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The Scope of Reserve Valuation Rules Used to Compute Life Insurance Reserves Defined In Section 816(b)

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Editor's Note: Due to publication deadlines, this article was completed before the Conference Committee reconciliation process and enactment of H.R. 1, The Tax Cuts and Jobs Act. The principles addressed in this article, however, continue to apply under the tax law as amended by it.

Section 816(b) provides that to qualify as a life insurance reserve, a statutory reserve must be,

1. "computed or estimated on the basis of recognized mortality or morbidity tables, and assumed rates of interest;"
2. "set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts" (including certain other specified contracts) "involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies;"
3. required by law.

This article addresses the scope of reserve valuation rules that satisfy the first requirement; that is, to compute or estimate reserves "on the basis of recognized mortality or morbidity tables, and assumed rates of interest."

THE DEFINITION OF LIFE INSURANCE RESERVE UNDER SECTION 816(B)

The definition of life insurance reserve under Section 816(b) draws from the Supreme Court's opinion in *Maryland Casualty*.[2] The Court stated,

> [t]he term "reserve" or "reserves" has a special meaning in the law of insurance. While its scope varies under different laws, in general it means a sum of money, variously computed or estimated, which, with accretions from interest, is set aside, "reserved," as a fund with which to mature or liquidate, by payment or reinsurance with other companies, future unaccrued and contingent claims, and claims accrued, but contingent and indefinite as to amount or time of payment.[3]

SIGNIFICANCE OF QUALIFYING AS A LIFE INSURANCE RESERVE

A life insurer deducts an increase, and includes in gross income a decrease, in its Section 807(c) reserves (after certain adjustments) for a given taxable year.[4] A reserve qualifies as a life insurance reserve under Section 807(c)(1), which is the most comprehensive of the six tax reserve categories for life insurers, if it is defined as a life insurance reserve in Section 816(b). For contracts issued in taxable years beginning before Jan. 1, 1984, the value of a life insurance reserve described in Section 807(c)(1) generally was based on the value of the statutory reserve for the contract.

For contracts issued in taxable years beginning after Dec. 31, 1983, the value of a Section 807(c)(1) reserve is determined by rules provided in Section 807(d). The value of the reserve generally is the federally prescribed reserve, which is determined by applying prescribed actuarial factors. Congress enacted these rules so that reserve computations would more closely reflect realistic economic assumptions, and in that sense to enhance the accuracy of the valuation of the reserves for tax purposes.[5] Section 807(d)(1) provides that the reserve for a given contract cannot be lower than the contract's net surrender value nor greater than the statutory reserve as defined in Section 807(d)(6).

Whether a reserve qualifies as a life insurance reserve under Section 816(b) also influences the tax status of an insurance company as a life or nonlife insurer. An insurance company qualifies as a life insurer under Section 816(a) if more than half of its total reserves, defined in Section 816(c), are life insurance reserves (defined in Section 816(b)) plus unearned premiums and unpaid loss reserves on noncancelable accident and health insurance (not already included in life insurance reserves).[6]

IMPACT OF APPLYING FACTORS IN ADDITION TO RECOGNIZED TABLES AND ASSUMED INTEREST RATES

In *Mutual Benefit Life Insurance Co. v. Commissioner*,[7] the government argued that "additional reserves" for certain life insurance contracts were not life insurance reserves under (the predecessor of) Section 816(b), in part, because factors in addition to mortality tables and assumed interest rates were used in the reserve valuation methodology. Beneficiaries of the life

insurance contracts could choose to receive death benefits in a lump sum or under one of several settlement options. Under one option, a beneficiary would receive installments for the rest of his life (although Mutual Benefit had to pay at least a specified number of installments).

