ACTUARY/ACCOUNTANT/TAX ATTORNEY DIALOGUE ON INTERNAL REVENUE CODE DEFERENCE TO THE NAIC PART I: TAX RESERVES

Peter Winslow (Moderator)
John T. Adney, Timothy Branch, Sheryl Flum, Susan Hotine, and Mark S. Smith

Editor's Note: *For our 10th anniversary year of* TAXING TIMES, *we are reviving a popular format that we have used several times over the years: a dialogue among tax professionals of various backgrounds (actuarial, legal and accounting) exploring federal income tax issues applicable to life insurance companies. This dialogue will examine the important and evolving topic of the extent to which the tax law defers to the NAIC in taxing life insurance companies. It is our most ambitious dialogue yet and will be published as a three-part series in this, and the next two editions of* TAXING TIMES. *The first part of the dialogue that follows focuses on tax reserves. The next part will continue with a discussion of product taxation, and the last in the series will be a catch-all of other life insurance tax provisions where deference to the NAIC may be relevant.*

I am grateful to Peter Winslow of Scribner, Hall & Thompson, LLP, for developing the concept for this dialogue and for volunteering to serve as moderator. A core group of panelists will join Peter in this series: Mark Smith of PricewaterhouseCoopers, LLP and Sheryl Flum of KPMG LLP (both of whom have previously headed the IRS Chief Counsel's Insurance Branch), along with Susan Hotine of Scribner, Hall & Thompson, LLP and John T. Adney of Davis & Harman, LLP. Susan, John and Peter were all active in the legislative process "in the beginning"—during the enactment of the Tax Reform Act of 1984.

Joining these impressive panelists will be two actuaries who will be familiar to TAXING TIMES *readers. Tim Branch of Ernst & Young LLP will cover the first and third parts of the dialogue on tax reserves and other company tax issues, and Brian King of Ernst & Young LLP will join the panelists for product taxation.*

We hope you enjoy these dialogues!

Peter Winslow: I am pleased to serve as a moderator of this dialogue on the general topic of deference to the NAIC in the federal income taxation of life insurance companies. This first part will focus on tax reserves. It seems to me that there are two major issues on tax reserves for our panelists to discuss. The first is the basic question of what types of liabilities are deductible on a reserve basis, and what role NAIC guidance has in answering that question. Once we determine what type of liability is deductible as a tax reserve, the second issue becomes how much is deductible. And, who gets to decide—the taxpayer, the NAIC, the state regulator, or the IRS? What I would like to do is organize our discussion into three sections. First, we can set the general rules by describing how the Tax Reform Act of 1984 dealt with tax reserves and deference to the NAIC. Then, we can move into a discussion of how the case law and IRS rulings have dealt with the deference issue since 1984. And, finally, we can speculate on where we may be heading on the NAIC deference issue in the future.

Before I turn it over to the panelists, I want to take a few minutes to set the stage on the state of the tax law before the 1984 Tax Act. Under the Life Insurance Company Income Tax Act of 1959, there were two Code sections that were most relevant on the question of what type of reserve was deductible. Former section 810(c) was much like current section 807(c) and listed the deductible tax reserves.

On the NAIC deference question, the pre-1984 law was somewhat of a mixed bag. On the one hand, the deductible reserve items could be considered terms of art used in NAIC accounting—so, to the extent Congress intended the NAIC's understanding of these terms of art to apply, there was some deference to how the NAIC characterized a particular reserve. On the other hand, the case law and IRS rulings placed a gloss on the statute to permit a deduction for only "insurance reserves," as opposed to surplus or contingency reserves.

The second relevant Code provision was former section 801(b) (similar to current section 816(b)), which prescribed computational requirements that must be met in order for an amount to be considered a deductible life insurance reserve.

Because of these computational requirements, deference to the NAIC did not apply to the classification of some reserves—at least in situations of failed life reserves. But, again, we had a mixed bag under pre-1984 law because, as a general rule, insurance reserves reported in the NAIC annual statement that flunked the computational requirements for life insurance reserves were usually still allowed as a deduction — typically reclassified for tax deduction purposes as unearned premium reserves.

Susan, how did Congress address this issue of what types of reserves are deductible under the 1984 Tax Act, and, please, focus particularly on the NAIC deference question? Before you answer, why don't you describe your role in the 1984 legislative process?

Susan Hotine: I was recruited by the staff of the Joint Committee on Taxation in the fall of 1981 from the Interpretative Division of the IRS Chief Counsel's Office, where I specialized in insurance tax issues, because Congress was expected to be taking up life insurance company tax legislation. By and large, I was the only Hill staffer who had any previous experience or familiarity with insurance accounting and tax issues.

Because so many of those working on the life insurance tax legislative project were starting from ground zero, the initial question with respect to reserves was not whether the Code should defer to the NAIC regarding what types of liabilities should be deductible on a reserve basis, but whether any liability should be deductible on a reserve basis. Treasury representatives argued very strongly that reserves should be limited to cash values; if the company did not have a cash surrender liability, the company should not recognize any reserve. So, I would say that, initially, the Hill staffers working on the project were not thinking of NAIC accounting or NAIC reserve requirements at all.

