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SOCIETY OF ACTUARIES®

Session 16 PD, Principle-Based Reserves and Taxation

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2018 SOA Life & Annuity Symposium

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PBR and Taxation-Agenda

- Principle-Based Reserves-Setting the Stage
  - Variable Annuity PBR
  - Life Insurance PBR
- PBR Issues under Prior Tax Law
  - Issues
  - Industry Issue Resolution Project
- Impact of 2017 Tax Cuts and Jobs Act (TCJA)
  - In General
  - Separate Rules for Variable Contracts, Qualified Supplemental Benefits, Term Certain Annuities
  - Changes in Basis/Section 807(f)
  - Transition Issues
- Questions?

Principle-Based Reserves:
Setting the Stage

Variable Annuities PBR

AG 43

- First example of Principle-based reserve methodology
- Effective 12/31/2009
- Retroactive for Variable Annuities (issued Jan. 1, 1981 and later)

Reserve Components under AG43

Two components:

Standard Scenario (SSA)	• Seriatim and formulaic • Prescribed assumptions • Floored at cash surrender value
Stochastic reserve (**SR**)	• Aggregate, using cash flow modeling • Company-specific and stochastic assumptions • CTE 70 (average of 30% worst scenarios)

Minimum reserve = SSA + Excess { **CTE 70** over **SSA** }

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Principle-Based Reserves
The Valuation Manual

- VM effective January 1, 2017
- VM defines the Commissioners' Reserve Valuation Method (CRVM, generally applicable to life insurance) or the Commissioners' Annuity Reserve Valuation Method (CARVM, applicable to annuities)
- VM-20 – new Life Insurance Contracts PBR
  - Generally applies to individual life insurance contracts issued on or after the "operative date" of the VM (Jan. 1, 2017)
- VM-21 – existing Actuarial Guideline (AG) 43 for variable annuities
- Possible PBR expansion to other products and amendments to current PBR

Reserve Components under Life PBR VM-20

Three components:

Net premium reserve (**NPR**)	• Seriatim and formulaic • Prescribed assumptions • Floored at cash surrender value
Deterministic reserve (**DR**)	• Aggregate, using cash flow modeling • Company-specific assumptions
Stochastic reserve (**SR**)	• Aggregate, using cash flow modeling • Company-specific and stochastic assumptions • CTE 70 (average of 30% worst scenarios)

$$\text{Minimum reserve} = \text{NPR} + \text{Excess}\left\{\text{Greater of DR or SR over NPR minus due/deferred premium}\right\}$$

PBR ISSUES
UNDER PRIOR TAX LAW

PBR Tax Considerations: Three Broad Areas of Concern

- Life Insurance Policyholder Tax Compliance
- PBR Implementation Issues
- Substantive Tax Reserve Rules

Policyholder Tax Compliance: Internal Revenue Code Section 7702

- 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.
  - Requirement remains the same after TCJA

Policyholder Tax Compliance

- Notice 2016-63 (November 7, 2016)
  - 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
- Rev. Proc. 2018-20 (March 12, 2018)
  - Age 100 safe harbor extended to 2017 CSO mortality tables

Valuation Issues
Internal Revenue Code under Prior Tax Law

- 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/CARVM prescribed by the NAIC which is in effect on the date of the issuance of the contract
  - Interest rate – greater of applicable Federal interest rate or prevailing State assumed interest rate for year in which contract was issued
  - Mortality tables – prevailing commissioners' standard tables when the contract was issued

PBR Implementation

- 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

PBR Implementation Issues

- If a company 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 must it implement Life PBR for purposes of computing the FPR?
- Other transition issues are addressed by TCJA

Substantive Reserve Issues

- Formulaic vs. Stochastic Reserves
    - Gross premium reserve methodology
    - Company-specific assumptions
    - Consideration of expenses
    - Prudent estimate assumptions
    - Aggregate versus contract-by-contract determination
    - Stochastic methodology and ability to audit
    - Tax Prescribed Mortality
    - Tax Prescribed Interest

Substantive Reserve Issues (cont'd)

- Status of Issues
  - Issues were the subject of Industry Issue Resolution project
  - Tax reform intervened and addressed many of the issues
  - IIR will address issues for AG 43 for past years and Life PBR for 2017 adopters
  - Other issues may still be the subject of IRS guidance

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.“
- Criteria for IIR program are focused on industry impact, degree of legal or factual uncertainty, and IRS and taxpayer resources
- 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)

Life PBR Guidance:
Industry Issue Resolution (IIR)

- August, 2016 – Group of companies requests IIR for issues raised by AG 43
- December, 2016 - IRS accepts issue into the program, with conditions
  - Include ACLI
  - Address Life PBR
  - Goal of published guidance
- February – December, 2017 – Multiple meetings between industry and IRS, multiple written submissions

What comes next?

