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DEFICIENCY RESERVES: THE CICADAS OF THE LIFE INSURANCE INDUSTRY

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Deficiency reserves could be described as the “cicadas” of the life insurance industry. They have existed since the early years of the industry and periodically emerge from underground during the transition to new mortality tables, as existing tables become outdated because of improvements in mortality. Despite efforts on the part of the actuarial profession to eliminate them, they have continued to exist, although changing and evolving along the way. Deficiency reserves also have an interesting connection to the federal income taxation of life insurance companies. Beginning with the 1959 Act, they were excluded from the definition of life insurance reserves, a political decision which made sense in 1959, but which has added complexity to the taxation of life insurance companies since that time. Deficiency reserves were also indirectly responsible in part for the development of the 1984 Act. Nonguaranteed premium plans, which were developed to avoid deficiency reserves for a variety of nonparticipating products during the transition from the 1958 CSO Table to the 1980 CSO Table, led to the broad definition of policyholder dividends currently found in section 808 of the Internal Revenue Code (the “Code”). Under the 1959 Act rules, these amounts were not deductible for many stock life insurance companies, the so-called “Phase II negative” companies, one of many issues addressed by the 1984 Act. This article traces the tax treatment of deficiency reserves, beginning with the 1959 Act, illustrating how the decisions made in the development of the 1959 Act continue to affect the tax treatment of those reserves today.

DEFICIENCY RESERVES AND THE STANDARD VALUATION LAW

Traditionally, where the gross premium charged for a life insurance contract is less than the valuation net premium, a deficiency reserve based on the difference between the valuation net premium (P) and the gross premium (GP) has been required under valuation statutes. Dating to the early 20th century, section 85 of the Insurance Laws of New York provided:

When the actual premium charged for an insurance by any life insurance corporation doing business in this State is less than the net premiums for such insurance computed

according to the table of mortality and rate of interest prescribed in this article, such corporation shall be charged as a separate liability with the value of an annuity, the amount of which shall equal the difference between such premiums and the term of which in years shall equal the number of future annual payments due on such insurance at the date of the valuation.¹

This had the effect of substituting the gross premium for the valuation net premium in the establishment of the statutory reserves. The relationship can be expressed as follows for a level premium whole life plan:

$$\begin{aligned} \text{Basic Reserve: } & A_{x+t} - P_x \ddot{a}_{x+t} \\ \text{Deficiency Reserve: } & (P_x - GP_x) \ddot{a}_{x+t} \\ \text{Combined: } & A_{x+t} - GP_x \ddot{a}_{x+t} \end{aligned}$$

As illustrated above, a net premium reserve is the present value of future benefits minus the present value of future net premiums. The argument for a deficiency reserve states that it is improper to deduct the total present value of net premiums if the gross premiums which are actually to be collected are less than those net premiums. That is, a deficiency reserve is merely a device by which the reserve is never permitted to be based on a prospective valuation premium to the extent that the premium will not be collected. Thus, the deficiency reserve requirement is regarded as a necessary element in a system of reserves where credit is taken for future net premiums. This logic carries an implication that the valuation mortality table is generally consistent with the pricing assumptions, with some degree of margins. However, the deficiency reserve problem has historically developed in circumstances where emerging mortality experience led insurance companies to charge gross nonparticipating premiums less than the valuation net premiums, which typically occurs during a transition in valuation tables. In this respect, a deficiency reserve can be characterized as an adjustment in reserves brought about by unrealistic actuarial assumptions. That is, assuming that product pricing is rational, the net premium can be more than the gross only if the mortality or interest basis, or both, are

very conservative. If this is the case, the present value of the benefits will be greatly overstated, and this overstatement will more than offset the overstatement in the present value of future premiums.

During the drafting of the Standard Valuation Law in the 1940s, consideration was given to the problem of deficiency reserves. At that time, deficiency reserve requirements had existed by statute or practice for a great many years in many states. The committee drafting the statute was faced with an existing requirement which would have been quite difficult to remove. While “considerable study was given to the problem, and suggestions for changing its form were made, the end result was a continuance in the standard legislation of substantially the form of deficiency reserve then in existence in the various states.”² Ultimately, a judgment was made not to raise the deficiency reserve issue out of fear that it would lead to opposition to the entire valuation law. There was a practical expedient to this decision as well, as the Standard Valuation Law also introduced the 1941 CSO Table, which would largely eliminate deficiency reserves on new issues, a theme that would be repeated again in the transition to the 1958 CSO Table.

