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ACLI Update
AG 43 Changes on the Horizon: What Will it Mean for Tax?

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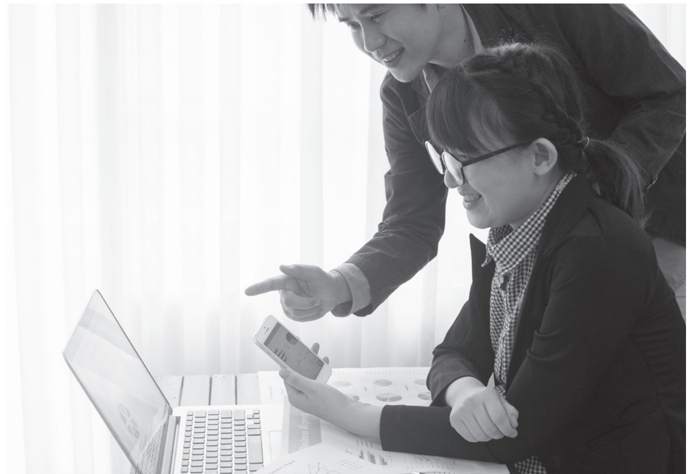

NAIC's enactment of C3 Phase II and AG 43 in 2006 and 2009, respectively, complicated variable annuity (VA) statutory balance sheets and risk management practices and caused insurance companies to increase their use of captive reinsurance transactions.

Since 2015, the NAIC has sought to identify changes to the statutory framework for VAs that could reduce the use of captive reinsurance while encouraging strong risk management, removing volatility caused by reserve and RBC requirements, and addressing solvency requirements to better align with the economics of the business.

The NAIC commissioned Oliver Wyman to assist with this effort. A September 2015 Oliver Wyman preliminary report to the NAIC recommended several sets of ideas for improvements to the current AG 43 and C3 Phase II frameworks with a focus on:

- Reducing the asset-liability accounting mismatch between hedge instruments and statutory liabilities;
- Eliminating non-economic volatility in statutory capital charges and resultant solvency ratios; and
- Fostering greater harmonization across insurers and products for greater comparability.

The NAIC undertook a Quantitative Impact Study (QIS) with selected VA writers, covering February–July 2016, in an effort to test the Oliver Wyman recommended ideas. While Oliver Wyman did not disclose the actual results of the QIS, the QIS provided valuable perspective to Oliver Wyman in support of the changes proposed in its September 2015 preliminary report and provided the basis for more detailed recommendations to help effectuate the desired changes.

As a result of the QIS, on Aug. 23, 2016, Oliver Wyman recommended more comprehensive changes to AG43 and C3 Phase II in three major areas: Standard Scenario, Stochastic Reserves and Hedging.

Oliver Wyman's recommendations for changes to the Standard Scenario are intended to more closely align the Standard Scenario with the stochastic CTE framework. The recommended changes suggest the Standard Scenario does not capture the risk arising from modern variable annuity guarantees and is therefore not aligned with the stochastic modeling. The proposed modifications to the Standard Scenario change the purpose for which the Standard Scenario was originally intended.

In 2010, the IRS issued interim guidance in Notice 2010-29 which acknowledged the AG-43 Standard Scenario as then defined to be acceptable as the federal tax reserve. The Oliver Wyman recommendations noted above, if adopted by the NAIC, would change the Standard Scenario significantly and raise questions about the tax impact of those changes.

ACLI and its member companies, together with several of our members' outside advisors, have embarked upon a process to review current AG 43 tax guidance with the IRS. That process will address whether reserves determined under the valuation manual in their entirety qualify as CRVM or CARVM under Section 807 of the Internal Revenue Code, and should therefore, be deductible subject to any appropriate adjustments for tax. Depending upon the outcome of that review, changes currently being considered to AG 43 could require future review at the NAIC in order to allow companies to have an appropriate basis for calculation of a proper tax reserve.

The industry has recommended and the NAIC has determined that a second QIS should be conducted to provide a more thorough view of the multitude of changes recommended by the

Oliver Wyman August report. The Oliver Wyman proposals acknowledge that regulatory considerations are the foremost objective of their recommendations. However, since these recommendations are comprehensive and complex, ACLI will work closely with the IRS and the NAIC in order to properly design a VA reserve construct that will satisfy the holistic needs of companies.

PBR PRODUCT TAX GUIDANCE: NOTICE 2016-63 PROVIDES SAFE HARBOR GUIDANCE ON USE OF 2017 CSO MORTALITY TABLES

On October 20th, the IRS released Notice 2016-63 with safe harbor guidance on use of the 2017 CSO Mortality Tables under §7702 of the IRC. It provides that a mortality charge with respect to a life insurance contract will satisfy the requirements of §7702(c)(3)(B)(i) as long as (1) the mortality charge does not exceed 100 percent of the applicable mortality charge set forth in the 2017 CSO tables; (2) the mortality charge does not exceed the mortality charge specified in the contract at issuance; and (3) either (a) the contract is issued after Dec. 31, 2019, or (b) the contract is issued before Jan. 1, 2020, in a state that permits or requires the use of the 2017 CSO tables at the time the contract is issued.

ACLI and member companies are pleased with the guidance. The guidance provides life insurance companies with more flexibility to administer and manage policy compliance for federal tax purposes. The guidance improves on Notice 2006-95, which addressed CSO tables transition issues for the 2001 CSO tables, and extends the improved treatment for transition to 2017 CSO tables. It provides that "if the only change to an existing contract is a reduction or deletion of benefits provided under the contract, such a change will not affect the determination of the issue date of a contract for purposes of the reasonable mortality charge safe harbor." It also provides flexibility regarding reinstatement of contracts by not requiring the contract's cash value be computed under a new mortality table if a contract is reinstated as required under applicable state or foreign law. ■

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