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LB&I Directive Provides Safe Harbor for AG43 and PBR for Pre-TCJA Years

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The Large Business and International Division (LB&I) of the Internal Revenue Service (IRS) recently resolved a third significant issue with the insurance industry through the Industry Issue Resolution Program (IIR) procedure outlined in Revenue Procedure 2016-19.[1] Readers will remember the LB&I Directive providing a safe harbor for bad debts related to structured securities in 2012[2] and the Directive providing a safe harbor method of accounting for Variable Annuity hedging related to Guaranteed Minimum Benefits (GMxB) in 2014.[3] This time, LB&I married the IIR program with its Campaign examination program to address the tax treatment under Internal Revenue Code (I.R.C.) § 807 of stochastic reserves under Actuarial Guideline XLIII (AG 43)/Valuation Manual 21 (VM-21) for variable annuities and for Principle-Based Reserves (PBR) under VM-20. The guidance, which applies only to reserves for tax years 2010 through 2017, comes in the form of LB&I Directive *IRC Section 807: Large Business and International (LB&I) Directive Related to Principle Based Reserves for Variable Annuity Contracts (AG 43/VM-21) and Life Insurance Contracts (VM-20)*, LB&I-04-0818-015 (Aug. 24, 2018). This article provides a top-level overview of the Directive.

BACKGROUND ON TAX DEDUCTIBILITY OF PRINCIPLE-BASED RESERVES

The Tax Cuts and Jobs Act of 2017 (TCJA),[4] effective for tax years 2018 and following, provides that reserves determined under the Commissioners' Reserve Valuation Method (CRVM) for life insurance contracts and the Commissioners' Annuity Reserve Valuation Method (CARVM) for annuities, as prescribed by the National Association of Insurance Commissioners (NAIC) as of the date the reserve was determined, are deductible under I.R.C § 807, subject to a haircut.[5] Thus, to the extent CRVM/CARVM or other NAIC-prescribed method encompasses principle-based reserving methodologies, those principle-based reserves (after appropriate haircut) are deductible for tax purposes. This new statutory framework abandons the prior law requirements that reserves must be determined based on the CRVM/CARVM that was in existence on the date the contract was issued based on prescribed interest rate and mortality assumptions also determined as of the date the contract was issued.[6] In the place of the old fixed-at-issue assumptions, the new framework conforms the calculations to the NAIC-prescribed methods at the time of determination, which in most cases will be based on statutory accounting (with the prescribed haircut).[7]

The new law for reserve computations could be viewed as a clarification that principle-based reserves determined under CRVM or CARVM in general are deductible under I.R.C. § 807. However, before the TCJA, there were some issues regarding whether principle-based reserves were deductible and, if so, how the calculations were to be made under the fixed-at-issue mortality and interest rate assumptions required under prior law. In Notice 2010-29,[8] the IRS took the position that the reserve for variable annuities (VA Contracts) with guaranteed minimum benefits (GMxBs) was limited to the Standard Scenario Amount (SSA) determined using prescribed interest rates and mortality assumptions and that the excess stochastic portion of the reserve under AG 43 (*i.e.*, the excess Conditional Tail Expectation Amount, or CTE Excess) was not included in the deductible reserve. The Notice applied only to contracts issued on or after Dec. 31, 2009, which was the effective date of AG 43 for statutory accounting purposes. The Notice did not address the tax method for determining the reserves for contracts that had been issued before Dec. 31, 2009, and were subject as of the date of issuance to Actuarial Guideline XXXIV (AG 34) for VA

Contracts with guaranteed death benefits and Actuarial Guideline XXXIX (AG 39) for VA Contracts with guaranteed living benefits. The Notice was only interim in nature and requested comments regarding the status of principle-based reserves.

Taxing Times has published articles that readers may want to revisit to gain a more detailed understanding of the issues dealt with under prior law and in Notice 2010-29. The March 2016 issue explains why the CTE Excess under AG 43/VM-21 and the stochastic reserve under VM-20 should qualify as a deductible tax reserve under former I.R.C. § 807.[9] The June 2016 issue provides a follow-up discussion of why the deterministic reserve under VM-20 for life insurance contracts likewise should be deductible under the former version of I.R.C § 807.[10] A major point made in the articles was that principle-based reserves qualify as life insurance reserves under I.R.C. § 816 because they are actuarially determined amounts that are established to satisfy future unaccrued claims. Furthermore, the articles point out that the reserves are an integral part of the CARVM (in the case of the AG 43/VM-21 CTE Excess) and CRVM (in the case of VM-20 deterministic and stochastic reserves) methods for determining amounts to set aside to satisfy future unaccrued claims and therefore were required to be accounted for as part of life insurance reserves under prior law. Other issues revolved around how to make adjustments to the PBR concepts to fit within the fixed-at-issue requirements under prior law for interest rates and mortality assumptions. Several viable options for accomplishing this were discussed in the prior *Taxing Times* articles.

