

A banner for the 2017 SOA Annual Meeting & Exhibit. It features a silhouette of a person in a suit standing on a city skyline at night, with a large blue arrow pointing right in the background.

2017 SOA
**Annual Meeting
& Exhibit**

Oct. 15-18, 2017
Boston, MA

Session 052 PD - Principle Based Reserves and Taxation

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2017 SOA Annual Meeting & Exhibit

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052 PD - Principle Based Reserves and Taxation

Monday, October 16, 2017



SOCIETY OF ACTUARIES

Antitrust Compliance Guidelines

Active participation in the Society of Actuaries is an important aspect of membership. While the positive contributions of professional societies and associations are well-recognized and encouraged, association activities are vulnerable to close antitrust scrutiny. By their very nature, associations bring together industry competitors and other market participants.

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- **Do not** speak on behalf of the SOA or any of its committees unless specifically authorized to do so.
- **Do** leave a meeting where any anticompetitive pricing or market allocation discussion occurs.
- **Do** alert SOA staff and/or legal counsel to any concerning discussions
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Principle Based Reserves and Taxation

- Overview of PBR Tax Issues
- IRS Industry Issue Resolution (IIR) project
- What should companies be doing and thinking about in 2017?

Life PBR Tax Considerations:

Overview

- Life PBR represents at least as great a change for tax reserves as it does for statutory reserves.
- Unlike the NAIC, the IRS must administer a Federal statute – the Internal Revenue Code – which uses statutory accounting as a starting point but did not contemplate the mechanics of Life PBR
- IRS has provided life insurance product guidance under Life PBR and promises additional guidance on tax reserves

Life PBR Tax Considerations: Prior IRS Guidance

- Notice 2008-18

- Issued by IRS in Feb. 2008, when PBR was still in development stages for both life and annuities
- Identified areas in which Treasury and IRS had concerns
- Requested comments

- Notice 2010-29

- Issued by IRS in March 2010, shortly after AG 43 became effective
- Defined a safe harbor for variable annuity contracts issued on or after 12/31/2009
- “No inference should be drawn from this notice” on any other federal tax issues, including those arising from Life PBR
- Highly controversial

Life PBR Tax Considerations: Three Broad Areas of Concern

- Policyholder Tax Compliance
- Reserve Transition Rules
- Substantive Reserve Rules

Policyholder Tax Compliance: Internal Revenue Code

- Section 7702: Qualification as a life insurance contract
 - Contract must be a life insurance contract under the applicable law
 - Contract must either:
 - Meet the cash value accumulation test, or
 - Meet the guideline premium requirements AND fall within cash value corridor
 - Actuarial tests are based on “reasonable mortality charges” that meet requirements of regulations and that, except as provided in regulations, *do not exceed the prevailing commissioners’ standard tables as of the time the contract is issued.* Guidance on the treatment of substandard policies is pending.

Policyholder Tax Compliance

Notice 2016-63 (November 7, 2016)

- Issues Addressed
 - 2017 CSO tables as the prevailing tables
 - Optional three-year transition period
 - Accommodation of routine, non-tax motivated changes that are pursuant to policyholder expectations
 - Changes in death benefit
 - Reconsideration of ratings (smokers who stop smoking)
 - Reinstatements
 - Addition of qualified additional benefits, change in death benefit option, addition/removal of rider

Reserve Transition Rules: Internal Revenue Code

- Section 807(d) provides rules for determining life insurance reserves for any contract
 - Greater of net surrender value or Federally prescribed reserve
 - In no event greater than “amount which would be taken into account with respect to such contract . . . in determining statutory reserves”
- Federally prescribed reserve (FPR)
 - Method – CRVM prescribed by the NAIC which is in effect on the date of the issuance of the contract (for a contract covered by the CRVM)

Reserve Transition Rules: Valuation Manual

- Generally, Life PBR is effective for contracts issued on or after 1/1/2017 – but there are exceptions
 - Initial three-year transition period
 - Companies may elect to use existing requirements for business issued in first three years after operative date
 - Small-company exemption permits companies to use existing requirements if they meet defined criteria
 - Single-state exemption available in many states, with permission from commissioner
 - Not all states adopted PBR as of 1/1/2017

Reserve Transition Rules: Discussion of Issues

- IRS policy not to provide “retroactive” guidance (January 2017, ABA Taxation Section Insurance Companies Committee, Helen Hubbard)
- If a company defers implementation or is exempt from Life PBR, when (if at all) must it implement Life PBR for purposes of computing the FPR?
- If a company is not subject to Life PBR because it operates only in states that have not enacted the current SVL, when (if at all) must it implement Life PBR for purposes of computing the FPR?
- Different structure for effective date and transition rules in Life PBR vs. AG 43
- Regardless of timing of IRS guidance, many companies have to consider now what substantive reserve positions they will take on their tax returns. We’ll be circulating back to that

Substantive Reserve Issues: Internal Revenue Code

- Section 807(d)
 - Prescribes a Federally-prescribed reserve (FPR), bounded by a cap (stat reserves) and a floor (NSV).
 - Comparison is made contract-by-contract
- Requirements for FPR
 - Method – CRVM prescribed by the NAIC which is in effect on the date of the issuance of the contract (for a contract covered by the CRVM)
 - Interest rate – greater of applicable Federal interest rate or prevailing State assumed interest rate as of beginning of year in which contract was issued
 - Mortality tables – prevailing commissioners' standard tables (adjusted as appropriate) when the contract was issued