- Industry proposals on the table
- Priorities are administrability, resolution of old years
- Likelihood of further dialogue in light of TCJA

Impact of 2017 Tax Cuts and Jobs Act

New Section 807(d)

"(A) In general. For purposes of this part (other than section 816), the amount of the life insurance reserves for any contract (other than a contract to which subparagraph (B) applies) shall be the greater of –

i. the net surrender value of such contract, or
ii. 92.81 percent of the reserve determined under paragraph (2).

(B) Variable contracts. For purposes of this part (other than section 816), the amount of the life insurance reserves for a variable contract shall be equal to the sum of –

i. The greater of –
    I. the net surrender value of such contract, or
    II. the portion of the reserve that is separately accounted for under section 817, plus
ii. 92.81 percent of the excess (if any) of the reserve determined under paragraph (2) over the amount in clause (i)"

Life Insurance Reserves – Summary (Life Insurance, Annuities, Non-Can A&H)

- General Rule – Tax reserve equals greater of net surrender value or 92.81% of reserve computed using NAIC-prescribed method applicable to the contract at the valuation date
- Statutory Reserves Cap – Tax reserve capped by statutory reserves for the contract
- 92.81% applied to entire NAIC-prescribed reserve if no net surrender value (*e.g.*, term insurance, immediate annuities, long-term care, disability income)
- Rules apply on contract-by-contract basis as in pre-2018 tax law
- Separate rules for variable contracts, qualified supplemental benefits, term certain annuities

What Is The Same as Pre-2018 Tax Reserves?

- Tax reserves determined at contract level
- Tax reserves method = NAIC-prescribed method
- Portion of reserves attributable to deficiency reserves and deferred and uncollected premiums not deductible
- Asset adequacy reserves required by Sections 3 and 6 of the Standard Valuation Law not deductible
- No change to statutory reserves cap or statutory reserves test for life company qualification

What Is New?

- No 26-state rule for mortality or interest
- 7.19% haircut applied to NAIC-prescribed reserve
- Tax reserve method determined at valuation date
- Separate rules for variable contracts, qualified supplemental benefits and term certain annuities

What Has Not Changed?

Deficiency Reserves – No Change

- "No additional reserve deduction allowed for deficiency reserves. Nothing in any reserve method described under this paragraph shall permit any increase in the reserve because the net premium (computed on the basis of assumptions required under this subsection) exceeds the actual premiums or other consideration charged for the benefit."

D&U Premiums – No Change

- "Nothing in this part shall permit – . . .

  a reserve to be established for any item unless the gross amount of premiums and other consideration attributable to such item are required to be included in life insurance gross income."

What Has Not Changed?

Excess Interest – No Change

- "For purposes of this part (other than section 816), amounts in the nature of interest to be paid or credited under any contract for any period which is computed at a rate which –
  1) exceeds the interest rate in effect under section 808(g) for the contract for such period, and
  2) is guaranteed beyond the end of the taxable year on which the reserves are being computed, shall be taken into account in computing the reserves with respect to such contract as if such interest were guaranteed only up to the end of the taxable year."

Other Insurance Reserves

- Generally same as Pre-2018 Law
  - I.R.C. § 807(c)(2) – unearned premiums and unpaid losses
  - I.R.C. § 807(c)(4) – dividend accumulations and amounts held at interest
  - I.R.C. § 807(c)(5) – premiums paid in advance and premium deposit funds
  - I.R.C. § 807(c)(6) – reasonable premium stabilization reserves

Tax Reserve Observations

- Companies that compute statutory reserves using single-state permitted or prescribed method, or companies holding GAAP or IFRS reserves, must compute tax reserves using NAIC-prescribed method

- Tax reserve assumptions must be –
  - Consistent with statutory reserve assumptions if statutory reserves use NAIC-prescribed method
  - Permissible under, and compatible with, NAIC-prescribed method

- Aggregate PBR included in tax reserves, provided –
  - PBR is the prescribed NAIC method
  - Aggregate reserves must be allocated to individual contracts

- Haircut for contracts without net surrender values proportionally greater

- Statutory reserves cap still aggregate reserves for the contract (not just life insurance reserves)

Separate Rules for Variable Contracts, Qualified Supplemental Benefits, Term Certain Annuities

Variable Life and Annuity Contracts

- Separate rule– Tax reserve equals greater of net surrender value or separate account portion of reserve plus 92.81% of excess (if any) of reserve computed using NAIC-prescribed method applicable to the contract at the valuation date

- Statutory Reserves Cap – Tax reserve capped by statutory reserves for the contract

