily auditable by the IRS, to adopt the approach in Option 2 and determine weighted average discount rates.

Option 3. A simpler method may be preferable if it is determined that a discount rate adjustment to the stochastic reserve component of AG 43 is required by I.R.C. § 807(d). A less burdensome option could be to rely directly on the NAIC-prescribed method's contract-by-contract statutory reserve allocations. For non-tax reasons, it is necessary for the NAIC to adopt a method by which the aggregate statutory reserve is allocated to individual contracts. This is because in the event of insolvency and liquidation of the company, the starting place for distribution of insufficient assets to each policyholder is the statutory reserve for each contract. For this reason, Appendix 6 of AG 43 has specific rules for allocation of statutory reserves to the contract level.

Under this third approach, the starting place for the I.R.C. § 807(d) adjustments would be the allocated contract-level statutory reserve. For example, under A6.2) of AG 43, when the aggregate reserve is equal to the Standard Scenario Amount, the discount and mortality tax adjustments simply would be made to each contract's separately computed Standard Scenario Amount without consideration of the CTE Amount. When the aggregate reserve is equal to the CTE Amount, the general approach of A6.1) of AG 43 could be followed using the Standard Scenario Amount instead of the cash surrender value as the base. First, the contract's Standard Scenario Amount would be recomputed making the appropriate tax adjustments. Then, a ratio of the tax-to-statutory Standard Scenario Amount would be computed. Next, the amount of excess of the contract's statutory reserves over the contract's statutory Standard Scenario Amount would be multiplied by the tax-to-statutory ratio of the Standard Scenario Amount. The final tax reserve would be the contract's tax-adjusted Standard Scenario Amount plus the tax-adjusted excess.

The following simple example of three annuity policies shows how Option 1 and Option 3 would operate for AG 43.

Aggregate Statutory Stochastic Resv
1100

NAIC allocation method

Policy #	Allocated Stat Resv
A	545
B	325
C	230

Option 1

(a)	(b)	(c)	(a) + (c) − (b)
SSA After I.R.C. § 807 Adjustments	Statutory SSA	Statutory CTE Amount	Final Tax Resv
500	525	545	520
290	310	325	305
200	220	230	210

Option 3

(d)	(e) = (d) − (b)	(f) = (e) × "(a)" / "(b)"	(a) + (f)
Allocated Stat Resv	Allocated Stat Resv less SSA	Tax Adjusted Excess	Final Tax Resv
545	20	19	519
325	15	14	304
230	10	9	209

As demonstrated by this example, because Option 3 would require an adjustment to the statutory reserve excess of the stochastic reserve over the net premium reserve component, it generally would result in smaller tax reserves than Option 1. The Option 2 approach could result in smaller or larger tax reserves as compared to either Option 1 or 3 depending on the level of discount rates used in the stochastic reserve and the amount by which the stochastic reserve exceeds the net premium reserve component. For example, in the case of AG 43, if the CTE Amount exceeds the Standard Scenario Amount and the implicit weighted average interest rate in the CTE Amount exceeds the weighted average AFIR, any tax adjustment to statutory reserves under Option 2 likely would be attributable to the mortality assumption and may be relatively small as compared to the tax adjustments in Options 1 and 3. For this reason, this author hopes that the IRS will have an incentive not to adopt the more burdensome and difficult-to-audit Option 2 as the preferred

method of implementing the tax adjustments required by I.R.C. § 807(d) for AG 43.

Whatever method is used to implement I.R.C. § 807(d)(2), the final step in the tax reserve computation—the comparison of the federally prescribed reserve to the cash surrender value and statutory reserves on a contract-by-contract basis—should be straightforward. The methods of allocation of the total statutory reserve to specific contracts in AG 43 and PBR can, and should, be applied for tax purposes.

ARE STOCHASTIC RESERVES INSURANCE RESERVES?

