

PRIMER: INTRODUCTION TO TAX RESERVES (FOCUS ON LIFE RESERVES UNDER IRC §807, RELATED REGULATIONS AND PBR)

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2020 Virtual Insurance Tax Conference

AGENDA

- Principle Based Reserves
- Life Insurance Company Reserve Taxation
- Tax Reserve Method – Summary (Life Insurance, Annuities, Non-Can A&H)
- Tax Reserve Method (Other)
- Recent Regulations & Guidance



PRINCIPLE BASED RESERVES (PBR)



RESERVE BASICS

- Historically, reserves were formulaic
- In the simplest form, a formulaic reserve is the present value of future benefits less the present value of future premiums
- Based on a single set of assumptions, typically mortality and interest set at issue
- The assumptions can be prescribed as part of the specific method or minimum levels of conservatism can be established more generally in the valuation manual, such as the periodic restating of a maximum valuation rate based on issue year
- Additional, separately determined Asset Adequacy Reserves could be required, but are not related to a specific product or policy



WHY CHANGE?

- Increasing product complexity, such as providing guarantees on variable products
- Increasing impact of risks due to policyholder behavior
- Poor correlation of formulaic reserves to actual risks for certain products in different market rate environments
- Lack of correlation affected pricing of products and encouraged reinsurance of risks to limit reserves overall, even when reinsured to captives domiciled in a different state



RECENT HISTORY OF RESERVING CHANGES

- Life Insurance Reserves
 - AG 36 covering IUL (indexed universal life)
 - AG37 covering GMDB's (guaranteed minimum death benefits) on VUL (variable universal life) products
 - AG38 covering ULSG products (universal life with secondary guarantees)
 - VM-20 effective 1/1/2017, grandfathering for 3 years allowed, new issues only
- Variable Annuity Reserves
 - AG33 covering VA (variable annuities) was introduced in 1995
 - AG34 covering GMDBs (guaranteed minimum death benefits)
 - AG35 covering FIA's (fixed indexed annuities)
 - AG39 covering GMWBs (guaranteed minimum withdrawal benefits)
 - AG43 was introduced in 2009 - first coordinated principles-based reserve requirements for VA, later part of VM -21
 - Revised VM - 21 published in 2019, all inforce



PRINCIPLE BASED RESERVES TODAY

- Considers risks beyond mortality/morbidity and interest
- Reflects the insurer's own experience for some parts of the calculation
- Considers how different economic and other factors would affect the reserves via scenarios
- Considers the impact of policyholder behavior
- Different approaches by product group
- PBR methods are now recognized as CRVM and CARVM under the Tax Cuts and Jobs Act (TCJA)



EFFECTIVE DATES OF CURRENT PBR METHODS

- Life PBR
 - VM-20 effective 1/1/2017
 - included a 3-year optional deferral
 - applied to new issues only
- Variable annuity PBR
 - VM-21 effective 1/1/2020
 - included a 3 year phase-in of the impact
 - contained an option for a 7 year phase in, with permission
 - could be adopted early on 12/31/2019 with no phase-in
 - by referring to AG43, effectively applies to all VA policies, regardless of issue year



WHICH PRODUCTS ARE SUBJECT TO PBR?

- VM – 20
 - Term Life
 - Whole Life
 - UL/VUL/IUL
 - ULSG
 - Some Riders
- VM – 21
 - Individual deferred variable annuities
 - Individual immediate variable annuities
 - Group annuities with GMDB or VAGLB type benefits



WHICH PRODUCTS ARE NOT SUBJECT TO PBR?

- Pre-need life insurance
- Credit life insurance
- Industrial policies
- Accident and health policies
- Fixed rate annuities
- Fixed Index Annuities
- Debt type contracts



LIFE PBR – VM 20

- Company can be exempt based on size of company and product risks
- Minimum floor is a net premium reserve (NPR) that is determined life by life
- Deterministic Reserve (DR) is the result of an aggregate, single scenario for the included population and reflects impacts of all material risks
- Stochastic Reserve (SR) is an aggregate reserve amount, based on multiple economic scenarios for the included population and all material risks
- For both DR and SR, must model material risks



GENERAL FORMULA

- The general PBR reserve formula is:

$$\text{NPR}^* + \text{Max}(0, \text{Max}(\text{DR}, \text{SR}) - (\text{NPR}^* - \text{Due and Deferred Premium Asset}^*))$$