THE 1959 ACT

With the continued improvement in mortality since the development of the 1941 CSO Table, deficiency reserves once again emerged in the latter half of the 1950s, creating pressure to either change the valuation law or replace the 1941 CSO Table with a more up-to-date table. Unlike participating insurance which could be issued at the valuation net premium because of the operation of the dividend scale, nonparticipating policies were once again being issued where the gross premiums were less than the net premiums according to the 1941 CSO Table. The emergence of deficiency reserves became a divisive force in the industry, not only between stock and mutual companies but also between established and newer, more lightly capitalized stock companies, who were not in a position to set up the required deficiency reserves to compete with the older companies issuing low-cost nonparticipating policies. The result was the development of the 1958 CSO Table, which was based on experience between 1950 and 1954. Since companies were moving to adopt product portfolios based on the new table in the late 1950s, the development of the 1959 Act occurred during the transition in mortality standards between the 1941 and 1958 CSO Tables.

This raised the issue of the treatment of deficiency reserves under the 1959 Act, particularly for smaller stock companies, who would be taxed on their gain from operations, known as the “Phase II negative” tax base. The legislative history makes the Congressional intent of excluding deficiency reserves clear, noting “these reserves will not be taken into account in determining gains from operations, and thus deficiency reserves which have been built up prior to 1958 will not produce an increase in the life insurance company’s tax base under phase 2 when they decrease in years after 1957.”³ This was an early form of “fresh start,” a technique more broadly used in the tax legislation of the 1980s.

A similar perspective was provided by Buist M. Anderson in his report on the effects of the 1959 Act:

This new provision excludes deficiency reserves from the definition of “life insurance reserves.” If the industry (meaning here the stock companies because mutuals, generally speaking are not concerned with deficiency reserves) had so desired and acted accordingly, we probably could have had the law so drafted that deficiency reserves would have been treated as allowable reserves. The disadvantage, of course, would be that such reserves existing December 31, 1957 would, in time, come back through earnings and would then be taxed under Phase II. The assumption is that deficiency reserves will be of less importance in the future because of the adoption of the new mortality table and that such reserves will, generally speaking, decrease and, in time, disappear.⁴

In anticipation that the exclusion of deficiency reserves would in the aggregate reduce taxable income, the decision to exclude deficiency reserves from the definition of life insurance reserves was incorporated into the 1959 Act, thus setting the treatment that remains today. This had the effect of increasing the taxes on companies taxed on a net investment income tax base, as deficiency reserves were excluded from the calculation of required (reserve) interest, thus increasing the taxable amount. This affected the large stock companies on the Phase II positive tax base, who held deficiency reserves, and to a

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lesser degree mutual companies under Phase I, because of their generally lower deficiency reserves which were limited principally to term insurance plans.

Years later, as deficiency reserves were once again emerging as an issue for the industry, in reflecting on that judgment in the 1959 Act one commentator remarked:

Deficiency reserves seems to me like a good example of poor strategic tax planning back in the 1950s. The industry was given a choice when the 1959 act was being developed of either excluding or including deficiency reserves as life insurance reserves. The industry chose to exclude them because they were expected to run off and excluding them would reduce the Phase 2 tax that would be paid primarily by the stock companies. I think if the industry had done a better job of strategic tax planning, it might have foreseen that deficiency reserves would not disappear in a few years but there would be further deficiency reserves as mortality improved and premiums came down. Unfortunately the industry did not do this. As a result, we have had a reserve excluded which would have been much better included.⁵

THE 1976 AMENDMENTS TO THE STANDARD LAW

The 1959 Act defined deficiency reserves for any contract consistent with the statutory definition at the time as “that portion of the reserve for such contract equal to the amount (if any) by which—(A) the present value of the future net premiums required for such contract, exceeds (B) the present value of the future actual premiums and consideration charged for such contract.”⁶

The 1976 amendments removed any references to deficiency reserves, but required additional reserves in situations where “the gross premium charged by a company on a policy is less than the valuation net premium for the policy or contract calculated . . . using the minimum valuation standards of mortality and interest.”⁷ The revised requirements defined the minimum required reserve as the greater of two values:

- (1) The present value of future benefits less the present value of future valuation net premiums calculated by the method (commissioners or net level) actually used in computing the reserve for that policy but using the minimum valuation standards of mortality and rate of interest and

substituting the gross premium in the reserve calculation for each contract year where it was less than the valuation net premium.

- (2) The reserve calculated according to the mortality table, rate of interest and valuation method actually used for the policy.

This approach permitted a company to use a stronger basis for valuation than the minimum required by law without being forced to put up additional reserves if its gross premiums are less than actual net valuation premiums but more than the minimum net valuation premiums specified by law. However, it also created an inconsistency between the valuation law and the Code definition of deficiency reserves.