In the end, the items listed as deductible reserves under the 1984 Act were based on those that had been deductible under prior law, with some modifications regarding how they should be computed. There are the prescribed computation rules in section 807(d) for life insurance reserves, but then there were the requirements that section 807(c)(3) reserves be discounted at the appropriate rate of interest (i.e., the interest rate prescribed in section 807(d)(4)) and that special contingency reserves be "reasonable." Because the section 807(c) items are pretty much the same as they were under prior law, I would say that it was assumed that regulations and guidance under prior law would continue to be applicable. Although common industry understanding of what liabilities are referenced or included in the section 807(c) items would be relevant, at the same time the descriptive language used in the Code for the item might be used to determine what could be included therein. For example, the legislative history discussing the consequences of an annuity contract having less than permanent purchase rate guarantees explains that an increase in the fund for such contract will be treated as an increase in a reserve item under section 807(c)(3) or (4), presumably depending on whether the fund is discounted from a specific maturity value or is an accumulation fund.[1]

Peter: So, what I am hearing is that Treasury's view was not adopted and the drafters of the 1984 Act decided to just carry over the pre-1984 law on the types of liabilities that get reserve treatment – which I described as a mixed bag on the NAIC deference issue.

Susan: While I do not think that the drafters of the 1984 Act were thinking about deference to the NAIC generally with respect to the types of reserves eligible for reserve treatment, I do agree that by carrying over the reserve items from prior law, some prior law deference also might be carried over (to the extent not inconsistent with guidance issued under prior law or some change adopted by the 1984 Act).

Peter: Mark, it seems Susan and I agree that Congress intended to carry over pre-1984 law for the types of liabilities that get tax reserve treatment, yet a new phrase was added in section 807(c)(1) that identifies deductible life insurance reserves by a cross-reference to the computational requirements in section 816(b). Does this mean that Susan and I have gotten it wrong—Congress in fact changed the law to clarify that failed life insurance reserves are not deductible?

Mark Smith: I wouldn't say you and Susan have it wrong, but at the same time I don't think the question itself is that simple. That is because some amounts may be deductible by a life insurance company even if they do not represent life insurance reserves under section 807(c)(1). Section 807(c)(2) through (6) lists several categories of reserves that are deductible even though they are not life insurance reserves. Those categories include unearned premium reserves, amounts necessary to satisfy obligations under insurance contracts that do not involve life contingencies, special contingency reserves, and so on. True, the amount of the reserves is not computed in the

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same way one would compute life insurance reserves, but falling into one of those categories doesn't mean there is no reserve deduction at all.

Also, one element of the definition of life insurance reserves is that they be set aside to liquidate claims under life insurance, endowment or annuity contracts. Section 7702(g)—also added by the 1984 Act—includes a special rule that treats a failed life insurance contract as an "insurance contract" even if it's not a life insurance contract. This rule means that the issuer of failed life insurance contracts may still qualify as an insurance company, and reserves may still be deductible as reserves even if not as life insurance reserves.

It's worth pointing out that the 1984 Act Blue Book says that the reason for the cross-reference to section 816(a) is "merely to identify the type of reserve for which increases and decreases should be taken into account."[2] It does not superimpose a requirement of proper computation of state law reserves, nor does it provide license for the IRS or companies to bifurcate life insurance reserves between components that qualify and components that do not meet section 816(a)'s computational requirements for life insurance reserves. But here, I may be jumping ahead.

Peter: Now that we have set the stage for what types of reserves are deductible under the current law, let's jump ahead, as Mark says, and turn to the question of how much is deductible. On this issue I think there was quite a bit of deference to the NAIC under pre-1984 law. The Supreme Court held in *Standard Life*[3] that former section 818(a) required deference to established NAIC accounting procedures in calculating tax reserves. Specifically, the Court said that because accrual accounting is not controlling for life insurance reserves, "the statute requires use of the NAIC approach to fill the gap."

John, because you were heavily involved in the legislative process in 1984, can you share your insights on how Congress dealt in the 1984 Act with the issue of the deductible amount of reserves and the NAIC deference question?

John T. Adney: With regard to life insurance reserves within the meaning of section 807(c)(1), in 1984 Congress resolved to allow a deduction but to limit it, generally speaking, based on the minimum amount of reserves required under state law. Under prior law, the reserve deduction had been determined with reference to the reserves that an insurance company reported on its statutory annual statement, with a formulaic increase allowed for preliminary term reserves in order for the deduction to approximate net level reserves (under former section 818(c)), with the objective of providing all companies a similar deduction for similar liabilities. That objective remained in 1984, but a very different course was taken to achieve it. It was here, in the enactment of the section 807(d) rules, that deference to the NAIC emerged in the legislation.

In crafting the 1984 tax law, Congress was aware that state laws and regulations prescribed minimum reserve requirements with respect to life insurance and annuity products. These requirements were largely (though not completely) uniform throughout the nation due to the fact that the NAIC promulgated model laws and regulations relating to valuation of insurers' liabilities. The drafters of section 807(d) appropriated these requirements, more or less, in prescribing the calculation of the so-called federally prescribed reserves (FPR), which serve as one of the limits on the reserve deduction. (The other two limits found in section 807(d)—a minimum deduction based on contracts' net surrender values and a maximum based on the reserve reported in the annual statement—are unique to each insurance company taxpayer.) More specifically, the FPR for a given life insurance or annuity (or today, long-term care insurance) contract is determined using a maximum interest rate generally allowed by state law, a mortality or morbidity table generally required by state law, and a reserve "method" in wide use—all with the intent of providing a deduction based on the minimum amount of reserves generally required by state law. A detailed examination of each of these demonstrates the deference Congress showed to the NAIC's model rules, as well as the degree of that deference.