- The excess of the total final reserve over the aggregate NPR is allocated to individual policies, generally proportional based on the NPR

EXCLUSION TESTS

- Company can demonstrate that stochastic (most rigorous) testing is not necessary under a Stochastic Exclusion Test (SET)
 - Policies cannot be subject to material interest rate risk or asset return volatility
 - There are no limitations as to which products can be tested for exclusion
 - Removes SR from the general VM-20 formula
- Company can further demonstrate that deterministic testing is not necessary for a product under a Deterministic Exclusion Test (DET)
 - DET is NOT allowed for Term, ULSG, or other life products with material secondary guarantees
 - General reserve formula where both the DET and SET are passed is the NPR



NET PREMIUM RESERVE (NPR)

- Based on specific interest rate established at issue
- Based on prescribed mortality at issue
- Based on prescribed lapse rates, including shock lapses for term
- Subject to minimum of the cash surrender value



DETERMINISTIC RESERVE

- Based on a single standard set of economic assumptions as defined by the valuation manual and generated by an economic scenario generator
- Cash flow based calculations reflecting
 - death, surrenders, withdrawal and annuitization benefits
 - expenses other than FIT
 - premiums
 - secondary guarantees
 - asset portfolio's cash flows
- Also reflects loans, interest maintenance reserves and derivatives in certain cases



DETERMINISTIC RESERVE (CONT'D)

- Reflects policyholder behavior
- Reflects the impact of reinsurance (currently formulaic is allowed)
- Assumptions change each year as part of the method, which leads to reserve changes
- Despite assets being included in the DR and SR calculations, there are still separate Asset Adequacy reserve requirements

STOCHASTIC RESERVE

- Average over multiple scenarios
- Greatest Present Value of Accumulated Deficiency (GPVAD) methodology
- Based on the average of the worst 30% (CTE 70) of 1000 – 10,000 defined scenarios required to be generated via the Economic Scenario Generator (ESG)
- Anticipated company-specific experience,
- Interest, equity assumptions, and discount rates are specific to each scenario
- Change each year as part of the method, which leads to changes in the reserves

VARIABLE ANNUITY PBR

- Intent is to establish a CARVM reserve that is sufficient to cover the obligations of the company for the product, given the material associated risks
- Examples of risks to be considered in modeling
 - Asset – Separate Account fund performance, call risk, hedge risk
 - Liability – mortality, utilization of living benefits, impacts of policyholder behavior on other guarantees
 - Combination – disintermediation



REQUIRED CALCULATIONS

- No NPR on annuity PBR
- Stochastic Reserve (SR) determined on 1000 – 10,000 economic scenarios, prudent assumptions and covering material risks is the base reserve (CTE 70)
- Additional Standard Projection Amount uses 1000 -10,000 economic scenarios BUT uses some prescribed assumptions to ensures a minimum floor based on a more standard set of assumptions
- If no guarantees or only GMDBs, can use alternate methodology for specific blocks – which are then excluded from SR and additional standard projection amount calculations
- Greatest Present Value of Accumulated Deficiency (GPVAD) methodology
- Cash Surrender Value floor

AGGREGATE RESERVE

- Stochastic Reserve for the modeled blocks, plus
- Additional standard projection amounts for the same blocks (if needed), plus
- Impact of hedging, which could be positive or negative, less
- Pretax interest maintenance reserve as of the valuation date, plus
- Any reserves calculated under the alternate methodology, but not less than the aggregate cash surrender value of those policies
- Allocation to the underlying policies generally of the aggregate excess over cash surrender value



STOCHASTIC RESERVE

- Based on a “broad range” of economic scenarios (1000-10,000)
- Cash flow based calculation reflects
 - death, surrenders and withdrawal benefits
 - expenses other than FIT
 - premiums
- Also reflects beginning general and separate account assets, loans, interest maintenance reserves and derivatives to varying extents



STOCHASTIC RESERVE (CONT'D)

- Reflects the impact of reinsurance ceded
- Assumptions are dynamic in that policyholder behavior changes when there is additional or reduced value to taking actions, based on the scenario
- Assumptions change each year as part of the method, which leads to changes in value
- Minimum reserve is the aggregate Cash Surrender Value

