Article from

Taxing Times

February 2018
Volume 14, Issue 1

Working Through Uncertainty

By Cindy D. Barnard, Housseine Essaheb, Sheryl B. Flum, James P. Van Etten, and Peter H. Winslow

Editor's Note: Due to publication deadlines, it was necessary for this dialogue to occur before the Conference Committee reconciliation process and enactment of H.R. 1, The Tax Cuts and Jobs Act.

Sheryl: As we write this article, both the House of Representatives and the U.S. Senate have passed versions of the Tax Cuts and Jobs Act. Both proposals include significant changes to how life insurance companies are taxed. The Senate version includes a change to the computation of life insurance reserves for purposes of determining taxable income that applies a haircut to statutory reserves. An early version of the House's bill included a similar approach.

> The uncertainty tax lawyers must deal with is not over once tax legislation has been enacted. The new laws have to be interpreted and often there is ambiguity.

We are also in the middle of the transition period for implementing principle-based reserves (PBR). Life insurance companies have been working on creating systems to support PBR, determining the ideal time to adopt PBR, and developing new life insurance products that will have reserves determined using PBR, even though the exact method for computing reserves for tax purposes remains unclear. The life insurance industry has been working with the IRS through an industry issue resolution process (IIR) to determine the tax consequences under the existing Internal Revenue Code (Code). But Congress is on the cusp of passing a new Code that will likely affect the tax issues surrounding principle based reserves.

Wow! We are experiencing a lot of unknowns in how life insurance companies will be taxed. But business continues regardless of these uncertainties. New life insurance products are being developed. Taxes are being paid. How do we manage to get this done with all these unknowns? In this article, we attempt to provide some guidance on working in the current environment. I posed questions to Peter Winslow, a tax attorney, and actuaries Cindy Barnard, Housseine Essaheb, and Jim Van Etten. Their responses follow.

Question 1: As a tax lawyer representing insurance companies, how does uncertainty caused by potential tax legislation come into play in the advice you give to your clients?

Peter: Advising clients on potential tax legislation is a major aspect of the practice of many tax lawyers, particularly in D.C., and our firm is no exception. Since I joined ScribnerHall, tax legislative advocacy has changed dramatically. In representing clients during consideration of the 1982, 1984 and 1986 Tax Acts, a tax lawyer could advocate on Capitol Hill on behalf of a single client and obtain results. He or she did not have to be a lobbyist. That has changed. Now, virtually all tax legislative advocacy is done on behalf of a coalition of companies with a common legislative agenda. Tax lawyers tend to play more of a technical role in support of full-time in-house government affairs personnel or full-time Washington lobbyists. So, over the years my tax legislative practice has changed quite a bit. We still have a major role to play, but typically we do not make the congressional visits anymore.

I assume that your question does not relate to this aspect of practicing tax law, however. You have asked how the uncertainty caused by potential future tax law changes affects our tax advice to life insurance companies. Not surprisingly, dealing with uncertainty caused by potential changes in tax law usually involves dealing directly with actuaries.

The first area where potential tax legislation needs to be addressed in assisting companies and consulting actuaries is in developing pricing assumptions. Actuaries need to make expense assumptions in pricing, and tax expense is a major category to consider. In general, pricing adjustments usually are not made based on the likelihood that corporate tax rates may go down in a future tax bill, or that, for example, the alternative minimum tax will be repealed. It is too risky to assume in pricing that Congress will provide future tax relief. However, pricing assumptions do need to consider potential changes to the tax law that could affect particular products. When Congress makes a change to the policyholder's tax on insurance products, generally the tax effects on previously-issued contracts are grandfathered. Grandfather protection is usually not the rule for company-level taxes, however. Therefore, pricing actuaries need to consider whether future tax legislation will impact product-specific tax costs. For example, because of the

long-term nature of life insurance products, pricing actuaries must consider whether future tax legislation will have a material impact on the statutory-to-tax reserve adjustment for the product, as well as any increased deferred acquisition costs. As a tax lawyer, I frequently am called upon to look into a tax legislation crystal ball and make an informed guess.