Notice 2008-18 expresses several issues that need to be addressed in the IRS' consideration of the 2015–2016 Priority Business Plan project. First, the Notice questions whether some portion, or even all, of the stochastic components of AG 43 and PBR are not really insurance reserves. The Notice asks whether stochastic reserves are nondeductible "solvency" or "contingency" reserves because they "would not represent an expected value of a company's obligations with respect to the underlying contracts." Although not specifically in the Notice, IRS personnel have noted informally that consideration of an individual company's assets and expenses in the reserve calculation may lend support to the view that at least a portion of the stochastic reserves could be viewed as "asset adequacy reserves" or reserves for expenses that are not deductible.[26]

Consideration of the nature of the stochastic reserve components of AG 43 and PBR should alleviate these concerns. An insurance reserve generally is computed as the present value of future benefits less the present value of future funding sources for those benefits. Historically, net premium reserves have been the industry norm for this computation and the assumptions used to determine the present value of future benefits and future funding sources have been fixed at issue and based on industry-wide data. Advancements in technology and computing capabilities have made it possible for reserves to more accurately reflect future liabilities, by analysis of multiple scenarios in varying economic conditions and company-specific facts. Stochastic reserves, in concept, are still determined in the same way as net premium reserves—as the present value of future benefits less the present value of the funding sources for those benefits. They merely take into account many potential cash flows on an aggregate basis using more available information. The computational differences from net premium reserves, however, do not make stochastic reserves anything other than insurance reserves. In fact, they are intended to achieve the same purpose—an appropriate measurement of the company's contractual liabilities.

To better see why this is the correct conclusion, it is useful to examine specific elements of stochastic reserves to compare the treatment of these elements with their treatment in traditional net premium reserves.

PROVISION FOR MODERATELY ADVERSE CONDITIONS

Stochastic reserves are not distinguishable from net premium reserves simply because the former contains "prudent estimates." NAIC-prescribed net premium reserve methods generally take into account prudent estimates in several ways. The most obvious is in the standard mortality and morbidity tables, which typically are developed using industry-wide data and then "loaded" by an adjustment to ensure that the resulting assumptions will be sufficient to cover moderately adverse mortality and morbidity. By deferring to the commissioners' standard tables in computing federally prescribed reserves, I.R.C. § 807(d) recognizes that tax reserves should contain the tables' provisions for possible adverse experience.

The NAIC-prescribed reserve method itself also reflects a need to hold a prudent estimate level of reserves in an amount necessary for moderately adverse conditions. For example, CARVM requires that the greatest of the present values of the various possible benefit scenarios be used as the prescribed reserve. It does not permit a lower reserve equal to a weighted average of all future scenarios or a reserve equal to the most likely scenario. Similarly, CRVM currently does not permit a lapse assumption even though taking lapse rates into account could lower reserves.

This author has been told by life, property/casualty and health valuation actuaries who are responsible for a wide variety of products that the goal is generally the same across the board for contract and claim reserves—statutory reserves should be established at a level such that they will be sufficient in moderately adverse conditions. To satisfy this standard, a rule-of-thumb confidence level for reserve adequacy used by many actuaries is a confidence level in the 75 to 85 percent range. Is this conservatism in the reserve method? Not really; it is recognition that insurance reserves need to be adequate.

> Stochastic reserves are not distinguishable from net premium reserves simply because the former contains "prudent estimates." NAIC-prescribed net premium reserve methods generally take into account prudent estimates in several ways.

Several important conclusions can be reached from these observations. First, a provision for moderately adverse conditions is consistent with, and in fact generally required for, insurance reserves. Second, inclusion of "prudent estimates" in reserves does not mean that a portion of the reserve is for something other than the expected value of the company's obligations. Third, the tax law has always incorporated this insurance reserve standard in determining the amount of deductible reserves. Fourth, it is inappropriate to suggest that an NAIC-prescribed reserve method is not an insurance reserve, or a portion is a "surplus" or "contingency" reserve, simply because the method unbundles the provision for moderately adverse conditions in the interest of greater transparency and accuracy. The objective is the same as for net premium reserves—to hold an appropriate level of reserves for the contractual benefits. Finally, there is a distinction between an insurance reserve estimated on the basis of prudent estimates and a "surplus" reserve reflected in the balance sheet, for example, to satisfy minimum risk-based capital objectives.