IIR AND LB&I CAMPAIGN EFFORT

By letters dated Aug. 23, 2016, a group of life insurance companies and the American Council of Life Insurers (ACLI) requested an IIR effort under Rev. Proc. 2016-19 to address the deductibility under I.R.C. § 807 of the CTE Excess amount under AG 43/VM-21 for VA Contracts with GMxBs issued after 2009 and the deterministic and stochastic reserves under VM-20 for life insurance contracts.[11] By the letter dated Nov. 10, 2016, LB&I accepted the request into the IIR program and agreed to work with the industry group and the ACLI to address the issues. In January 2017, LB&I also added the issues addressed in the IIR to its list of examination "Campaigns" under its then-new procedures for strategically focusing on identified issues that either present compliance issues or that otherwise could be dealt with in a manner that most efficiently utilizes IRS examination resources.[12]

Throughout 2017 and into 2018, industry representatives met several times with the IRS team to present the industry's positions and to address questions and comments. The effort gained significant steam, and perhaps was put on an easier road to resolution, when the TCJA was enacted in December 2017, and it became clear that the most difficult issues addressed in the IIR/Campaign were limited to tax years before 2018 because the new rules for determining reserves are no longer based on the actuarial assumptions as of the date of issuance. It also became clear during the IIR process that the LB&I team wanted to implement a solution using a true-up mechanism on the 2017 tax return and did not want to deal with processing amended tax returns from, or making examination adjustments to, prior years. The IIR dialogue culminated with the issuance of the Directive in August 2018, just in time for inclusion on the 2017 tax returns. The Directive provides safe harbors for the treatment of pre-2018 tax reserves, to be implemented on the 2017 return on a cumulative basis, with spread amounts into future years in certain circumstances.

By all indications, the IIR process accomplished what it was intended to—that is, resolution of complex industry-wide issues on a basis mutually acceptable to the IRS and a large portion of the industry.

THE LB&I DIRECTIVE

The following describes in general the scope and operation of the Directive that resulted from the IIR/Campaign process.

Scope

The Directive may be implemented separately for VA Contracts with guaranteed minimum living benefits (GMLBs) issued before Dec. 31, 2009 (pre-2010 contracts),[13] and VA Contracts with GMxBs of any type that were issued after that date (post-2009 contracts), as to tax years 2010 through 2017.[14] It also applies to life insurance policies issued in 2017 if VM-20 was reported in 2017 on the company's NAIC Annual Statement. The necessary adjustments for VA Contracts are to be taken into account either entirely on the 2017 tax return or on the 2017 tax return and subsequent tax returns if 10-year spread amounts apply as described below. If the Directive is implemented, only limited ministerial-type adjustments to original returns (processable adjustments) are permitted for pre-2017 tax years. If the Directive is implemented for post-2009 contracts, then it also must be implemented on the 2017 tax return for life insurance contracts subject to VM-20 that were reported pursuant to VM-20 on the company's 2017 NAIC Annual Statement.[15]

The ultimate scope of the Directive nicely illustrates one of the best aspects of the IIR program—an ability to resolve difficult

industry-wide issues on a comprehensive basis. During the process, LB&I placed importance on the Directive applying (1) to contracts subject to VM-20 as well as those subject to AG-43/VM-21, (2) to pre-2010 VA Contracts, and (3) on the 2017 tax return. As noted above, the first two objectives were greatly facilitated by enactment of TCJA's reserve computational rules for post-2017 taxable years. Life insurance companies were interested in bringing pre-2010 contracts within scope but only if the option was available to implement the Directive separately for those contracts and for post-2009 contracts. In the end, the objectives on both sides were satisfied.

Tax Reserve Safe Harbors

For VA Contracts, the safe harbor tax reserve is equal to the SSA adjusted for interest and mortality assumptions under former I.R.C. § 807(d), plus 96 percent of the **statutory** CTE Excess over the (non-tax-adjusted) SSA.