Substantive Reserve Issues: Interim Guidance under AG 43

- Notice 2010-29
 - Provided interim safe harbor guidance on AG 43
 - Permitted SSA as the FPR, adjusted for mortality and interest requirements under section 807(d)
 - Did not permit stochastic reserve (CTE excess) to be included in FPR (safe harbor)
 - Provided no guidance on treatment of CTE excess under AG 43 in statutory cap
 - Has proven to be unworkable and in some cases produces unsupportable results

Substantive Reserve Issues:

Life PBR Reserve Components

- Net Premium Reserve
 - Prevailing interest rate - prescribed
 - Prevailing mortality tables - 2017 CSO tables
 - Consideration of lapses
 - Potential unlocking of mortality and lapse assumptions

Deterministic Reserve

- Gross premium reserve methodology
- Company-specific assumptions
- Consideration of expenses
- Prudent estimate assumptions
- Aggregate versus contract-by-contract determination

Substantive Reserve Issues: Life PBR Reserve Components (cont'd)

- Stochastic Reserve
 - Aggregate versus contract-by-contract
 - Cash flow modeling, CTE 70 methodology
 - Ability to audit

Life PBR Guidance: Why the IRS Can't Punt

- Priority Guidance Plan
- LB&I (Large Business & International) “Campaign”
- Industry Issue Resolution
 - Coalition of Companies
 - ACLI

Industry Issue Resolution (IIR) Program

- “The objective of the IIR Program is to identify and resolve frequently disputed or burdensome tax issues that are common to a significant number of entities. Resolving issues through pre-filing guidance rather than post-filing examination is a goal of the Internal Revenue Service (IRS) and the Office of Chief Counsel.”
- Two prior IIR projects have resulted in helpful LB&I Directives for insurance companies
 - Partial Worthlessness Deduction for Eligible Securities Reported by Insurance Companies (LB&I-4-0712-009, July 30, 2012)
 - Hedging of Variable Annuity Guaranteed Minimum Benefits by Insurance Companies (LB&I-04-0514-0050, July 17, 2014)

Industry Issue Resolution Program

- The types of issues most appropriate for consideration under the IIR Program have two or more of the following characteristics:
 - (1) The proper tax treatment of a common factual situation is uncertain;
 - (2) The uncertainty results in frequent, and often repetitive, examinations of the same issue;
 - (3) Frequent, and often repetitive, examinations require significant resources from both the IRS and impacted entities;
 - (4) The issue is significant and impacts a large number of entities;
 - (5) The issue requires extensive factual development; and
 - (6) Collaboration would facilitate proper resolution of the tax issues by promoting an understanding of entities' views and business practices.

Life PBR Guidance: Industry Issue Resolution (IIR)

- August, 2016 request for IIR
- December 2016 acceptance into the program
 - Include ACLI
 - Address Life PBR
 - Goal of published guidance
- February 7, 2017 Opening Meeting
- February 17, 2017, IRS request for information
- March through June, 2017 industry responses
- September 27, 2017, Second Meeting
- Expected next steps

Life PBR Tax Issues: IRS Questions

- Actuarial
 - Need for PBR
 - Computation of AG 43/VM-21 and VM-20
 - Reserve comparisons
 - Prudent estimates/moderately adverse conditions
 - Mortality
 - Invested assets/discount rate
 - Expenses
 - Actuarial discretion
 - Documentation and disclosure

Life PBR Tax Issues: IRS Questions

- Legal
 - Qualification as life insurance reserves
 - Mortality
 - Interest
 - Expenses
 - Compliance/auditability

What is IRS likely to do?

[Intentionally blank]

How do companies prepare?

- How does one approach tax issues that will likely not be covered by the IIR?
- How does one approach tax issues that likely WILL be covered, but not in time for 2017 Form 1120-L filing?
- What else are companies doing now?

Other PBR Tax Issues

- What tax assumptions should be used for pricing?
- Will updating assumptions be a change in basis of computing reserves?
 - Unlocking of assumptions?
 - Updates to VM-20?
- Any impact on
 - Life company qualification?
 - 7702/7702A qualification?
 - Tax hedge accounting?
 - Reinsurance accounting?

PBR Tax Return Decisions

- Do we deduct Stochastic and/or Deterministic Reserve Components of VM-20 on the tax return?
 - If not, how do we preserve our right if it is determined that these components are deductible?
- What adjustments to later statutory reserves, if any, should be made if we deduct Stochastic and/or Deterministic Reserves on the tax return?
 - How do we preserve our rights if it is determined that the adjustments made were too large?
- Is a tax provision required under ASC 730 (and IRS Schedule UTP)?

The rubber hits the road

- Collaboration between actuarial and tax function
- Choice of implementation date
- Decisions about positions that will be taken on uncertain tax issues
 - Quantify the effect of those issues?
- Systems requirements to implement tax positions

QUESTIONS??