CONSIDERATION OF ASSETS AND EXPENSES

Because a company's assets and expenses are not explicitly reflected in net premium reserves, questions have been raised as to whether, by taking into account assets and expenses in stochastic reserves, some portion of the reserves is a so-called "asset adequacy reserve," a reserve for expenses or a deficiency reserve, which may not be a deductible insurance reserve. These questions reflect a misunderstanding of the role of the assumptions relating to assets and expenses in the stochastic components of AG 43 and PBR.

At the outset, it is useful to dispel the notion that net premium reserves do not consider assets and expenses; they do. Net premium reserves consider assets implicitly by making two assumptions. The first assumption is that, once the reserve amount is determined, assets having a book value equal to the reserves will be available and sufficient to fund the contractual benefits when they become due. The second assumption is that the discount rate used to compute the reserve is a reasonable estimate of the earnings rate on the assets backing the reserve (net of the profit element and investment expenses). If the appointed actuary determines that these assumptions, which are hard-wired into the net premium reserve calculation, do not yield a sufficient aggregate level of reserves for the company as a whole, it may be necessary to hold an additional liability for the asset inadequacy. The need for an additional reserve in these circumstances is not because the assets themselves are inadequate in some way; it is because the assumptions in the reserve calculation as to the sufficiency of those assets and yield on those assets are imprecise.

Contract administration expense assumptions also are taken into account in a net premium reserve method; this is what the "net" means. As noted above, an insurance reserve is generally defined as the present value of future benefits less the present value of future premiums (or, more broadly, the present value of future funding sources for the benefits). If gross premiums were considered in this reserve computation without any consideration of administration expenses and profits, the reserve would be lower because the subtractive item for the present value of future premiums would be greater. The formula adjusts for this result by substituting only the value of future net premiums—gross premiums less the loading element that takes into account an assumed provision for expenses and profit in future considerations that are available to fund future liabilities.

This implicit consideration of expenses in a net premium calculation usually has the effect of increasing the level of reserves. Of course, due to many assumptions in the net premium method, it sometimes occurs that the assumed hypothetical future net premiums exceed the future actual gross premiums, which leads to the need for a deficiency reserve. As in the case of an asset adequacy reserve, the need for a deficiency reserve is not usually due to the fact that future gross premiums are actually inadequate to fund the contractual benefits; rather, it is a result of the fact that the assumptions in the net premium reserve calculation are not accurate.

Now, let's examine how assets and expenses are considered in the stochastic components of AG 43 and PBR. Oversimplifying, what is happening is that the reserve assumptions for assets and expenses are based on many possible, reasonable assumptions rather than one-size-fits-all implicit assumptions. The scenari-

os in the stochastic analysis attempt to model recoverable asset values, net investment returns on asset and expenses using real-world, company-specific assumptions. In essence, the scenarios are projected using assumptions taking into account expected actual loading amounts for future expenses. Moreover, because actual expected cash flows are considered, once the calculation is made, a stand-alone asset adequacy reserve for the block of business is less of a consideration—realistic returns on assets for purposes of determining an appropriate level of statutory reserves is considered in the calculation. That is not to say that cash flow testing for the company as a whole does not have to be performed or that the stochastic reserve may satisfy cash flow testing standards; it only means that it is less likely that the AG 43 or PBR block will be the source of any asset inadequacy. Similarly, deficiency reserves are not relevant because assumptions are set at a level reflecting up-to-date experience, which allows the calculation to arrive at a more accurate "net" premium. Further, no portion of the reserve is properly viewed as a reserve for expenses. Taking into account expenses has the effect of decreasing the gross premium component of the future cash flows, just as they do implicitly in a net premium reserve.

To argue that a portion of the stochastic components of AG 43 and PBR reserves should be excluded from the federally prescribed reserves, because they are deemed to contain disguised asset adequacy reserves, reserves for expenses or deficiency reserves, is another way of saying that Congress intended that tax reserves be forever computed using antiquated, inaccurate assumptions regardless of the evolution of insurance products, actuarial practice and NAIC reserve requirements. Fortunately, this is not what Congress did when it enacted I.R.C. § 807(d) and deferred to the NAIC to fashion, and to update when necessary, the most appropriate reserve methodology for both regulatory and tax purposes.

