

Taxation Section Webcast: “Federal Income Tax Issues Every Company Must Consider under Life PBR”

By Kristin R. Norberg, Mark S. Smith, and Peter H. Winslow

On June 10, 2016, the Taxation Section hosted a webcast entitled “Federal Income Tax Issues Every Company Must Consider under Life PBR.” Panelists Kristin R. Norberg, Mark S. Smith, and Peter H. Winslow led the audience through an exploration of the many potential tax issues and areas of interpretation that will arise once principle-based reserves (PBR) becomes the new statutory financial reporting regime for life insurance contracts.

The webcast had a great turn-out, with approximately 120 sites registered and well over 900 participants. Three-quarters of respondents to the polling questions identified as actuaries who are not primarily focused on tax. This was by far the largest audience the Taxation Section has attracted for a webcast, which is indicative of the importance of this topic as the industry marches ever closer to the operative date for Life PBR.

After a brief update on the state adoption status and an introduction to past guidance from the Internal Revenue Service (IRS), the panelists explored topics in the following categories:

- **Policyholder tax compliance**—relating to the concurrent adoption of the 2017 Commissioners’ Standard Ordinary Mortality Tables.
- **Transition rules**—including the initial three-year transition, the small company and single-state exemptions, and issues for companies domiciled in states that have not yet adopted PBR.
- **The three components of PBR**—the net premium, deterministic, and stochastic reserve components, addressing the inclusion of each component in the federally prescribed reserve and the statutory cap, as well as approaches for meeting the interest and mortality requirements and the other computational rules of Internal Revenue Code section 807(d).



Within each category of topics, the panelists first explained the relevant requirements in the NAIC’s Valuation Manual, the rules in the Internal Revenue Code, and any available guidance from the IRS, then continued with an open discussion of the interpretational challenges and potential ways to approach each tax compliance issue. Additionally, the panelists provided a reference to the many informative articles and dialogues that have been published in *TAXING TIMES* throughout the newsletter’s history (see sidebar).

CONTINUING PBR ADOPTION ACTIVITY

Later on the day of the webcast, the NAIC Joint Executive (EX) Committee and Plenary approved the recommendation of the Principle-Based Reserving Implementation (EX) Task Force that the legislation enacted in 45 states met the “substantially similar terms and provisions” threshold in the Standard Valuation Law, leading to an operative date of Jan. 1, 2017. At the date of this writing, 46 states, representing over 85 percent of relevant industry premium, had enacted a new version of the Standard Valuation Law to enable PBR, and legislation is progressing through the Massachusetts legislature. Additionally, the New York Department of Financial Services (DFS) Superintendent Maria T. Vullo announced on

July 6, 2016 that the DFS would adopt PBR, likely with some New York-specific guidelines and safeguards, beginning January 2018.¹ The future of life insurance reserving is here, and it is incumbent on the actuarial and tax professionals in insurance companies to work together to be ready to comply with the new regime for tax purposes as well as for statutory financial reporting. We hope this webcast helped companies along this journey by identifying key issues where each company will need to develop and document its tax interpretations.

If you missed the webcast, you can purchase a recording on the SOA website, <https://www.soa.org/professional-development/archive/webcast-recordings.aspx>. ■

ENDNOTES

¹ <http://www.dfs.ny.gov/about/press/pr1607061.htm> (accessed 8/5/2016).

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ARTICLES ON PBR IN PAST ISSUES OF *TAXING TIMES*

Joseph F. McKeever, III, John T. Adney and Lori A. Robbins, "The Federal Income Tax Consequences of Adopting a Principles-Based Life Insurance Reserve System," 1 *TAXING TIMES*, Vol. 2, Issue 1 (May 2006)

Consequences of Adopting a Principles-Based Life Insurance Reserve System," 1 *TAXING TIMES*, Vol. 2, Issue 1 (May 2006)

Kory J. Olsen, "Tax Implications of Applying Principles-Based Reserves Retroactively," 12 *TAXING TIMES*, Vol. 2, Issue 1 (May 2006)

Edward L. Robbins and Peter H. Winslow, "Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves Subject to CRVM," 1 *TAXING TIMES*, Vol. 3, Issue 1 (February 2007)

Christian DesRochers and Peter H. Winslow, "Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principles-Based Reserves (Part II)," 1 *TAXING TIMES*, Vol. 3, Issue 2 (May 2007)