The interest rate prescribed for the FPR calculation by section 807(d) as originally enacted is the highest rate allowed by a majority of the states in valuing the liability for a contract at the time the contract is issued. This rate, denominated the "prevailing state assumed interest rate" (PSAR) in the tax law, is determined by drawing on formulas contained in uniform state laws that are premised on the NAIC's model valuation law, namely, the Standard Valuation Law. In 1987, Congress added another interest rate to the mix, incorporating into the FPR calculation the *greater* of the PSAR and an "applicable federal interest rate" borrowed from section 846. The latter rate had been developed solely to discount, for tax purposes, the loss reserves principally held by property-casualty insurers. While one may suspect that Congress added that rate to section 807(d) mainly for tax revenue reasons, it retained the PSAR in the calculation, and for a number of years now the PSAR has been the higher rate.

The rule relating to the mortality or morbidity table to be used in the FPR calculation shows even greater deference to the NAIC. The table employed in calculating the FPR for a given contract is generally the "most recent" table prescribed by the NAIC that it is permitted to be used for the type of contract involved by a majority of the states when the contract is issued. Thus, the identification of the table begins with the NAIC's approval; the statute refers to the "prevailing commissioners' standard tables," meaning the state insurance commissioners who make up the NAIC. In the absence of a prevailing table, the Treasury Department may by regulation prescribe the table to be used, and in taking that step the Treasury has typically drawn upon tables approved by the NAIC.[4]

The most striking instance of deference to the NAIC in section 807(d) lies in the rule describing the "tax reserve method." In this instance, Congress did not provide a direct role for the states, but instead chose to rely exclusively on the NAIC to prescribe the reserve method to be used in the FPR calculation. According to the statute, the CRVM is the commissioners' reserve valuation method to be used for a contract covered by the CRVM, the CARVM is the commissioners' annuity reserve valuation method to be used for a contract covered by the CARVM, and in both situations the named method is the one so named and defined by the NAIC that is in effect at the time the contract is issued. Further, for completeness, in the case of a type of contract not listed in it, the statute says to use the NAIC reserve method prescribed for that contract, and if the NAIC has failed to prescribe a method with respect to a contract, the method to be used for the contract must be consistent with one of the methods otherwise listed in the statute. The heavy reliance of the statute on the NAIC's prescription of the reserve method has broad implications for determining the manner in which section 807(d) will apply to principles based reserves.

It is true that for noncancellable accident and health insurance contracts, section 807(d) does not expressly reference the NAIC, instead specifying the use of a two-year preliminary term method (a one-year preliminary term method is used for qualified long-term care contracts). However, the very definition of a preliminary term method is rooted in NAIC model laws, regulations, and other guidance. On the other hand, in a clear divergence from the NAIC-prescribed reserve method, section 807(d) excludes deficiency reserves from the FPR. Also, to restrict the deduction for reserves so that there is an appropriate matching of income and expense for tax purposes, section 811 denies a deduction for reserves in respect of interest guaranteed beyond year-end at a rate above the section 807(d) interest rate as well as for reserves reflecting deferred and uncollected premiums. In these two situations, the interest earnings and the premiums, respectively, are not included in the insurer's gross income.

Peter: To summarize what you are saying as to the amount of the deduction for life insurance reserves, in the 1984 Act Congress could be said to have increased deference to the NAIC, except when it imposed specific adjustments, and even for the most important of these adjustments—interest and mortality assumptions—Congress could be said to have indirectly deferred to the NAIC by relying on 26-state rules.

John: That's right, Peter. Under pre-1984 law, Congress could be said to have deferred to the NAIC indirectly, by accepting as deductible reserves the amounts insurers recorded on their annual statements. But under the 1984 law, Congress explicitly deferred to the NAIC on the reserve method while making use of the NAIC's rules for the interest and mortality assumptions.

Peter: That's what Congress did in the 1984 Act for life insurance reserves. What about other types of reserves?

John: As Susan mentioned, section 807(c) places its own limits on the deductible amount of the section 807(c)(3) and (6) reserves. Section 807(c)(3) includes the reserves held for insurance and annuity contracts not involving life, health,

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or accident contingencies in the list of deductible items, and section 807(c) requires that the deduction be determined by discounting the annual statement amount for a contract at the greatest of the two rates used for the FPR and the rate assumed by the insurer in determining the guaranteed benefit under the contract. And, in the case of the section 807(c)(6) special contingency reserves for retired lives and premium stabilization, the deduction is limited to the "reasonable" amount of the reserves.

"There is no second pass through section 807(c)(1) to bifurcate a tax reserve between life and non-life features, nor is there room in the Code to disaggregate the annual statement reserve…."

Peter: So, I guess for these other types of reserves, deference to the NAIC is not as relevant in determining the amount of the deduction. But, let's go back to the question of the scope of NAIC deference relating to the types of liabilities that we get to deduct on a reserve basis. There is a general rule of statutory construction that terms of art used in the statute that are particular to a specific industry are interpreted consistently with that industry's understanding of the meaning. This concept has been applied to the insurance provisions of the Internal Revenue Code. It seems to me that in accordance with this rule of statutory construction there should be some deference to the NAIC to the extent current section 807(c) identifies deductible reserves using terms of art. Does it, Tim?

Tim Branch: As the lone actuary on the panel, I'd like to acknowledge that this topic is more in depth than the average valuation actuary normally ventures, and this information and historical perspective may be new to some of our readers. Generally, there is deference to the NAIC and the life insurance industry's terms of art in categorizing the section 807(c) deductible reserves. However, industry terms of art used by actuaries don't always line up nicely with the deductible reserve categories outlined in section 807(c). Most actuaries would not have difficulty categorizing life insurance and annuity reserves as section 807(c)(1) "life insurance" reserves (these are typically Exhibit 5 reserves from the NAIC Annual Statement). Section 807(c)(2), concerning "unpaid losses" and "unearned premiums," gets a little trickier as these terms are not defined in the Code (although they are defined in the regulations).[6] Generally actuaries look to the statutory definitions used in the applicable NAIC Statements of Statutory Accounting Principles[7] for determination of these amounts. But after we get past sections 807(c)(1) and 807(c)(2), and start to look at the terms of art used in the industry compared to the terms used in section 807(c)(3) through (6), things may not always be so clear.