A second aspect of my practice, somewhat related to the issues a pricing actuary faces, is to assist actuaries in making the tax assumptions for valuing a block of business for an acquisition or for a reinsurance transaction. As in the case of pricing a product, tax expense assumptions need to be made for future cash flows and the uncertainty of potential future tax legislation can be a major factor. In addition to the valuation issues, in indemnity reinsurance in particular, the uncertainty caused by the tax legislation sometimes can be managed by determining which company will bear the risk of a tax law change and then drafting the reinsurance agreement accordingly with, for example, an elective termination provision.

A third, and perhaps a less obvious, impact of uncertainty caused by potential tax legislation is in resolving disputes with the IRS over issues that extend into future years. Here, we are dealing with a company's tax department, not the actuaries. For example, in drafting a closing agreement with the IRS that resolves an issue with a future tax impact, we always have to consider the implications of the possibility that the agreement may no longer apply if the tax law changes.

Managing risks of uncertainty is much of what we do as tax lawyers, and the risk of possible changes in future tax legislation frequently is part of the equation.

It is important to bear in mind that the uncertainty tax lawyers must deal with is not over once tax legislation has been enacted. The new laws have to be interpreted and often there is ambiguity. This is particularly true for life insurance companies because general tax provisions intended to apply to all corporate taxpayers frequently do not fit well with the insurance companies' unique accounting methods and business models. Another frequent area of uncertainty is how the transition rules from the old to new laws operate.

Tax professionals need to make reasonable interpretations of the law to file tax returns and then must ascertain whether the positions are uncertain. Documentation of uncertain tax positions is required for GAAP and statutory accounting and tax provisions must be estimated and reported under ASC 740 (previously known as FIN 48) rules. Then, these provisions must be disclosed to the IRS in a Schedule UTP filed with the tax return. The enactment of major tax legislation would create significant ASC 740/Schedule UTP compliance work to address the uncertainty.

Question 2: How do changes occur in the regulation of life insurance reserves, particularly changes to actuarial guidelines and mortality tables?

> This is a time of extreme uncertainty regarding tax reserves for life insurance and annuity products subject to PBR. ... The keys to dealing with all this ambiguity are communication and flexibility.

Jim: As a result of the introduction of principle-based reserves (PBR), the process for making changes to mortality tables (as well as changes to statutes that relate to reserve determination) has been streamlined. In lieu of action by state legislatures, implementation can now be effected through action by the NAIC. The mortality tables are included in the Valuation Manual, and there is a defined process for updating the Valuation Manual. Actuarial guidelines are contained in the Accounting Practices and Procedures Manual. The process for updating actuarial guidelines was not changed by the introduction of PBR.

Prior to PBR, there were a number of steps to developing and implementing a change in reserve determination. First, development and discussion of the idea occurred within the National Association of Insurance Commissioners (NAIC) as well as among interested parties within the industry. The end result of this process, which in general included exposure drafts and opportunities for industry comment, was that the NAIC developed a new or amended model Standard Valuation Law (SVL)[1] or a new or revised model regulation. Then, to make the new or amended SVL effective, each state (or other jurisdiction) adopted the law through its legislative procedures (it typically takes several years before all states adopt a new or amended model law). New or revised regulations could generally be implemented in a state by action of its insurance commissioner. This process is simpler than legislative action, but in practice there could be delays in adoption by some states.

With respect to mortality tables, until the adoption of the 1980 CSO Tables, the valuation mortality tables were specified in the SVL. Before the 2001 CSO Table was adopted, the SVL was amended to permit use of

> "any ordinary mortality table adopted after 1980 by the NAIC, which is approved by regulation promulgated by the commissioner for use in determining the minimum standard of valuation for such policies."[2]

The NAIC also adopted a corresponding model regulation.[3]

The NAIC has also promulgated a number of actuarial guidelines over the years to define the standards to be followed in making specific types of reserve determinations or for other types of actuarial standards.