The beneficiaries lived longer than Mutual Benefit anticipated when it issued the contracts so it had to pay more than it expected when beneficiaries chose this option. Mutual Benefit established an additional reserve to cover the increase in its liabilities. It determined the additional reserves by applying mortality tables and assumed interest rates as well as the proportion of instances in which beneficiaries chose to apply the option.[8]

The Third Circuit held that the additional reserves qualified as life insurance reserves, stating,

> [t]here is nothing in the statute which states that these two elements [mortality tables and assumed rates of interest] are the only factors which are permissible and that all others must be excluded.[9]

The scope of the requirement that life insurance companies had to base life insurance reserves on recognized actuarial tables and assumed interest rates was not so limited as to prevent the use of additional factors that would enable a life insurer to value reserves more accurately. The court stated, "[i]n the factual context present here, we can perceive no considerations which would require us to adopt a construction of the Act so narrow as to mandate the exclusion of circumstances which would tend to make the calculation of the reserve more exact."[10]

RESERVE METHODOLOGIES MUST BE BASED ON SOUND ACTUARIAL STANDARDS

In *Union Mutual Life Insurance Co. v. United States*,[11] a life insurer issued policies that allowed beneficiaries to choose to exercise guaranteed insurability rider options to "acquire specified additional amounts of insurance at specific future dates without having to present evidence of current insurability."[12] The First Circuit concluded that the reserve valuation methodology was not valid because it assumed that all option holders would exercise their option although far fewer did so. The court stated,

> it is difficult for us to give any meaning to this part of the statute [, prior law Section 801(b)(1), the predecessor of Section 816(b)(1),] if the taxpayer is permitted to write into the computation a factor as unsubstantiated as the company's assumption that it will be necessary to establish reserves for every possible contingency which any option-holder might elect to exercise at several future dates. This is especially true in view of the fact that the record demonstrates that the assumption is a false one.[13]

IMPACT OF OTHER FACTORS

The tax reserve valuation methodology prescribed for annuities—the Commissioner's Annuity Reserve Valuation Method (CARVM)[14]—is influenced by numerous factors in addition to mortality tables and assumed interest rates. The reserve under CARVM for a given valuation date is the largest of a set of reserve computations. Separate amounts are computed to determine the amounts that—with future premiums and interest—would be needed to fund all guaranteed benefits, including nonforfeiture benefits, other than disability and accidental death benefits, until the end of each period until the maturity of the contract.[15]

CARVM would apply to value tax reserves for annuities under Section 807(d)(3)(A)(ii) for a given annuity contract, only if the factors that are taken into account did not prevent the reserve from qualifying as a life insurance reserve for the contract under Section 816(b), and therefore did not prevent the reserve from qualifying as a reserve described in Section 807(c)(1). Treating CARVM as the prescribed reserve valuation methodology for annuities supports the view that guaranteed benefits can be taken into account to compute life insurance reserves that qualify under Section 816(b).

IMPACT OF APPLYING TABLES BASED ON AN INSURER'S EXPERIENCE

In Revenue Ruling 89-43,[16] the IRS concluded that "recognized mortality or morbidity tables" can include a table based on a life insurance company's experience if the life insurer has adequate experience that it can use to construct a reasonable table. In the ruling, a life insurer issued level premium, guaranteed renewable, group long-term care policies that cover certain costs for individuals who become chronically impaired. The life insurer used "either a recognized morbidity table reasonably adjusted to reflect the Policies' risks that are not otherwise taken into account or a morbidity table based on [the life insurer's] experience (provided [that the life insurer] has adequate experience upon which to construct a reasonable table)"[17] to determine active lives reserves and various other reserves, other than unearned premium reserves, for these policies.

The IRS concluded that the tables qualify as recognized morbidity tables, reasoning,

> [a]lthough neither the Code nor the regulations define the term "recognized mortality or morbidity tables,"

the legislative history of the term provides useful guidance. The Revenue Act of 1942 substituted the term "recognized mortality or morbidity tables" for the term "recognized experience tables" in prior law. The Senate Finance Committee Report accompanying the Act indicates that the change was designed to expand rather than to restrict the types of morality or morbidity tables that would qualify.[18]

RESERVE METHODOLOGIES FOR UNIVERSAL LIFE INSURANCE CONTRACTS

Life insurers started issuing universal life insurance contracts in the late 1970s.[19] The NAIC responded by issuing a model regulation that "codified the application of the CRVM to Universal Life"[20] in December 1983. Statutory reserves for these contracts are determined by applying highly complex reserve valuation rules.