An example of where section 807(c) categories don't line up nicely with industry terms of art would be certain pension plan contracts. Some pension plan contracts may have permanent annuity purchase rate guarantees, and would be categorized as section 807(c)(1) life insurance reserves, whereas others may be categorized as section 807(c)(3) or (4) reserves if they only have temporary annuity purchase rate guarantees (as Susan mentioned earlier). Under the industry terms or art, both of these contracts would typically be considered "pension plan" contracts by an actuary and not considered separately.

On the other hand, an example of where section 807(c) categories do line up nicely with industry terms of art would be contingent deferred annuities (CDAs), which are a type of longevity insurance where benefits are paid to policyholders if they survive to a specified age and certain designated investments are depleted. The insurance industry and the NAIC both consider this type of product to be an annuity (the NAIC describes progress in "establishing CDAs as a distinct annuity product best sold by life insurance companies").[8] In various Private Letter Rulings,[9] some of which Sheryl may be familiar with, the IRS has deferred to the NAIC and industry's categorization, and held that these types of contracts are more annuity than financial guarantee. Based on these rulings, it appears that CDAs should be classified as section 807(c)(1) annuity reserves.

As actuaries, we'd like to have a roadmap of how the NAIC reserve categories (e.g., Exhibits 5, 6, 7 and 8 in the NAIC Annual Statement) translate to the corresponding section 807(c)(1) through (6) categories, but unfortunately this is not always possible.

Peter: For me, it is helpful to think of the deductible reserve items listed in section 807(c), not so much classifying them by types of contracts as you might as an actuary, but instead in a time continuum that includes four general categories: pre-effective-date items, such as advance premiums and premium deposits; pre-claim reserve items, such as premium reserves, active-lives reserves and unearned premiums; claim reserves; and post-claim reserves, such as dividend accumulations and amounts held as interest. Viewed this way, it's easier for me to think about the NAIC deference issue. I ask myself "how does the NAIC annual statement deal with reserve accounting during these various time periods?"

Mark: Whether you try to map the section 807(c) reserve categories to types of contracts or to a time continuum in a single contract's life cycle, I would think you end up with many of the same questions. I do like the "time continuum" you describe, Peter, because it also makes sense of the fact that at some point a claim payable under a particular contract may become a liability of the company and no longer a reserve item at all.

Peter: John mentioned the limitation on the deduction based on statutory reserves. Does deference to the NAIC have any relevance in determining statutory reserves for this purpose?

Mark: It would be hard to say the NAIC is "irrelevant" to any of this, but really the statutory reserve cap defers to what is reported on the annual statement, not what is required by the NAIC. The NAIC is influential in prescribing model laws and regulations, and actuarial guidelines, but here the state insurance regulators are in control. The reason I say this is found in the Code itself: Whereas the computational rules apply the CRVM (or CARVM) "prescribed by the [NAIC]," and the "prevailing" mortality tables and interest rates when the contract is issued, section 807(d)(6) refers simply to "the aggregate amount set forth in the annual statement with regard to items described in section 807(c)." This means that "statutory reserves" means just that, statutory reserves. If a state imposes a different requirement from that set out in NAIC model laws, model regulations, and actuarial guidelines, the state requirements govern.

As a practical matter, the statutory reserve cap prevents a company from deducting more than the amount it has set aside for regulatory purposes, that is, the amount set forth in the annual statement. Other than the Code's instruction to exclude reserves attributable to a deferred and uncollected premium, if such a reserve isn't permitted under the Code's no double-counting rule, it is pretty clear that you pick up what is on the annual statement "with respect to" the reserve items listed in section 807(c). That list is not limited to life insurance reserves.

This is a useful reminder that there are not multiple "bites at the apple" to disqualify life insurance reserves under section 807. Once it is determined that a reserve is a life insurance reserve, section 807(d)(2) prescribes the tax reserve method, and the amount determined under the tax reserve method is bounded by a floor (the contract's net surrender value) and a cap (the annual statement reserve with respect to the contract). There is no second pass through section 807(c)(1) to bifurcate a tax reserve between life and non-life features, nor is there room in the Code to disaggregate the annual statement reserve with respect to a contract between life and non-life features. The Code does not do this; neither does the NAIC nor any state regulator.

Peter: Now that we've spent some time on what Congress did in 1984, I would like to turn to how the IRS has dealt with the issue of NAIC deference in its guidance and in litigation. To stir things up a little, I will make two observations. First, my sense is that the National Office Insurance Branch has been reluctant to fully accept NAIC deference—sometimes even where Congress dictated deference. And, second, on the deference issue, the IRS sometimes has conflated the question of whether the liability is deductible on a reserve basis with the question of how much is deductible. Sheryl, as the last head of the Insurance Branch, you are probably in the best position to comment on the IRS's view on the deference issue.

Sheryl Flum: I want to start by reminding everyone that my comments are my opinions and do not necessarily reflect the views of the IRS or my current employer, KPMG LLP. In order to understand the tension between the IRS and life insurance taxpayers regarding the weight to be given NAIC guidance when interpreting the tax law, we need to recognize that there is an inherent tension between the concerns of the NAIC and the concerns of the IRS. The reserve rules put forth by the NAIC are intended to ensure that insurance companies remain financially stable and have sufficient funds available to pay policyholder claims. In other words, the NAIC's primary concern is consumer protection. The Internal Revenue Code should be interpreted so that all taxpayers' taxable incomes are determined fairly and uniformly, and the IRS's interpretations tend to focus on not providing unfair advantages or windfalls to any one group of taxpayers. Given this difference in starting points, it is no surprise that statutory reserving principles have historically tended to be more conservative, i.e., often yielding higher reserves, than the income tax rules for computing reserves.

