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TAM 201844009: When is a Permitted Practice not a "Permitted Practice"?

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On Nov. 2, 2018, the Internal Revenue Service (IRS) released Technical Advice Memorandum 201844009 (the TAM). The TAM addressed the proper morbidity assumptions to be used under pre-2018 tax law to compute tax reserves for a block of long-term care (LTC) insurance contracts when the statutory reserving assumptions had been changed after the policies were issued. As will be explained in more detail in this article, the IRS concluded that the tax reserve assumptions under consideration should also be updated to follow the new statutory reserve assumptions, rather than being locked in at the issue date.

The paragraph of the Internal Revenue Code (IRC)[1] at issue in the TAM has been repealed by the 2017 tax law commonly known as the Tax Cuts and Jobs Act (TCJA),[2] and the regulations discussed in the TAM are effectively obsolete for tax years beginning after 2017. However, LTC insurance reserves are an area where guidance from the National Association of Insurance Commissioners (NAIC) has historically been more principle-based than specifically prescribed, and the pre-2018 tax reserve requirements for LTC insurance relied more directly on a company's annual statement reporting than was the case for individual life insurance or annuity contracts. As a result, the TAM raises some interesting questions of ongoing relevance in a post-TCJA, principle-based reserve (PBR) environment, particularly around the identification of NAIC-prescribed methods and assumptions vs. state-specific permitted practices.

BACKGROUND: TAX RESERVE ASSUMPTIONS PRE-TCJA

For life insurance reserves computed under IRC § 807(d), which typically include active life reserves (contract reserves) held for LTC insurance, prior law required specific methods, mortality or morbidity tables, and interest rates. For mortality and morbidity assumptions, IRC § 807(d)(2)(C) required use of the prevailing commissioners' standard tables, with appropriate adjustments, such as for substandard risks. Such tables were defined in IRC § 807(d)(5)(A), generally, as the most recent commissioners' standard tables prescribed by the NAIC that were permitted to be used in computing reserves for a particular type of contract under the insurance laws of at least 26 states when the contract was issued. Under a special rule in IRC § 807(d)(5)(C), if there was no prevailing table applicable to a contract when it was issued, the Secretary of the Treasury was directed to prescribe regulations for determining the applicable table.

The Treasury Department did promulgate such regulations, as Treas. Reg. § 1.807-1.[3] The regulation prescribed the tables to be used for certain categories of insurance contracts or benefits that did not have a prevailing table at the time, including various group life insurance benefits and various noncancellable accident and health (A&H) insurance benefits. Pursuant to IRC § 816(e), the tables prescribed for noncancellable A&H insurance contracts would apply also for guaranteed renewable A&H insurance contracts, such as the LTC insurance contracts at issue in the TAM.

Treas. Reg. § 1.807-1(a) provided descriptions of mortality and morbidity tables potentially applicable to LTC insurance contracts (Table 1).

Table 1
Mortality and Morbidity Tables for LTC Insurance Contracts

Type of Contract	Table
9. Noncancellable A&H insurance (active life reserves); benefits issued before 1984	Tables used for NAIC annual statement reserves as of Dec. 31, 1983
12. Noncancellable A&H insurance (active life reserves); all benefits issued after 1983 other than disability and accidental death	Tables used for NAIC annual statement reserves
14. Noncancellable A&H insurance (claim reserves); all benefits other than disability for all years of issue	Tables used for annual statement reserves

Source: Treas. Reg. § 1.807-1(a).

Note that for benefits issued before 1984, the mortality and morbidity tables for active life reserves prescribed by Treas. Reg. § 1.807-1(a) line 9 were locked in based on the 1983 NAIC annual statement. For LTC insurance and other A&H insurance benefits addressed in lines 12 and 14 of the regulation, however, neither the chart nor the accompanying text specified whether the relevant tables were limited to those used for the annual statement in the year a contract was issued or in a particular specified year. This question, with respect to line 12 of the regulation, is the primary issue addressed in the TAM.

As discussed in some detail in the TAM, there have been no NAIC-prescribed tables for guaranteed renewable individual LTC insurance to date. Rather, the NAIC Health Insurance Reserves Model Regulation (the Model Regulation), as incorporated in the NAIC Accounting Practices and Procedures Manual (APPM) as Appendix A-010, provides that contracts "for which tabular morbidity standards are not specified in Exhibit 1 [of APPM Appendix A-010] shall be valued using tables established for reserve purposes by a qualified actuary."[4]

THE FACTS OF TAM 201844009

The company in the TAM is a reinsurance company that assumes, via reinsurance and retrocession, risks under LTC insurance contracts. The company is a life insurance company for federal income tax purposes and is subject to NAIC accounting and reserving requirements, including those contained in the APPM. The company files its annual statement with its state department of insurance (DOI).