Christian DesRochers, "Tax Uncertainty Swirls Around Principles-Based Reserves," 15 *TAXING TIMES*, Vol. 3, Issue 3 (September 2007)

Edward L. Robbins, "Calculation of Tax Expense in a Principles-Based Reserves Environment," 24 *TAXING TIMES*, Vol. 4, Issue 1 (February 2008)

Peter H. Winslow, Christian DesRochers and Edward L. Robbins, "Tax Attorney and Tax Actuary Dialogue on IRS Notice 2008-18—AG VACARVM and Life PBR (Part III)," 1 *TAXING TIMES*, Supplement (March 2008)

Peter H. Winslow, "The Tax Reserve Method Should Be PBR Once It Is Adopted by the NAIC," 24 *TAXING TIMES*, Vol. 4, Issue 3 (September 2008)

Christian DesRochers, Mark S. Smith and Peter H. Winslow, "Actuary/Tax Attorney Dialogue on Selected Tax Issues in Principle-Based Reserves (Part IV)," 46 *TAXING TIMES*, Vol. 9, Issue 1 (February 2013)

Peter H. Winslow, "Options for Inclusion of Stochastic Reserves in Federally-Prescribed Reserves," 21 *TAXING TIMES*, Vol. 12, Issue 1 (March 2016)

Peter H. Winslow, "VM-20 Deterministic Reserves in Federally-Prescribed Reserves," 26 *TAXING TIMES*, Vol. 12, Issue 2 (June 2016)

Subchapter L: Can You Believe It? The Internal Revenue Code Requires Companies to Use Statutory Reserve Assumptions for Tax Reserves (Except Where It Doesn't)

By: Peter H. Winslow

Insurance tax professionals sometimes downplay the role of statutory reserves in the computation of tax reserves, asserting that Federally Prescribed Reserves are required to be computed in accordance with I.R.C. § 807(d). This is an incomplete and often misleading way to describe the tax reserve provisions. In fact, the proper starting place for computing tax reserves is not I.R.C. § 807(d), which provides certain rules for computing life insurance reserves, but I.R.C. § 811, the Internal Revenue Code (the Code) section that sets forth the accounting requirements for determining life insurance company taxable income. This hierarchy of relevant Code provisions has important ramifications in determining deductible tax reserves.

I.R.C. § 811(a) provides a general rule that taxable income for life insurance companies shall be determined using the accrual method of accounting. But, this Code provision goes on to add the following qualification to the general accrual accounting rule:

To the extent not inconsistent with the preceding sentence or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

In the 1977 *Standard Life & Accident*¹ case, the Supreme Court interpreted similar language in the predecessor of I.R.C. § 811 to mean that NAIC accounting principles must be used for tax



reserves because accrual accounting concepts are not applicable. In that case, the Supreme Court further concluded that accrual accounting should not apply to exclude unaccrued net deferred and uncollected premiums from gross income because doing so would be inconsistent with NAIC accounting. This Supreme Court holding was overturned by Congress in the 1984 Act. Congress amended the accounting provisions in what is now I.R.C. § 811(a) to legislatively reverse the holding of *Standard Life & Accident* as it related to the timing for recognition of premium income. As a result, premium income is now determined on an accrual basis and unaccrued deferred and uncollected premiums are no longer included in gross income. To make sure that premium income and reserve deductions remained matched, a special provision was added in I.R.C. § 811(c)(1) to exclude deferred and uncollected premiums from tax reserves. Importantly, however, the 1984 Act did not change the Supreme Court's holding as it related to tax reserves generally; I.R.C. § 811(a) carried over the basic rule that NAIC accounting rules apply to tax reserves, *i.e.*, because tax concepts of accrual accounting do not apply to insurance reserves, which Subchapter L specifically allows as deductions.