For life insurance contracts subject to VM-20 and reported under VM-20 on the 2017 Annual Statement, the safe harbor tax reserve is equal to the Net Premium Reserve (NPR) adjusted for interest, mortality, and deferred and uncollected premiums under former I.R.C. § 807(d), plus 96 percent of the allocated **statutory** excess of the deterministic and/or stochastic reserve over the (non-tax-adjusted) NPR.

Consistency/Consolidated Basis

The election[16] to implement the Directive safe harbors and the determination of the earliest open year are to be made on a consolidated basis, and all companies in the group are to be treated consistently. However, the safe harbor calculations, implementation adjustments (including the 10-year spread adjustments), and certifications are to be done on a company-by-company basis.

Optionality

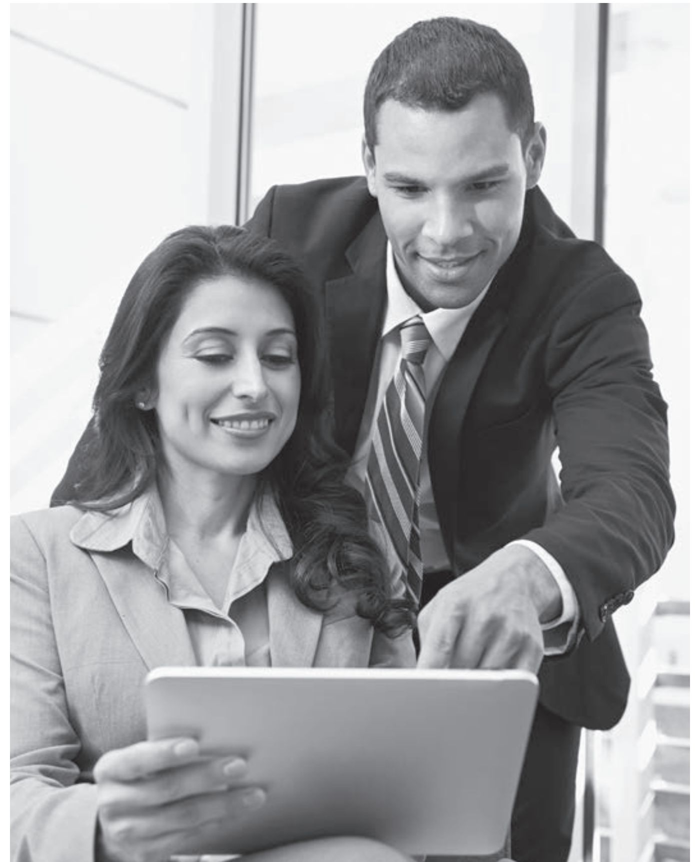
The Directive provides for optionality in implementation in that the Directive applies separately to pre-2010 VA Contracts and post-2009 VA Contracts, and there is optionality with respect to those two sets of contracts. In other words, a company can choose to implement the Directive method for pre-2010 VA contracts, for post-2009 VA Contracts or both. However, a company that implements the Directive for post-2009 VA Contracts also is required to apply it to any VM-20 life insurance contracts within its scope.

Effect on Examinations

If a company implements the Directive, the IRS must stand down on examinations of the reserve issues covered by the Directive for the years 2010 through 2017. Likewise, by implementing the Directive, companies agree not to pursue refund claims with respect to issues covered by the Directive. The IRS, however, is permitted to audit implementation of the Directive (*i.e.*, whether the company complied with the terms of the Directive), but only in connection with examination of the 2017 tax return. A company is considered to properly implement the Directive if it attempts in good faith to do so and subsequently and in good faith provides any necessary corrections or additional information. If the company does not implement the Directive, or only implements with respect to a portion of the Directive, regular audit procedures still apply to the portions not elected if the company comes under examination.

Implementation for VA Contracts

For VA Contracts, implementation of the Directive depends on whether a 10-year spread is required. Generally, a 10-year spread is required unless no I.R.C. § 807(f) adjustment would have been required if the Directive method had hypothetically been adopted in the company's earliest open year as determined on a consolidated return basis. Another situation in which no 10-year spread is required is where the first year in which a statutory CTE Excess occurred is an open tax year. For this purpose, the earliest open year is determined by examining whether a hypothetical use of the tax reserve safe harbor would have resulted in a refund or deficiency for that tax year.