Under PBR, the Introduction to the Valuation Manual (in VM-00) contains the following statement under the heading "Process for Updating Valuation Manual":

> "The NAIC is responsible for the process of updating the Valuation Manual. The Life Actuarial (A) Task Force (LATF)[4] is primarily charged with maintenance of the Valuation Manual for adoption by the NAIC Plenary. LATF will coordinate with the Health Actuarial (B) Task Force (HATF), the Statutory Accounting Principles (E) Working Group (SAPWG), and other NAIC groups as necessary when considering changes. HATF will be primarily charged with developing and maintaining the health sections … As provided under Section 11C of the Standard Valuation law (Model #820), any change to the Valuation Manual ultimately requires adoption by the NAIC by an affirmative vote representing (a) at least three-fourths (3/4) of the members of the NAIC voting, but not less than a majority of the total membership, and (b) members of the NAIC representing jurisdictions totaling greater than 75% of the relevant direct premiums written."

This statement is clarified by further description of the process. Information and issues with respect to amendment of the Valuation Manual can be presented to LATF/HATF for consideration. This can be formally proposed by other NAIC work groups or by interested parties.[5] LATF/HATF may then choose to move the issue to a "Rejected List" or an "Active List." Items on the Active List will be identified as Substantive (that would alter the meaning, application or interpretation of a provision), Non-Substantive or an Update to a Table.

With respect to Updates to Tables there is a further distinction. Certain tables are "Designated Tables." The Introduction to the Valuation Manual states:

> "Certain designated Tables contained in the Valuation Manual are intended to be updated on a periodic basis, as they provide current reference data integral to annual calculations (e.g., those tables located in Appendix 2 of VM-20,[6] which have a process for annual and quarterly updates specifically prescribed in the Valuation Manual). Updates to these tables in accordance with this process are not considered to be an amendment of the Valuation Manual itself, and are not subject to the requirements of Section 11C of Model #820 for the amendment of the Valuation Manual."

Mortality tables are not "Designated Tables."

Proposed changes will be exposed to the public for a comment period before LATF/HATF votes on adoption.

Proposed changes are also required to be consistent with existing model laws, including the Standard Valuation Law, and, to the extent determinable, with models in development. To the extent the proposed changes have an impact on accounting and reporting guidance and other requirements referenced by the *Accounting Practices and Procedures Manual*, proposed changes must be reviewed by SAPWG for consistency with respect to content and implementation timing. Once these steps have been taken, the Valuation Manual changes will be forwarded to parent committees[7] and ultimately to consideration of NAIC adoption by the Executive and Plenary Committees.[8] Updates to Tables will be reported to the appropriate committee, but will not require a separate vote.

Appendix C of the Valuation Manual incorporates a list of actuarial guidelines that are contained in the *Accounting Practices and Procedures Manual* which are identified for continued use after the operative date of the Valuation Manual. Changes to these requirements, including introduction of a new actuarial guidelines, would require a change to the Valuation Manual and therefore would be subject to the Process for Updating Valuation Manual.

Appendix M of the Valuation Manual defines Valuation Mortality Tables and Industry Experience Valuation Basic Tables applicable under PBR. The use of these tables in valuation is specified in Section 3.C. of VM-20 for life policies where PBR is applicable and in VM-21 for variable annuity contracts where PBR is applicable. VM-02, Minimum Nonforfeiture Mortality and Interest, includes in Section 5 the mortality tables applicable for use in determining minimum nonforfeiture values for life policies issued on and after the operative date of the Valuation Manual. The Valuation Manual anticipates that these mortality tables will be supplemented in the future. In fact, in both VM-02 and in VM-20, a transition period of 4.5 years is recommended for implementation following the introduction of new tables. More specifically, it is recommended that a table be adopted by July 1 of a given year, that the table be permitted for use beginning on Jan. 1 of the second following calendar year, and that it remain optional until Jan. 1 of the fifth following calendar year. Thereafter, the tables become mandatory.

Introduction of new valuation or nonforfeiture mortality tables would require a change to the Valuation Manual and therefore would be subject to the Processes for Updating Valuation Manual.