- What is different?
  - Confirmation that NAIC-prescribed stochastic reserve included in tax reserves
  - 7.19% haircut (but only on a portion)

Qualified Supplemental Benefits

- Qualified Supplemental Benefits – includes benefits when there is a separately identified premium and net surrender value is not a funding source
  - guaranteed insurability
  - accidental death or disability benefits
  - convertibility
  - disability waiver benefit
  - other benefits prescribed by regulations
- Separate Rule – Tax reserve computed as if benefits provided by separate contract, *i.e.*, 92.81% of reserve computed using NAIC-prescribed method applicable to the contract at the valuation date
- Statutory Reserves Cap – Tax reserve capped by statutory reserves for the qualified supplemental benefits
- What is different?
  - Separate reserve for QSB no longer full statutory reserve

Term Certain Annuities

- I.R.C. § 807(c)(3) reserves – not life insurance reserves
- Separate Rule – Discount rate equal to highest rate or rates permitted by the NAIC to be used to discount the obligations at the valuation date
- No haircut
- What is different?
  - No AFIR as of contract issue date
  - Discount rate updated if NAIC changes highest permitted rate for previously-issued contract

Step-By-Step Calculation of Life Insurance Reserves for Tax

1. Start with statutory reserves computed according to NAIC statutory accounting

2. Adjust statutory reserves, if necessary, to conform with CRVM, CARVM or another NAIC-prescribed method applicable to the contract as of the valuation date – use NAIC method, not a single-state permitted or prescribed practice

3. Adjust those reserves for mortality, interest or other assumptions only if the assumptions are not permissible under method prescribed by the NAIC

4. Allocate any aggregate reserves to particular contracts

Step-By-Step Calculation of Life Insurance Reserves for Tax (Cont'd)

5. Reduce the NAIC-prescribed reserves by deficiency reserves, D&U premiums

6. Reduce the adjusted reserve by the 7.19% haircut applied in the manner specified for the type of contract

7. Floor the reserve by the net surrender value

8. Cap the reserve by allocable statutory reserves

Changes in Basis/Section 807(f)

Changes in basis/Section 807(f)

- Old Tax Law
  - Ten-year spread for adjustments
    - Difference between year-end reserves computed under old and new method
  - Definition of change in basis
    - Subset of change in accounting method
    - Versus change in estimate, correction of error
    - Change in statutory reserves cap
  - No audit protection
  - Application to closed years
  - Acceleration of unamortized balance
    - Termination as insurance company, for example

Changes in basis/Section 807(f)

- Post - Tax Cuts and Jobs Act
  - Treat as change in accounting method initiated by company and approved by IRS
    - 1-year for negative adjustment (we think)
    - 4-year spread for positive
    - No need for advance consent
  - Procedural issues
    - Applicability of IRS “automatic change” revenue procedure?

Changes in basis/Section 807(f)

- Open issues
  - Interaction with reserve transition adjustments
  - IRS procedures for changes
    - Automatic change revenue procedure
    - Audit protection
    - Return attachment
    - Window periods
  - Continued status of Rev. Rul. 94-74

Transition issues

Transition – Recomputation of Year-End 2017 Tax Reserves

"Transition rule. For the first taxable year beginning after December 31, 2017, the reserve with respect to any contract (as determined under section 807(d) of the Internal Revenue Code of 1986) at the end of the preceding taxable year shall be determined as if the amendments made by this section had applied to such reserve in such preceding taxable year."

Transition – 8-Year Spread

- “In general. If –
    i. the reserve determined under section 807(d) of the Internal Revenue Code of 1986 (determined after application of paragraph (2)) with respect to any contract as of the close of the year preceding the first taxable year beginning after December 31, 2017, differs from
    ii. the reserve which would have been determined with respect to such contract as of the close of such taxable year under such section determined without regard to paragraph (2), then the difference between the amount of the reserve described in clause (i) and the amount of the reserve described in clause (ii) shall be taken into account under the method provided in subparagraph (B).”

- “Method. The method provided in this subparagraph is as follows:
    i. If the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), ½ of such excess shall be taken into account, for each of the 8 succeeding taxable years, as a deduction under section 805(a)(2) or 832(c)(4) of such Code, as applicable.
    ii. If the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), ½ of such excess shall be included in gross income, for each of the 8 succeeding taxable years, under section 803(a)(2) or 832(b)(1)(C) of such Code, as applicable.”

Transition Rule Observations

- 8-year spread only applies to reserves classified for tax purposes as life insurance reserves (not reserves for term certain annuities)

- Although somewhat ambiguous, 8-year spread likely begins in 2018

- Tax reserve errors in 2017 tax reserves should be corrected in measuring 8-year spread

QUESTIONS?

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