It is true that the 1984 Act added new I.R.C. § 807(d) that sets forth specific rules for computing some tax reserves. That Code section provides that life insurance reserves in most, but not all, cases should be computed using the NAIC-prescribed tax reserve method, specified prevailing mortality and morbidity tables and assumed rates of interest. The § 807(d)-mandated tax reserve method and assumptions do not operate in a vacuum, however; they are adjustments made to statutory reserves. The legislative history makes this clear:

Thus, in computing the Federally prescribed reserve, a company should begin with its statutory or annual statement reserve, and modify that reserve to take into account the prescribed method, the prevailing interest rate, the prevailing mortality or morbidity table, as well as the elimination of any net deferred and uncollected premiums (*see* new sec. 811(c)) and the elimination of any reserve in respect of “excess interest” guaranteed beyond the end of the taxable year (*see* new sec. 811(d)). Except for the Federally prescribed items, the methods and assumptions employed in computing the Federally prescribed reserve. . . should be consistent with those employed in computing a company’s statutory reserve.²

A conclusion that the computation of tax reserves begins with statutory reserves has important consequences when a company makes a change to a statutory reserve assumption by adjusting a factor not prescribed by I.R.C. § 807(d). Is it necessary to make a change to tax reserves to conform with the changed statutory reserve assumptions? The answer is usually yes; I.R.C. § 811(a) requires this result.

Let’s examine a few examples dealing with lapse assumptions to illustrate how I.R.C. § 811(a) and § 807(d) interact. Suppose the NAIC-prescribed reserve method applicable for a particular type of contract at the time the contract was issued permitted lapses to be taken into account in establishing statutory reserves, but otherwise did not specify how the lapse assumptions were to be determined. At contract issuance, the company established statutory reserves using the NAIC-prescribed method with certain lapse assumptions, but in a subsequent year changes these assumptions. In such case, as required by I.R.C. § 811(a), the company should change its tax reserve lapse assumptions to conform to the change in statutory reserves. The statutory reserve lapse assumptions should be conformed to the statutory reserve assumptions whether they were originally “locked-in” and later changed, or whether the reserve method initially adopted by the company contemplated the unlocking of lapse assumptions anticipating that the assumptions would be updated periodically. It should be noted, however, that when the NAIC-prescribed method requires, or the company’s adopted method includes, the unlocking of lapse assumptions, the periodic updates proba-

bly would not rise to the level of changes in basis of computing reserves subject to the ten-year spread rule of I.R.C. § 807(f) because the periodic updating would be considered an integral part of the original tax reserve method.

Now assume the same facts except that at the time the contract was issued only particular lapse assumptions, or a range of assumptions, were permissible under the then-applicable NAIC-prescribed reserve method. The company initially used permissible assumptions, but later updated its statutory reserves to use lapse assumptions based on post-issue-date experience that were not permissible at the time the contract was issued. In such case, as required by I.R.C. § 807(d), the changed statutory reserve assumptions should not be used for tax reserves and should be adjusted to conform to the NAIC-prescribed method applicable at the time the contract was issued. The new lapse assumptions would not be permissible for tax reserves because they are inconsistent with the tax reserve method which is determined under I.R.C. § 807(d)(3) at the time the contract was issued.

The role of I.R.C. § 811(a) may have important implications for tax reserves when VM-20 becomes effective in 2017. For exam-

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ple, the Valuation Manual provides an elective transition rule that permits companies, on a block-by-block basis, not to apply VM-20 to contracts issued up to three years after the operative date. Therefore, the companies can comply with the Commissioners Reserve Valuation Method (CRVM) for contracts issued during 2017-2019 either by changing to the VM-20 method or sticking with the old method. After its effective date in 2017, will VM-20 be the tax reserve method prescribed by I.R.C. § 807(d) even for companies that have elected to defer implementation for statutory reserves? The answer is no and here are the two

steps that lead to this conclusion. First, we start under I.R.C. § 811(a) with statutory reserves—in this case reserves computed using the pre-VM-20 method during the transition period. Next, we make an adjustment to statutory reserves only if I.R.C. § 807(d) dictates something else. In this case, a change would not be required for tax reserves because the pre-VM-20 method is fully compliant with the NAIC-prescribed CRVM at the time the contract is issued, *i.e.*, it is a proper tax reserve method as defined in I.R.C. § 807(d)(3).

So, the basic tax reserve rule is that statutory reserve assumptions must be used to determine the deduction for tax reserves, except where something specific in the Code tells us an adjustment must be made. ■

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ENDNOTES

¹ *Commissioner v. Standard Life & Accident Ins. Co.*, 433 U.S. 148 (1977).

² Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 599 (1984). See also S. Prt. No. 98-169, vol. I, at 540 (1984).