CONCLUSION

Since Notice 2010-29 was issued, the IRS National Office has been focusing its attention on whether the CTE Amount in AG 43 should be included in statutory reserves under I.R.C. § 807(d)(6) for purposes of the statutory reserves cap on tax reserves. In the aftermath of the *American Financial* case, and the Supreme Court's repeated admonition to lower courts and administrative agencies to adhere to the plain language of the statute, it is hoped that the IRS will expand its consideration to the role of stochastic reserves in the federally prescribed reserve. Absent guidance from the IRS, taxpayers will be forced to devise their own approaches to implementing I.R.C. § 807(d) for stochastic reserves, which are likely to be upheld if they are reasonable and consistently applied. It would be far better for the IRS to work together with the insurance industry to come up with an approach that makes sense and complies with Congress' mandate to use the NAIC-prescribed method for tax reserves. ■

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END NOTES

[1] 2015-15 I.R.B. 547.

[2] For a detailed discussion of Notice 2010-29, see Peter H. Winslow and Christian Des-Rochers, *Attorney-Actuary Dialogue on Notice* 2010-29, Society of Actuaries *Taxing Times,* Vol. 6, Issue 3 (September 2010).

[3] *American Financial Group v. United States,* 678 F.3d 422 (6th Cir. 2012); *State Farm Mutual Auto. Ins. Co. v. Commissioner*, 698 F.3d 357 (7th Cir. 2012); *Acuity v. Commissioner*, T.C. Memo 2013-209.

[4] I.R.C. § 807(d)(6).

[5] Joint Comm. on Taxation, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 599 (1984).

[6] This article discusses only the stochastic component of PBR and leaves for another day consideration of the deterministic gross premium reserve component.

[7] 2008-1 C.B. 363.

[8] *E.g., United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 242 (1989); *The Limited, Inc. v. Commissioner,* 286 F.3d 324, 332 (6th Cir. 2002).

[9] *King v. Burwell,* 135 S. Ct. 2480, 2489 (2015).

[10] *American Financial Group v. United States*, 678 F.3d 422 (6th Cir. 2012).

[11] *State Farm Mutual Auto. Ins. Co. v. Commissioner,* 698 F.3d 357 (7th Cir. 2012); *Acuity v. Commissioner,* T.C. Memo 2013-209.

[12] I.R.C. § 832(b)(1), (b)(3); § 846(b), (f).

[13] *Acuity v. Commissioner,* T.C. Memo 2013-209 (citing *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992)).

[14] *Skidmore v. Swift*, 323 U.S. 134 (1944).

[15] *United States v. Mead Corp*., 533 U.S. 218 (2001).

[16] H.R. Rep. No. 98-432, pt. 2, at 599–600 (1984).

[17] *E.g.*, I.R.C. § 807(d)(2)(C) permitting adjustments to tables for nonstandard risks.

[18] H.R. Rep. No. 98-861, at 1051 (1984) (Conf. Rep.); S. Prt. 98-169, at 540 (1984).

[19] Rev. Rul. 71-544, 1971-2 C.B. 227.

[20] *United States v. Cambridge Loan & Building Co.*, 278 U.S. 55 (1928).

[21] H.R. Rep. No. 98-861, at 1052 (1984) (Conf. Rep.).

[22] *United States. v. Cleveland Indians Baseball Co.*, 532 U.S. 200, 217 (2001).

[23] Representatives of the IRS have sometimes argued that company-specific assumptions based on actuarial discretion are not permitted in federally prescribed reserves. As indicated above, there is no support for this contention in the statute or legislative history. Similarly, arguments have been made that federally prescribed reserves should be adjusted to eliminate prudent estimates. This argument is addressed later in this article. Also, for the reasons discussed below, the concepts of nondeductible deficiency reserves, a reserve for expenses, or an adjustment for deferred and uncollected premiums are not relevant for the stochastic portion of the reserves.

[24] As indicated earlier in the article, the legislative history sometimes relied on to suggest that Congress intended companies to obtain the same reserve deduction for similar products regardless of company-specific experience does not, in fact, support this assertion.

[25] S. Rep. No. 1631, 77th Cong., 2nd Sess. (1942).

[26] Treas. Reg. § 1.801-4(e)(5).