Congress was sensitive to the impact of the implementation of the NAIC Model Regulation for universal life insurance contracts on the application of Section 807(d) to compute tax reserves, when it considered legislation enacted as the Tax Reform Act of 1984. The Joint Committee on Taxation indicated in the *General Explanation of the Tax Reform Act of 1984* that life insurers must apply prescribed CRVM rules for universal life insurance contracts issued after 1983, stating,

> [a]n example of a life insurance contract not covered until recently by an NAIC prescribed method was a universal life insurance contract. The NAIC prescribed a CRVM for universal life insurance for the first time in December 1983. Thus, reserves for such contracts issued after 1983 must be computed using the prescribed CRVM;[[21]] reserves for such contracts issued prior to the NAIC recommendation could be computed using the newly prescribed CRVM and would be considered to be computed on a method consistent with CRVM.[22]

Section 807(d) could not apply to compute tax reserves for these contracts if the statutory reserves for the contracts did not qualify as life insurance reserves under Section 816(b).

CONCLUSION

Congress, the courts, and even the IRS, in at least one ruling, interpret the scope of the requirement that a life insurance reserve defined in Section 816(b) must be "computed or estimated on the basis of recognized mortality or morbidity tables, and assumed rates of interest" broadly. A reserve valuation method can include factors other than a recognized actuarial table and assumed interest rates although a qualified reserve methodology must be based on sound actuarial principles. Reserve valuation methods for complex life insurance products, such as universal life contracts, also can qualify. ■

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ENDNOTES

1 Emanuel Burstein is the author of *Federal Income Taxation of Insurance Companies* (4th edition), published in May 2017 by Bloomberg BNA. This book provides a comprehensive analysis of "life insurance reserves" as defined in Section 816(b) on pages 6-6 to 6-21.

2 251 U.S. 342 (1920).

3 *Id*. at 350.

4 *See* Section 807(a) for the gross income inclusion of reserve decreases and 807(b) for the deduction of reserve increases.

5 The legislative history of the Tax Reform Act of 1984 stated that the value of life insurance reserves under (the predecessor of) Section 807 generally was "based on [the life insurer's] statutory reserves, which [were] computed using assumptions under State law. The result [was] a significant overstatement of liabilities in comparison to those measured under realistic economic assumptions." H.R. Rep. No. 98-432, Pt. 2 at 1397. Congress concluded that "a more accurate measure of liabilities for tax purposes can be achieved by imposing specific rules for the computation of tax reserves [that approximate] the least conservative (smallest) reserve that would be required under the prevailing law of the States." *Id*.

6 Section 816(a).

7 488 F.2d 1101 (3rd Cir. 1974).

8 *Id*. at 1108.

9 *Id.* at 1107.

10 *Id.*

11 570 F.2d 382 (1st Cir. 1978), *cert. denied* 439 U.S. 821 (1978).

12 *Id.* at 394.

13 *Id.* at 396.

14 Section 807(d)(3)(A)(ii).

15 CARVM has been described as the "'worst case' valuation method, in that the reserve for a particular contract is calculated taking into account the scenario which maximizes the liability." Louis Lombardi, Valuation of Life Insurance Liabilities (4th edition) 159 (2006).

16 1989-1 C.B. 213.

17 *Id.* at 214.

18 *Id.* The ruling cited S. Rep. No. 1631, 77th Cong., 2d Sess. 142 (1942), 1942-2 C.B. 510, 610.

19 *See,* Dwight Bartlett and Dan McGill, History of the Development of Preliminary Term Valuation of Life Insurance Policies in the United States, *Journal of Insurance Regulation* 382, 397 (Vol 15 No, 3) Spring, 1997.

20 *Id.* The reserve valuation method for universal life insurance is illustrated in 94 T.C. 499 (1990), *rev'd. and remanded on other grounds, revd. without published opinion* 937 F.2d 606 (5th Cir. 1991), *on remand,* T.C. Memo 1993-18; 65 T.C.M. 1756 (1993).

21 Section 807(d)(3)(A)(i), added by the Tax Reform Act of 1984, prescribes CRVM as the tax reserve method for life insurance contracts issued after 1983.

22 Staff of the Joint Committee on Taxation, 98th Cong. 2d. Sess., *General Explanation of the Revenue Provisions of the Tax Reform Act of 1984*, at 600 (1984).