- **If no 10-year spread for a company is required,** the Directive provides the change for that company to be implemented on the 2017 tax return on a cumulative basis without spreading any amount to future tax years. Specifically, the company is required to compare the 2016 closing balance determined on the old method to the closing 2017 balance determined on the Directive method, and the entire change is to be reported on the 2017 tax return. As an example, if the company's earliest open year is 2013 and it had a statutory CTE Excess amount for the first time in that year, a change in basis of determining reserves would not have occurred in 2013 if it had reported on the Directive basis in that year. Thus, the company's adjustment to adopt the Directive method is to be implemented entirely in 2017, with no spread amount to future taxable years.

- **If a 10-year spread is required,** the company has two options for compliance with the Directive. The selected option is required to be applied consistently to all companies in a consolidated group.

  - **Option 1.** Under the first option, the company assumes that the change in basis of determining reserves occurs in 2016, and the company implements the change with a 10-year spread but including contracts issued in 2016 for purposes of the adjustment. Thus, the company determines the spread amount by comparing its closing 2016 reserves computed on the Directive method to its 2016 closing reserves computed on the old method and begins spreading this adjustment amount over the following 10 years starting in 2017. The beginning reserve for 2017 is based on the Directive method, and the change in reserves in 2017 is reported on the 2017 return. This method of implementation is required for companies that have an intervening closed year between the earliest open year and 2017 (such as where the IRS skipped examination years), if a 10-year spread would have been required had the method been adopted in the earliest open year. Otherwise, this option is likely to be adopted only where the Directive would result in tax reserve weakening and the company seeks audit protection.

  - **Option 2.** Under the second option, the company is required to determine a 10-year spread adjustment amount as if the change in basis of determining reserves occurs in the earliest open year and as if the 10-year spread amortization begins in the year following the earliest open year. The company then makes a cumulative true-up adjustment on its 2017 tax return as if the 10-year spread adjustment has been implemented based on a change in basis of determining reserves in the earliest open year. Any remaining spread amounts that would not have been recognized under the hypothetical 10-year spread are recognized in 2018 and subsequent tax years.

    For example, assume that a company's earliest open year is 2013 and its 10-year spread amount would have been $50 to be recognized *pro rata* at $5 per year starting in 2014 if the company implemented the Directive method in 2013. Under the Directive Option 2, the company would include in its 2017 true-up adjustment a cumulative 10-year spread amount of $20 (for 2014, 2015, 2016 and 2017 at $5 per year) and have a remaining amount of $30 to spread over the years 2018 through 2023, at $5 per year. Assume further that the company's 2017 opening balance under the old method is $1,000 and its 2017 closing balance under the Directive method is $1,200. The company's 2017 true-up adjustment (inclusive of the $20 for the first four years of spread) is $170 (*i.e.*, the $200 change in balance minus the $30 that remains to be spread in future years 2018 through 2023).

Implementation for pre-2010 VA Contracts With GMLBs

The same rules as described, at the company's option, apply to pre-2010 VA contracts. Although this may often result in a 10-year spread adjustment, such an adjustment likely would not apply if, for example, GMLB risks were assumed by reinsurance in an open year, or if tax reserves using both the old method and the Directive method would have been capped by statutory reserves in the earliest open year.

Implementation for Life Contracts

The implementation for life insurance contracts subject to VM-20 and that are reported under VM-20 on the annual statement is simply reported under the safe harbor method as of year-end 2017 on the 2017 tax return.

Processable Adjustments

If the Directive is adopted (for either post-2009 VA Contracts, pre-2010 VA Contracts with GMLB or both), the original tax return treatment of the tax reserves for the relevant type of contracts must be accepted by both LB&I auditors and companies. "Processable adjustments" can be made, however, which include carrybacks or carryovers triggered by adoption of the Directive, correction of mathematical and posting errors, adjustments necessary to conform closing tax reserves with opening tax reserves between years, and adjustments to reflect final administrative or judicial proceedings.

Certifications

The Directive requires detailed certifications that are signed under penalty of perjury by an officer of the company on a

company-by-company basis within the group. The certifications contain the details of the adjustments described and are required to be provided to the IRS within 30 days of a request by the IRS. Errors made in certifications prepared in good faith will not invalidate adoption of the Directive if appropriately corrected.