The company enters into administrative agreements under which it designs and prices policies, files policy forms and actuarial memoranda on behalf of various direct writers, and calculates statutory reserves and reports them to the direct writers. According to the TAM, the pricing and initial statutory reserving were done using the company's "best estimate of assumptions, including the mortality rate, the morbidity rate, and the lapse rate."

For a particular block of LTC insurance policies, the company had initially used morbidity assumptions based on government nursing home data, adjusted to reflect experience of the parties that ceded business to the company via reinsurance or retrocession. Additionally, as later discovered in a DOI audit, the company had initially used joint life (*i.e.*, first-to-die) mortality tables on second-to-die contracts, which understated the statutory reserves.

As a result of the audit, in "Year 5" the DOI required that the company correct its reserves to use second-to-die mortality tables. To mitigate the significant increase in reserves that would result from this correction, the company requested and received permission from the DOI to update its morbidity and lapse assumptions at the same time as the mortality assumptions. The significant increase in reserves due to the mortality change and the slight increase from the lapse assumptions were partly offset by a significant decrease in reserves due to favorable morbidity experience. The changes to all three assumptions were reflected on the company's annual statement for Year 5.

According to the TAM, the DOI viewed the change to the morbidity assumptions as being within the bounds of the Model Regulation and determined the change did not constitute a permitted practice. Specifically, in a footnote, the TAM states: "The DOI notes that the change in the morbidity assumption is not a permitted practice provided the tables and calculations still satisfy the general requirements of the prescribed accounting practice." (As we will see, the DOI's categorization appeared to be one of the key determining factors in the TAM's conclusion.)

It appears that the company initially filed its tax return for the subsequent year reflecting the changes to all three assumptions as a change in basis subject to IRC § 807(f), with the 10-year spread beginning in the year after Year 5. However, the company later asserted that it should not have changed the morbidity assumptions for tax reserve purposes, but only the mortality and lapse assumptions. The question at issue in the TAM was whether the company should be allowed to continue using its original morbidity assumptions after Year 5 or if it must change the tax reserves to use the same morbidity assumptions as were used in statutory reserves.[5]

THE IRS'S ANALYSIS

The TAM's conclusion that the company's morbidity tables must be updated to match the tables underlying the then-current NAIC annual statement reserves was based primarily on references to the issue date found in IRC § 807(d)(5)(A) but not in IRC § 807(d)(5)(C) or Treas. Reg. § 1.807-1. As mentioned earlier, the general rule in IRC § 807(d)(5)(A) requires the use of the most recent commissioners' standard tables permitted by at least 26 states when the contract was issued. A three-year transition period is allowed under IRC § 807(d)(5)(B) when new tables become prevailing. IRC § 807(d)(5)(C) does include two references to the issue date: first, as a threshold test to determine whether a contract is subject to subparagraph A (prevailing tables) or subparagraph C (tables defined by regulation), which depends on whether a commissioners' standard table was applicable to the contract when it was issued; and second, to define the earliest applicable issue years and the timing of the three-year transition period in the event Treasury changes the table applicable to a contract. These two references are repeated in the regulation. However, the IRS concludes in the TAM, nothing in IRC § 807(d)(5)(C) or Treas. Reg. § 1.807-1 requires that the tables in line 12 of the regulation be locked in at issue if a company subsequently changes the tables used in determining its NAIC annual statement reserves.

To summarize the IRS's logic in the TAM:

1. IRC § 807(d)(5)(A), defining prevailing commissioners' standard tables based on when contracts were issued, does not apply to this situation;
2. IRC § 807(d)(5)(C) and Treas. Reg. § 1.807-1 do not provide that the morbidity tables for reserves covered by line 12 of the regulation are locked in at issue or at a particular year; and
3. the Year 5 morbidity tables were established by a qualified actuary and, as expressed in the TAM, otherwise met the requirements of the Model Regulation and were not considered by the DOI to be a permitted practice.

Therefore, the IRS concluded, the Year 5 morbidity tables were the tables referred to by line 12 of Treas. Reg. § 1.807-1(a) beginning in Year 5, and the company must use those updated statutory morbidity assumptions for tax reserves as well.

In the TAM, the IRS also expressed its understanding of a number of additional arguments the company had made for locking in the table at the issue date, dismissing each argument in turn, as follows.