As noted above, implementation of a new mortality table via a change to the Valuation Manual is generally expected to be accomplished without any changes to state statutes and, as a result, will be implemented in all states simultaneously. Prior to PBR, when changes to state statutes were required, there were times when companies had to delay product implementation in one or more states due to the timing of legislative actions.

Question 3: How do the pricing and valuation actuaries deal with the VUCA (volatility, uncertainty, complexity and ambiguity) of PBR tax reserves?

Cindy: This is a time of extreme uncertainty regarding tax reserves for life insurance and annuity products subject to PBR. Not only is there ambiguity on how to account for PBR reserves under the current tax code, we are in the midst of tax reform, which puts forth further unpredictability.

As any material change that affects the profitability of a life insurance company, a modification to the tax reserve methodology permeates throughout the financial modelling of the company including pricing, valuation, business planning and capital management. Though actuaries are used to dealing with uncertainty, this adds an additional layer of complexity because tax reserves are not always theoretically relatable to other accounting reserves.

The keys to dealing with all this ambiguity are **communication** and **flexibility**. It is imperative for the pricing and valuation actuaries to keep an open line of communication with their tax departments to not only understand the methodology changes but also to influence the outcomes. Actuaries need to opine on both the feasibility and financial implications of any changes. Identify all key personnel across the business lines and functions to make sure any methodologies changes are communicated and understood. Sharing ideas on how to implement the changes can only benefit everyone. Making sure that all business areas appropriately reflect tax methodology changes consistently is important. If there are differences in implementation, **document.** This helps future personnel who need to understand why something was done and if it needs to be updated.

Because the nature of PBR reserves is to move away from a formulaic—one path solution, actuaries will need to build in flexibility to their models. Having an in-house system may provide more flexibility and timeliness on instituting PBR tax reserves if the resources are available to make changes. However, companies may benefit from vendor systems that rely on diversity of thought from multiple companies' input to come up with innovative solutions. For those using vendor systems, it is important to communicate with their support staff early in order to communicate a company's view of flexibility needed for PBR tax reserves.

Another important factor to be considered with systems and data is maintaining availability to audit and to determine any

adjustments that the IRS may require. Companies will need to consider how re-computations can be provided as systems upgrades occur.

Question 4: Are there differences in the way you think about the uncertainty associated with lack of guidance under PBR and the uncertainty inherent in tax law change?

Jim: The change to the use of PBR is very significant, but its scope is relatively limited when compared to proposed tax legislation. In the case of legislation, at this time the situation is very fluid, with two different versions of legislation—one passed by the House and one passed by the Senate. We anticipate clarification of the proposed provisions in the Conference Committee reconciliation process, which will be followed by a vote in both houses.

We have been discussing and analyzing PBR for some time and at this stage the state law requirements are fairly well understood. Companies are at various stages in deciding when to begin using PBR and in many cases have begun implementation efforts. The greatest source of uncertainty relates to exactly how the tax reserves will be determined, and how any transition rules will operate.

With respect to the tax legislation, it is probable but not certain that legislation will be enacted by the time this article is printed. But even after enactment, there will doubtless be instances where further guidance is needed.

In terms of impact, life PBR's effects are limited to new business so many companies can better afford to proceed without certainty on how tax reserves are determined. Also, companies have some flexibility in implementation timing for PBR.

The legislation may have far greater impacts, because it will affect existing business as well as new business. This means that the immediate financial impacts could be far more significant, and companies need to understand the potential impacts and then make decisions on repricing actions for existing business as well as on whether product changes are in order for new business. The timing of these financial impacts will be governed by the legislation, and companies will not have flexibility in complying with the new requirements. If past is prologue, time will be of the essence in making these decisions once legislation is enacted. Therefore, companies should be upgrading their price testing systems to incorporate the various proposals now so they can analyze the legislative proposals. On a second track, companies should be taking the organizational steps necessary to "clear the decks" so they are positioned to react as quickly as possible when legislation is enacted.

Question 5: How should companies think about system upgrades that appropriately consider the need to accommodate changes in law and PBR? In particular,

- What are the timing and retention requirements?
- What is the benefit of using an in-house developed or vendor system?
- How can modeling teams stay up-to-date with evolving changes?
- What is the impact of having separate systems for pricing and reserves?