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The legislative history from 1984 indicates that Congress intended that the federally prescribed reserves (FPR) be computed differently than the statutory reserve used for NAIC purposes. The IRS has taken the position that Congress intended that any interpretation of CRVM or CARVM for purposes of the FPR look to tax principles, and not to consumer protection principles. But the plain language of section 807 provides that CRVM and CARVM are prescribed by the NAIC. So to comply with the statute, the government views the FPR's starting point as the CRVM and CARVM as prescribed by the NAIC and then adjusted, as appropriate, to comply with tax principles.

To complicate matters, it seems that Congress's understanding in 1984 of how reserve methods were determined by state regulators was not completely accurate. Congress appears to have assumed that there would always be a prevailing reserve method for any life insurance product even if the NAIC had not issued an Actuarial Guideline or other requirement standardizing the operation of the reserve method. In reality, though, such standardization either does not exist or is not sufficiently documented by state insurance regulators for taxpayers (or the IRS) to rely upon. Nonetheless, the IRS interpreted section 807(d)(3) to mean that there was always an identifiable prevailing reserve method that would be applicable to any life or annuity contract as of the date the contract was executed.

The government has taken the position that CRVM and CARVM must be static over the life of the contract. Even though the IRS recognized in Rev. Rul. 94-74[10] that a company could choose to switch reserve assumptions within a method between two acceptable approaches (i.e., continuous v. curtate functions), it also took the position that once a life insurance company adopts a reserve method that is accepted by its regulator, that method must be the company's reserve method and the company cannot change to a different acceptable method. This disconnected position has led to litigation.[11]

In *American Financial*,[12] the taxpayer used a reserve method accepted by its regulator in computing statutory reserves for variable annuity contracts at the time those contracts were issued. It used that same reserve method to determine its FPR. Several years later, the NAIC issued AG 33 and the taxpayer changed its reserve method for both FPR and statutory purposes to that prescribed by AG 33. The IRS disallowed the reserve adjustment, asserting that the method employed prior to AG 33's adoption was a prevailing method and the taxpayer must continue to use for FPR purposes the reserve method prescribed as of the date the contracts were issued. The taxpayer argued that section 807(d) requires that the FPR be determined using the reserve method prescribed by the NAIC, and the NAIC required that AG 33 be applied for all contracts written after 1981. It further argued that the method prescribed by AG 33 was an acceptable reserve method that it could have chosen to use even before AG 33 was issued. The Sixth Circuit's opinion affirming the District Court's holding in favor of the taxpayer is quite instructive. The court clearly explains that the Internal Revenue Code defers to the NAIC to determine the method to apply for computing the FPR. The opinion interprets section 807(d)(3)(B)(ii) to mean that if the NAIC replaces the Standard Valuation Law or materially amends it, or issues new interpretive regulations, or issues an actuarial guideline that materially changes the commissioners' method, the taxpayer would be able to use that new reserve method prospectively only, but that AG 33 did not materially change the CARVM. Since the IRS has not issued an Action on Decision on *American Financial,* we do not know whether the government will continue to assert that CARVM and CRVM must be static.

Tim: It's also noteworthy that in the introduction to "Appendix C Actuarial Guidelines" of the NAIC's "Accounting Practices and Procedures Manual," the NAIC states that the guidelines are "merely a guide to be used in applying a statute to a specific circumstance," and not intended to be viewed as "statutory revisions." Based on the *American Financial* decision, it appears that the court deferred to the NAIC's own assessment of the role of its guidelines.

Peter: You have put your finger on the dispute in this area. Taxpayers, like American Financial, say that, with respect to the method for computing the FPR, the Code defers to the NAIC and the IRS has said "not always." In general, the IRS has agreed that deference is required to the method as defined by the NAIC at the time the contract is issued—but not if the NAIC later changes its mind and not if the NAIC's method includes a type of reserving method the IRS does not like (for example, stochastic reserves).

Tim: There has also been another recent case, *Acuity v. Commissioner*, involving property and casualty tax reserves that ended favorably for the taxpayer based on deference to the NAIC reserves. At issue were the insurance company's reserves used to determine underwriting income under section 832(b)(1)(A), which defers to reserves "computed on the basis … of the annual statement approved by the National Association of Insurance Commissioners." The IRS claimed that the company's reserves were excessive, however, the court's opinion held that Acuity's reserves were "computed in accordance with the rules of the [NAIC] and the Actuarial Standards of Practice (ASOPs) and … fell within a range of reasonable reserve estimates,"[13] and the deduction was allowed.

Peter: There's another property/casualty case, *State Farm*,[14] that bears directly on the deference issue—specifically the important difference between deference to the NAIC and deference to a single state regulator.

Sheryl: The relevant part of the *State Farm* case involved the company's treatment of $202 million liability for compensatory and punitive damages due to a finding of bad faith in State Farm's handling of an accident claim. State Farm included the liability as a discounted unpaid loss under section 832(b)(5). The IRS challenged by asserting that losses incurred must be "on the insurance contract" and that awards for bad faith were outside the scope of the contract. The Tax Court ruled in favor of the IRS, and State Farm appealed.