DIVIDENDS AND NONGUARANTEED PREMIUMS

By the mid-1970s, as was the case when the 1958 CSO Table replaced the 1941 CSO Table, growing deficiency reserve problems for certain plans of life insurance again became a problem due to the level of mortality underlying the 1958 CSO Table compared to the then-current mortality rates. The 1980 CSO Tables were developed by the Special Committee to Recommend New Mortality Tables for Valuation in 1979, to replace the existing 1958 CSO Tables as the minimum standard for valuation.⁸ At the same time, nonguaranteed premium products began to emerge as a solution to the deficiency reserve dilemma being faced by most stock life insurance companies. Under these plans, the current level of gross premiums would be guaranteed for an initial period, often as short as a year. Because the company had the right to increase the premium after the initial guarantee period, deficiency reserves were not required after the initial guarantee period if the maximum premium was equal to or greater than the valuation net premium. This was particularly important for nonparticipating plans with nonsmoker or preferred risk discounts which had also begun to emerge in the market. Although the deficiency reserves for these plans generally would be reduced by the adoption of the 1980 CSO, in some cases they would not be completely alleviated as deficiency reserves would still be required due to the low premiums for select classes of insureds.

However, the characterization of the difference between the actually charged premium and the maximum premium as a dividend for the company’s federal income tax emerged as an issue. Under Regulation section 1.811-2, “the term (dividend)

includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management.” The regulation further states, “similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company.” Thus, it was not surprising that nonguaranteed elements would be classified as dividends for company income tax. This issue was of great significance to “Phase II negative” companies, that is, companies whose gain from operations before deductions is less than taxable investment income. Because deductions for dividends to policyholders were limited to \$250,000 for companies in that tax situation, most if not all of the difference between the actual premium charged and the maximum premium would result in an increase to the gain from operations without a corresponding increase in allowable deductions for dividends to policyholders. This created a significant competitive issue for those companies, as neither the dividends nor deficiency reserves were deductible for those companies.

THE 1984 ACT

The 1984 Act addressed the issue of nonguaranteed elements by making policyholder dividends, broadly defined, deductible in computing life insurance company taxable income (subject to former section 809, since repealed). For many products, this has eliminated a deficiency reserves issue, as the guaranteed premium is set equal to or near the valuation net premium.

Congressional intent in the 1984 Act was to continue to disallow a deduction for “deficiency reserves.” The DEFRA Blue Book noted:

The new provision specifies that the reserve methods prescribed do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding “deficiency reserves” (whether such reserves are as defined under prior law or whether the NAIC prescribed method otherwise requires a company’s reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).

The limitation was enacted as section 807(d)(C)(3), which provides that “no additional reserve deduction” is allowed for deficiency reserves, but defines the deduction in terms of “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.” The statutory language appears to prevent the application of the statutory “minimum reserve” method in the development of federally prescribed reserves. In effect, this would not permit a “deficiency reserve” tax reserve component.

Section 816(h) excludes deficiency reserves from “life insurance reserves,” without defining deficiency reserves. This provision was not in the original 1984 language, but was added in the subsequent Technical Corrections as part of the Tax Reform Act of 1986. In general, deficiency reserves appear today only in limited circumstances. However, they are an element of *The Valuation of Life Insurance Policies Model Regulation* (Regulation XXX), creating a nondeductible element of the XXX reserves.

The final issue relative to deficiency reserves is their treatment in the “statutory cap.” Section 807(d) provides that the deductible reserve for a life insurance contract is the greater of net surrender value or the Federally Prescribed Reserve (FPR) calculated under prescribed interest rate and mortality assumptions, but in no event can the tax reserve exceed “aggregate statutory reserves” (*i.e.*, the statutory cap). On audit, the IRS has raised the issue of whether deficiency reserves are a part of the statutory cap, a position strongly held by the life insurance industry.⁹ The IRS Priority Business Plan for 2010–2011 includes providing guidance “clarifying whether deficiency reserves should be taken into account in computing the amount of statutory reserves under §807(d)(6),” (*i.e.*, the statutory cap).

CONCLUSION

The history of the tax treatment of deficiency reserves illustrates how decisions made in the development of life insurance tax laws may have implications far beyond what was anticipated by the drafters of the statutes. Although intended

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to reduce the overall tax on small stock life insurance companies (who were the majority of Phase II negative companies), as discussed above, the decision has had far-reaching consequences, more than 50 years later. It also continues to create controversy over the inclusion of deficiency reserves in the statutory cap. The introduction of nonguaranteed premiums as a way to minimize deficiency reserves also led in part to the emergence of the current section 808 definition of dividends, as well as the treatment of dividends in determining taxable income under the 1984 Act. If there is a lesson to be learned, it is simply that before practical expedients are introduced into the tax code, they should be judged in a broader and perhaps a more theoretical context, and not as a short-term fix to an immediate problem.

The views expressed are those of the author and do not necessarily represent those of Ernst & Young LLP. ◀

END NOTES

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