Housseine: Generally, all actuaries should stay up to date on pending regulation, whether it relates to Tax, Statutory or GAAP requirements. Some changes might require significant effort to implement, and adequate planning is necessary for successful and timely implementation. Modelling teams can stay up to date on regulation by keeping an open line of communication with their corporate actuarial department, tax department and other oversight governing departments. Periodic meetings, preferably monthly, with these groups are important to get updates and start quantifying potential impacts. In addition, actuaries should take advantage of education provided by actuarial organizations, such as the Society of Actuaries. This is critical for both teams utilizing in-house valuation systems or third-party vendor systems. Adequate planning and testing is required even if your company is using a vendor system. Vendors are usually up to speed on outstanding regulation, but having discussions with them early on would be beneficial to all parties.

In the face of uncertainty, companies should also be thoughtful about how much implementation work it is appropriate to undertake prior to new rules being finalized. For example, the tax bill recently passed by the House differed from the preliminary tax plan that was put out by the Ways and Means Committee just few weeks earlier as it relates to the calculation of tax reserves. I think it's important to keep modelling teams informed and to scope out the work but not to get too anxious and implement something that might not be a final regulation.

Sheryl: We hope that you find these musings helpful in navigating the current tax environment for life insurance companies. One thing is certain—things will change! ■

Cindy D. Barnard FSA, MAAA, is assistant vice president with Pacific Life Insurance Company and may be reached at *cbarnard@pacificlife.com.*

Housseine Essaheb, FSA, CERA, MAAA, is a director and actuary with Prudential Annuities and may be reached at *Housseine.Essaheb@prudential.com.*

Sheryl B. Flum is managing director in the Financial Institutions and Products group of KPMG LLP's Washington National Tax practice and may be reached at *sflum@kpmg.com.*

James P. Van Etten, FSA, MAAA, is managing partner with Van Etten Actuarial Services, LLC and may be reached at *vanetten.jim@gmail.com.*

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.*

ENDNOTES

1 The technical development of model laws and regulations generally occurs through committees and/or task forces of the NAIC. A description of the processes to accomplish this is beyond the scope of this article.

2 *See* Section 4. A. (3) of the Standard Valuation Law (NAIC Model 820).

3 Recognition of the 2001 CSO Mortality Table for use in Determining Minimum Reserve Liabilities and Nonforfeiture Benefits Model Regulation (NAIC Model 814).

4 LATF is organized under the Life Insurance and Annuities (A) Committee of the NAIC. Its mission is to identify, investigate and develop solutions to actuarial problems in the life insurance industry. Its membership consists of regulators from approximately 20 states.

5 Interested parties may include individual companies or even individuals, but it is very common for proposals to be submitted by industry groups such as the ACLI or the American Academy of Actuaries.

6 The heading for Appendix 2 is "Tables for Calculating Asset Default Costs and Asset Spreads."

7 The Life Insurance and Annuities (A) Committee (A Committee) or the Health Insurance and Managed Care (B) Committee (B Committee) will consider any Valuation Manual amendments at any regularly scheduled meeting. Such amendments must first be approved by LATF or HATF, as applicable. Updates to Tables will be reported to the appropriate Committee, but will not require a separate vote.

8 The NAIC Executive/Plenary will generally consider Valuation Manual amendments at the National Meeting following adoption by the appropriate Committee. The voting requirements for adoption at Executive/Plenary are as set out in Section 11C of Model #820. Unless otherwise specified, all Valuation Manual amendments shall be effective January 1 following adoption by the NAIC.

PRODUCT TAX SEMINAR

SEPTEMBER 12–14, 2018

Industry experts from the legal, tax and actuarial communities will be presenting their views on the latest policyholder tax issues at the 2018 Product Tax Seminar in Washington, D.C.

The 1 ½ day seminar will feature general sessions addressing current issues effecting the taxation of life insurance, annuities and other products sold and administered by life insurance companies. Don't miss the one day optional "boot camp" addressing the basics of life insurance and annuity taxation.

Look for more information from the Tax Section soon!