One of the company's arguments, as described in the TAM, was that the original tables the company's actuary had developed in accordance with the Model Regulation when the contracts were issued were, in fact, prevailing commissioners' standard tables under IRC § 807(d)(5)(A). In response to this argument, the IRS distinguished between "commissioners' standard tables" actually prescribed by the NAIC (such as the 1964 Commissioners' Standard Disability Table) and company-specific tables developed by a qualified actuary in accordance with NAIC guidance (such as tables used for LTC insurance benefits), concluding that the latter do not fall within the concept of a commissioners' standard table.[6]

The TAM notes that the company also argued that requiring it to update the morbidity tables on in-force contracts was inconsistent with other published guidance, such as Notice 2010-29, 2010-1 C.B. 547. Notice 2010-29 has to some extent been superseded by the IRS Large Business and International (LB&I) Division Directive issued in August 2018 regarding tax reserves for certain variable annuities and life insurance contracts,[7] but it held that Actuarial Guideline (AG) 43 could not be used to determine tax reserves for variable annuity contracts issued before AG 43's effective date. In response to this argument, the IRS distinguished between the requirement to determine the tax reserve method at the date a contract is issued and the requirement to determine mortality and morbidity tables in accordance with Treas. Reg. § 1.807-1 in the event that no prevailing commissioners' standard tables existed when the contract was issued.

Finally, the TAM indicates that the company made various arguments to the effect that the NAIC guidance requires continued use of the morbidity assumptions the company had established at issue, and these assumptions could not be changed except by means of a state variation departing from the Model Regulation. The IRS addressed this argument by pointing out that regardless of what the NAIC method requires for mortality or morbidity assumptions for statutory reserving purposes, the tax reserves must be determined under IRC § 807(d)(5)—in this case, subparagraph C. Further, the IRS stated, the DOI did not consider the company's updates to its morbidity tables to be a permitted practice or other departure from the Model Regulation.

CONTINUING RELEVANCE POST-TCJA

TAMs are not precedential and cannot be relied on by other taxpayers.[8] However, the IRS's observations and conclusions in the TAM can provide some insight into the IRS's views, particularly with respect to the identification of NAIC-prescribed methods and assumptions. Although the prevailing tables of prior IRC § 807(d)(5) and Treas. Reg. § 1.807-1 are obsolete for tax years beginning after 2017, the principles of required consistency with NAIC accounting requirements, the role of state regulators, and deference to qualified actuaries working within actuarial standards of practice are even more important under current tax law, which places heavy reliance on statutory reserves in determining a company's deductible reserves for income tax purposes.

In particular, it was notable that the TAM referred numerous times to the DOI's assessment of whether the company's change in morbidity assumptions constituted a permitted practice that departed from the Model Regulation. The TAM's reliance on the DOI's categorization of the reserving approach may lead companies to think carefully about how they seek authorization from their regulators for approaches to reserves that may fall into the gray area between actuarial discretion within an NAIC-prescribed method on the one hand, and divergence from the NAIC requirements (*i.e.*, a permitted practice) on the other. Given the complexity of PBR approaches and the TCJA's increased reliance on the NAIC-prescribed method and reserves reported in the annual statement, it may be more important than ever to understand where those lines should be drawn. ■

The views expressed here are the author's and do not necessarily reflect those of Symetra Life Insurance Company.

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ENDNOTES

1 References to the IRC are to the Internal Revenue Code of 1986, generally as amended prior to the 2017 Tax Cuts and Jobs Act (see note 2). References to "current IRC" sections include the 2017 Act's amendments.

2 Pub. L. No. 115-97, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," referred to herein as the 2017 Act or the TCJA.

3 T.D. 8278, 54 FR 52934 (Dec. 26, 1989); 55 FR 1768 (Jan. 18, 1990).

4 APPM (as of Mar. 2019), Appendix A-010, paragraph 49.a.i.(c).

5 The IRS evidently concurred that the mortality and lapse assumptions should be updated for tax purposes and that the impact of the changes would be spread under IRC § 807(f). The TAM also stated that the company had used the correct interest rates and method and had correctly applied the statutory cap.

6 There have also been indications in the context of life insurance contracts that a company-specific mortality table developed by an actuary to determine reserves for a particular company's contracts is not necessarily a "prevailing commissioners' standard table." For example, Notice 2008-18, 2008-1 C.B. 363 (Feb. 4, 2008), addressed issues that may arise under a PBR framework for life insurance (as well as variable annuities). At the time Notice 2008-18 was issued, there was no "net premium reserve" with prescribed assumptions such as exists under the version of PBR ultimately adopted in the NAIC Valuation Manual Section 20 (VM-20), and the "deterministic reserve" was a seriatim reserve developed using a combination of prescribed assumptions and prudent estimates, with company experience underlying the mortality assumptions. The IRS raised concerns (and indicated "some commentators have asked") about whether the mortality assumptions underlying the deterministic reserve would meet the definition of "prevailing commissioners' standard tables" and be permissible for life insurance contract qualification purposes under IRC § 7702.

7 *See* Samuel A. Mitchell and Arthur C. Schneider, LB&I Directive Provides Safe Harbor for AG43 and PBR for Pre-TCJA Years, *Taxing Times*, Vol. 15, Issue 1 at 20 (Feb. 2019).

8 IRC § 6110(k)(3).

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