TCJA Transition Adjustment

For companies implementing the Directive, the eight-year spread beginning in 2018 for the transition to tax reserves computed under the TCJA is to be computed by assuming that the Directive method was the proper tax return method as of year-end 2017. Further, the Directive requires any remaining 10-year spread resulting from adoption of the Directive to continue after 2017.

CONCLUSION

There may be some winners and losers in the IIR process, given the fact that the Directive requires companies to implement its terms on the 2017 tax return regardless of a company's tax posture and does not permit any amendments to prior tax returns. However, by all indications, the IIR process accomplished what it was intended to—that is, resolution of complex industry-wide issues on a basis mutually acceptable to the IRS and a large portion of the industry and in a manner that saves great amounts of time and resources for both the government and the taxpayers.

In retrospect, the IIR process served another valuable function. It helped focus the industry and government personnel on the shortcomings of the then-current tax reserve rules and helped pave the way to a legislative response in the TCJA that made the issues addressed in the IIR moot for post-2017 tax years. ■

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ENDNOTES

1 2016-13 I.R.B. 497.

2 *I.R.C. §166: LB&I Directive Related to Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies*, LB&I-4-0712-009 (July 30, 2012). *See also* Arthur C. Schneider & Samuel A. Mitchell, IRS Utilizes the Industry Issue Resolution Program to Resolve the Insurance Industry Bad Debt Issue, Taxing Times, Vol. 9, Issue 1, at 20 (Feb. 2013).

3 *I.R.C. §446: LB&I Directive for Hedging of Variable Annuity Guaranteed Minimum Benefits (GMxB) by Insurance Companies*, LB&I-04-0514-0050 (July 17, 2014). *See also* Eric Bisighini & Tim Branch, Variable Annuity Hedging Directive—A Long and Winding Road, Taxing Times, Vol. 10, Issue 3, at 1 (Oct. 2014).

4 Pub. L. No. 115-97 § 13517; I.R.C. § 807(d). Pub. L. No. 115-97 is formally titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

5 Specifically, the revised law provides that life insurance reserves are to be determined under CRVM/CARVM prescribed by the NAIC as of the date the reserve is determined and are deductible after a haircut of 7.19 percent, subject to a cap equal to the reserve reported on the annual statement. For variable contracts, the deductible reserve is equal to (1) the greater of the net surrender value or the reserve accounted for separately under I.R.C. § 817, plus (2) 92.81 percent of the excess of the reserve determined under CRVM (life)/CARVM (annuities) as prescribed by the NAIC on the date the reserve is determined, over the amount determined in (1), subject to a cap equal to the aggregate reserves for the contract reported on the annual statement. I.R.C. § 807(d).

6 *See generally* Kristin Norberg & Jeffrey Stabach, Changes to the Computation of Tax Reserves under P.L. 115-97, Taxing Times, Vol. 14, Issue 2, at 14 (June 2018).

7 As under prior law, certain reserves (*e.g.*, deficiency reserves and reserves attributable to deferred and uncollected premiums not includible in premium income) remain completely nondeductible.

8 2010-15 I.R.B. 547.

9 Peter H. Winslow, Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves, Taxing Times, Vol. 12, Issue 1, at 21 (Mar. 2016).

10 Peter H. Winslow, VM-20 Deterministic Reserves in Federally Prescribed Reserves, Taxing Times, Vol. 12, Issue 2, at 26 (June 2016).

11 The IRS IIR team later expanded the scope of the project to cover VA Contracts with Guaranteed Living Benefits issued before 2010. See further discussion.

12 *See generally* Samuel A. Mitchell, Significant LB&I Examination Developments, Taxing Times, Vol. 12, Issue 3, at 28 (Oct. 2016).

13 Specifically, pre-2010 contracts are those with GMLBs that became subject to AG 43 for statutory accounting on December 31, 2009 (*i.e.*, contracts with GMLBs that were issued on or after January 1, 1981, and before December 31, 2009.).

14 The Directive does not apply to pre-2010 VA contracts without GMLBs or to tax years beginning before 2010.

15 The Directive does not require the adoption of VM-20 for tax purposes in 2017 if not adopted for statutory reserves.

16 Implementation of the Directive may sometimes be referred to as elective, though there is no election statement as such. The "election" is to be made by applying the Directive on the 2017 federal income tax return and providing the required certifications.