The Seventh Circuit reversed the Tax Court's holding with regard to the compensatory damage awarded for bad faith because Congress intended that unpaid losses be determined by reference to the amount reported on the Annual Statement. The Annual Statement, of course, uses NAIC rules and regulations. The court actually held that deference to the NAIC's determination of unpaid losses is built into the Code. Since the NAIC requires non-life insurance companies to include extra-contractual compensatory liabilities as unpaid losses for statutory purposes on the Annual Statement, the court held that the compensatory liability at issue must be deductible.

Peter: I think *State Farm* is important because the deference to the NAIC was on the question of whether a particular type of liability can be considered part of deductible reserves, not strictly on the computational issue. Also, it's important what the court said about single state reserve requirements.

Mark: Well, that's where it gets interesting. In its analysis of the punitive damages issue, the Seventh Circuit had to address head-on the company's argument that various auditors and state regulators had approved the company's annual statements for the years at issue and had not taken exception to the inclusion of punitive damages in unpaid losses. The Seventh Circuit gave this argument no weight, and went so far as to say "[w]e are not bound by the section 832 statutory language to consider the views of any auditor or regulator other than the NAIC as a whole."[15] I find that remarkable, especially since the statutory reserve cap in section 846(a)(3) for non-life reserves makes specific reference to "the annual statement filed by the taxpayer." The rule seems to be that for nonlife reserves, NAIC methods control over single state requirements in computing the tax reserve, but not for purposes of applying the statutory cap on tax-deductible reserves. The analogies to section 807 here are striking.

Tim: That's right. Care must be taken when certain state insurance departments allow permitted reserving practices which may be different from the method prescribed by the NAIC. It's important to remember that in these situations where deviations from the NAIC method are allowed for statutory purposes, the method prescribed by the NAIC (in effect at the issuance of a contract) must still be used to determine the appropriate FPR for tax purposes. However, the statutory cap would still be based on the "amount set forth in the annual statement" (i.e., the amount computed under the permitted practice).

Mark: If there were ever any doubt about the IRS's thoughts on a single state's requirements versus NAIC-prescribed methods, one really ought to re-read the Technical Advice Memorandum on the Connecticut Method of reserving for Guaranteed Minimum Death Benefits.[16] There, the IRS rejected a company's argument that it should be allowed to use an approach based on an assumed one-third drop in asset values, on the theory that the method was more conservative than that required by the other 49 states. Rightly or wrongly, this is an area where the IRS has taken a very literal approach to the single state issue.

John: Sheryl makes a good point about the difficulty of determining the details of the prevailing reserve method in some instances. Congress deferred to the NAIC on the method because it had no method of its own to suggest, apart from desiring that a preliminary term method be used for life insurance and noncancellable A&H. When section 807(d) was enacted, the use of actuarial guidelines was in its infancy, and they were not even mentioned in the statute's legislative history. While Congress presumed the existence of an NAIC-prescribed method, at least in the case of life insurance and annuity contracts, it sensed (or was told) that the details would

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not always be spelled out by the NAIC, and so it instructed in the legislative history that if specific factors in the reserve method are not prescribed by the NAIC, the prevailing state interpretation of those factors should be considered.[17] Unfortunately, we are not told how to determine the prevailing state interpretation, and there is no single source of guidance on what that interpretation is.[18]

Peter: I have always interpreted this legislative history to mean that if the NAIC has not specifically prescribed a reserve factor, then we can look to the 26-state interpretation because, after all, 26 states represent a majority of the NAIC. So, to me, this legislative history is still just part of the 1984 Act's deference to the NAIC with respect to the tax reserve method. But, this 26-state rule in the legislative history should only apply if there is a clear majority state view as to a required factor (because otherwise there is no quasi-NAIC action). This situation has not come into play often.

Mark, Sheryl has discussed how the NAIC-deference issue has led to conflicts in implementing new NAIC actuarial guidelines. Let's go back to your earlier comments. What about the related deference issue as to whether the full NAIC-prescribed reserve is deductible as part of the FPR—for example the Conditional Tail Expectation (CTE) Amount under AG 43 for variable annuities? Do we defer to the NAIC if it defines CRVM or CARVM to include a stochastic reserve or does the IRS have the authority to say a portion of the reserve is non-deductible?

Mark: I personally believe there are compelling arguments for including the CTE Amount in the FPR, simply under the plain language of the Code. The FPR is determined using "the tax reserve method," which in turn means either the CARVM or CRVM that applies to the contract as prescribed by the NAIC. I don't see the Code as giving discretion to IRS to disaggregate, or bifurcate, a reserve that is a CARVM reserve under NAIC guidance. For a variable annuity that is governed by AG 43, a reserve that excludes a positive CTE Amount does not satisfy CARVM, period. What would be left of a reserve if IRS had discretion to remove some features that CARVM itself requires? Would the remaining reserve still be a CARVM reserve? Would something be added in substitution of the features excluded? What in the world would that be?

Notice 2010-29[19] was a useful first step in this area, providing interim guidance to companies that the IRS would honor as it continued to study the operation of AG 43 and the emergence of Life PBR. Notice 2010-29 was never intended to be the last word in this area, and at some point will become problematic if it functions as permanent, substantive guidance. The Notice's silence about the statutory reserve cap should not be read to create a negative inference about the inclusion of the CTE Amount in the cap. That issue was under consideration in 2010 and has been on the Priority Guidance Plan ever since. Likewise, the Notice's instruction not to include the CTE Amount in the FPR was included, in part, because the IRS was still considering the reasonableness of the allocation methodology that AG 43 itself uses to allocate the CTE Amount to individual contracts. The operation of that methodology in practice is now better understood, and a fresh look is warranted.

The same issue will present itself with the adoption of Life PBR: What is the status of the Stochastic Reserve and is it included in the FPR for tax purposes? At least to me, it is hard to imagine the IRS resolving that issue in a way that is inconsistent with its treatment of the CTE Amount under AG 43.

Sheryl: I agree with Mark that the CTE Amount is part of CARVM and should be accounted for in the FPR. However, the reserve method is only one part of the FPR. The FPR also requires use of a mortality or morbidity table required by state law and a maximum interest rate prescribed by either state or federal law. The CTE Amount is not computed using either a standard table or the maximum interest rate. So in order to include the CTE Amount in the FPR, the CTE Amount would need to be recalculated. The administrative complexity of such a recomputation would likely make it uneconomic to actually include the CTE Amount in the FPR even if it is part of CARVM.

Mark: Notice 2008-18 suggested a handful of alternative approaches to address what interest rate and mortality tables should apply to compute an FPR that includes a stochastic component such as the CTE Amount. In practice, some of those approaches might be dismissed as uneconomic and some might not. It depends on what approaches are taken. I think at least some of those approaches were administrable.

Peter: I don't think the problem is the cost; it is more the problem of trying to fit a square peg into a round hole. A good argument can be made that the CTE Amount must be included in the FPR because it is needed to comply with the NAIC's prescribed CARVM, but that no adjustment is required for the interest rate because making such an adjustment would do violence to CARVM, likely not reduce tax reserves and make no sense. In other words, the requirement to use the AFIR in section 807(d) should only apply when the use of a single discount rate is compatible with the NAIC-prescribed method. I also think that the IRS's notices present two additional problems with respect to stochastic reserves that the NAIC has required to be part of CRVM or CARVM. The first problem is that the IRS has not caught up with the way courts now look at statutory construction—and the requirement to apply the plain language of the statute. The second problem is an apparent assumption on the part of the IRS that stochastically computed reserves are surplus reserves held for asset inadequacy, rather than deductible insurance reserves.

John: Peter, I agree that it is difficult to reconcile the plain language of section 807(d) with Notice 2010-29's hesitation to include the CTE Amount in either the FPR or the statutory cap. As Mark pointed out, section 807(d) looks to the NAIC to prescribe the tax reserve method, and in AG 43, the NAIC prescribed a method that included the CTE Amount in the reserve. Without the CTE Amount when it exceeds the Standard Scenario Amount (SSA), the reserve established is not a reserve according to the CARVM. The same will be true of the Stochastic and Deterministic Reserves under Life PBR when SVL II and VM-20 come on line. A Life PBR reserve that omits those elements when they exceed the net premium floor will not be a reserve according to the CRVM. The IRS may be concerned about where this brave new world will lead, but the statute says what the statute says: Congress in 1984 relied on the NAIC to define what is the reserve method. The courts will enforce the statute and will observe that if there is a problem with the statute, the resort is to Congress, and only to Congress.

Peter: With four years of AG 43 under our belt, it has become clear that the SSA of AG 43 standing alone is not a sufficient CARVM reserve, particularly in light of the reduction of the SSA for approved hedges. This calls into question whether the interim guidance in Notice 2010-29 should be reconsidered. If it isn't, the Notice's validity is likely to be challenged.

Tim, what about my second point – from an actuarial perspective is the Notice's implication correct that all stochastic reserves should be treated as non-deductible reserves for asset inadequacies?

Tim: It's not explicit in the Notice that *all* stochastic reserves should be treated as non-deductible reserves; the interim guidance simply says that the CTE Amount is not taken into account for purposes of determining the federally prescribed reserve under section 807(d)(2). It does not go on to say why the CTE Amount is not taken into account, which leaves us to speculate that the IRS may consider it to be similar in nature to a deficiency or asset adequacy reserve (neither of which are deductible under section 807). The Notice goes on to say that no inference can be drawn for purposes of Life PBR or other tax issues, so it's not a certainty that other stochastic reserves will be treated as non-deductible (although it appears the IRS may be headed in that direction). Part of the IRS's reluctance to include stochastic reserves as life insurance reserves may come from the degree of actuarial judgment involved in setting these reserves. Instead of a constant, deterministic projection and discount rates, the CTE Amount is calculated using 1,000 (or more) stochastically generated economic paths. Instead of prescribed assumptions, prudent estimate assumptions are determined by the actuary based on relevance, availability and credibility. The concepts of actuaries choosing reserve assumptions, and multiple economic scenarios, deviates from the "prescribed" and "prevailing" language in the Code (although one can make the argument that these prudent estimates are "prescribed" by the AG). The lack of historical reserve trends of stochastic reserves may also be troubling

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to the IRS; the industry is still adjusting to the less predictable nature of the CTE Amount for statutory purposes, and there may be a concern in the IRS about the predictability of taxable income produced by these types of reserves. Again, the Notice is meant to provide interim guidance, so the IRS may be taking a "wait and see" approach with respect to stochastic reserves.

Peter: Your comment highlights one of the primary reasons we are having this dialogue. It may be true that the IRS has all these concerns about stochastic reserves, but I question whether the IRS has the authority to say that they are not part of the deductible FPR if the NAIC has prescribed them as an essential component of CRVM or CARVM reserves. I also think there is a distinction to be drawn between a stochastic reserve that is designed to arrive at a minimum reserve to be held for the specific class of contract benefits and an asset adequacy reserve that is computed after the minimum reserve has been established and determined of the basis of the company's total assets and liabilities. Both types of reserves may be based on cash flows from multiple scenarios using actuarial judgment, but their purpose and character are materially different.

Mark: I think you've hit the nail on the head. Life insurance reserves represent the value of a company's obligations to its policyholders. When those reserves are computed by reference to asset values or models of asset values, some may mistakenly assume that the reserves are established to protect the company as owner of those assets. This is a dangerous and sometimes incorrect leap, because sometimes the risk that asset values will change represents a risk that more will be owed to the policyholder. The only way to make sense of this is to stay focused on the purpose of the computation: is it a measurement of the minimum reserve to be held to satisfy or liquidate obligations to policyholders, or is it instead determined after such a minimum reserve is computed, based on the assets and liabilities of the company? The trend to using stochastic reserves for statutory purposes obviously makes the issue important for tax as well. This is a current challenge for a system that both disallows deductions for asset adequacy reserves and defers to statutory accounting as defined by the NAIC.

Peter: Now that we've identified some of the issues of NAIC deference under prior law and current law, let's look to a future. Susan, how did former Ways & Means Committee Chairman Camp deal with the deference issue?

Susan: Under the Camp Discussion Draft, the current-law prescribed discount rate for life insurance reserves would be replaced with the average applicable Federal mid-term rate over the 60 months ending before the beginning of the calendar year for which the determination is made, plus 3.5 percentage points. The effect of the provision on computing reserves for contracts issued before the (2015) effective date would be taken into account ratably over the succeeding eight tax years (there would be no "fresh start"). For the tax reserve computation, the Camp Discussion Draft retains the use of the NAIC recommended reserve method for tax reserves (and so the deference to the NAIC in that area). However, by setting a new federally prescribed assumed interest rate and eliminating the use of the prevailing state assumed interest rate entirely from the tax reserve computation, Camp's Draft moves away from any NAIC deference with respect to permitted assumed interest rates.

Peter: That's what the Camp Draft would do. From your experience in helping draft the 1984 Act, and from lessons learned under the 1984 Act, what do you think Congress should do in comprehensive tax reform on the deference issue for tax reserves?

Susan: The problem for a comprehensive tax reform that covers life insurance companies is pretty much the same as it was for the Congress in 1984. Life insurance companies issue contracts that have potential liabilities far into the future; even though premiums may be paid currently, and invested to earn current investment income, the companies' use of the premiums and investment income is limited and restricted by state insurance regulators through minimum reserve requirements. Because of those regulatory restrictions, the companies do not have free use of all their assets as might be the case for non-insurance companies. The tax code has generally recognized the uniqueness of an insurance company's regulatory restrictions for maintaining required reserves by allowing a reserve deduction. By adopting certain prescribed rules for computing tax reserves, Congress regularized the amount of the deduction among similarly situated companies, which the Camp Discussion Draft would continue and which I think would be important under any comprehensive tax reform proposal. At the same time, by incorporating a clear deference to the NAIC, current law contains an implicit acknowledgement that an insurance reserve computation is not your typical "present value" tax computation. As with other industries, the life insurance industry's products are ever evolving,

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incorporating new benefits and factors to consider. The NAIC reserving recommendations are designed to address these evolving benefits and other factors, to properly measure a life insurance company's future liabilities. I think it would be important for any comprehensive tax reform proposal to continue a deference to NAIC reserving recommendations so that the Code maintains flexibility for the computation of tax reserves to address evolving industry products in the future.

John: Agreed. Given the complexity of insurance products today, the statutory reserving rules necessarily must be complex, and if Congress desires to impose tax on the income of companies, there seems little choice but to follow the NAIC's rules as to the reserve method. To do otherwise risks imposing tax without regard to income.

Peter: I'd like to thank the panel for this lively discussion on tax reserves. I look forward to our continuing discussion of the deference issue as it relates to product tax issues. Until then ….◂

Note: The views expressed herein are those of the authors and do not necessarily reflect the views of their current or former employers.

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END NOTES

1. S. Prt. 98-169, Vol I, at 527, n.7 (1984).
2. Joint Comm. Tax'n, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) 598 (1984).
3. *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148, 151 (1977).
4. *See* Treas. Reg. § 1.807-1.
5. *Mutual Benefit Life Ins. Co. v. Commissioner*, 488 F.2d 1101 (3d. Cir. 1973); *Alinco Life Ins. Co. v. United States*, 373 F.2d 336 (Ct. Cl. 1967).
6. Treas. Reg. § 1.801-3.
7. "SSAP 53 Property Casualty Contracts – Premiums," "SSAP 54 Individual and Group Accident and Health Contracts."
8. http://www.naic.org/cipr_topics/topic_contingent_deferred_annuities.htm.
9. *See* PLR 201117013; PLR 201117012; PLR 201105005; PLR 201105004; PLR 201001016; PLR 200949036; PLR 200949007.
10. 1994-2 C.B. 157.
11. *See American Financial Group v. United States*, 726 F. Supp. 2d 802 (S.D. Ohio), *aff'd,* 678 F.3d 422 (6th Cir. 2012); *Cigna Corp. v. Commissioner,* T.C. Memo. 2012-266.
12. T.C. Memo. 2013-209.
13. *Id.*
14. *State Farm Mutual Automobile Ins. Co. v. Commissioner,* 698 F.3d 357 (7th Cir. 2012).
15. 698 F.3d at 366.
16. Technical Advice Memorandum 200448046.
17. *See* Joint Comm. Tax'n, JCS-41-84, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Pub. L. No. 98-369) 601 (1984).
18. For a discussion of this subject, see Edward Robbins and Richard Bush, *Tax Basis Assets and Liabilities of U.S. Life Insurers* pp.106–107 (ACTEX Publications 2014).
19. 2010-15 I.R.B. 547.