TAX RESERVES BASED ON PBR

- Since PBR is now defined as CRVM or CARVM, tax reserves rely on PBR amounts at the policy level
- Must use NAIC method, not state specific (e.g., where NY requirements differ) or permitted practices as base for determining tax reserves
- State specific or permitted practices influence the max tax reserve allowed

OTHER REQUIREMENTS

- Actuarial PBR Report is required annually
- Periodic review of report and exemptions
- Certain changes of available alternatives would require regulator approval
- Annual review of assumptions

OTHER PBR DEVELOPMENTS

- NY's PBR for annuities is now effective for 2020
- Fixed annuity/FIA PBR is under development by NAIC

LIFE INSURANCE COMPANY RESERVE TAXATION



LIFE INSURANCE CONTRACTS

- Reserves are established on Life insurance and Annuity contracts
- Life insurance contract definition - IRC §7702
 - Any contract which is a life insurance contract under the applicable law, but only if such contract—
 - meets the cash value accumulation test
 - meets the guideline premium test including cash value corridor
- Amounts received under a life insurance contract are not included in gross income if the amount is paid by reason of death of the insured - IRC §101



ANNUITY CONTRACTS

- A contract shall not be treated as an annuity contract for purposes of IRC §72(s) unless it provides that
 - if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and
 - if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.



LIFE INSURANCE COMPANY RESERVES

IRC §807

- Life insurance reserves – IRC §807(c)(1) as defined in IRC §816(b)
- The unearned premiums and unpaid losses - IRC §807(c)(2) as included in IRC §816(c)(2)
- The amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve life, accident, or health contingencies - IRC §807(c)(3)
- Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts - IRC §807(c)(4)
- Premiums received in advance, and liabilities for premium deposit funds IRC §807(c)(5)
- Reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof - IRC §807(c)(6)



LIFE INSURANCE COMPANY RESERVES

IRC §807(c)(1)

As defined in IRC §816(b)

- Amounts which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
- which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies.
- Blue Book – exhibit 5



LIFE INSURANCE COMPANY RESERVES

IRC §807(c)(1)

Examples

- 10 Year Term Life Insurance contract
 - Blue Book - exhibit 5
- Fixed deferred annuity
 - Blue Book - exhibit 5
- Individual disability policy that is noncancellable
 - Blue Book - exhibit 6
- Guaranteed renewable long-term care contracts qualifying under IRC §7702B
 - Blue Book - exhibit 6
- Reinsurance on the above type of contracts



LIFE INSURANCE COMPANY RESERVES

IRC §807(c)(2)

Included in IRC §816(c)(2)

- Unearned premiums, and unpaid losses (whether or not ascertained), not included in life insurance reserves
- Examples:
 - Unearned premiums on cancellable A&H other than disability income
 - Non-cancellable disability income payments due but not yet paid at the valuation date is a claim liability under IRC §807(c)(2)



LIFE INSURANCE COMPANY RESERVES

IRC §807(c)(3) & IRC §807(c)(4)

- Insurance and Annuity contracts that do not involve life, accident or health contingencies IRC §807(c)(3)
 - Blue Book - exhibit 7
 - Example:
 - Term Certain Annuity – payment are made for a certain period of time based on the contract regardless of whether the annuitant dies
- Dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts IRC §807(c)(4)
 - Blue Book - exhibit 7



LIFE INSURANCE COMPANY

IRC §816

- An insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with accident and health insurance), or noncancellable contracts of health and accident insurance, if—
 - its life insurance reserves, plus
 - unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves
 - comprise more than 50 percent of its total reserves



TAX RESERVES METHOD – SUMMARY (LIFE INSURANCE, ANNUITIES, NON-CAN A&H)

TAX RESERVES METHOD – SUMMARY

- General Rule – Tax reserves associated with IRC §807(c)(1) 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, long term care benefits
- Disabled lives reserves on cancellable disability treated similarly to life insurance reserves



NON-DEDUCTIBLE RESERVES

- Deficiency Reserves – IRC §811(c)(1) & 807(d)(3)(C)
- D&U Premiums – IRC §811(c)(1)
- Excess interest reserves – IRC §811(d)
- Asset adequacy reserves – Treas. Reg. §1.807-1



STEP-BY-STEP CALCULATION OF IRC § 807(c)(1) LIFE INSURANCE RESERVES FOR TAX

1. Start with statutory reserves computed according to 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 IRC §807(c)(1) LIFE INSURANCE RESERVES FOR TAX

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



WHAT RESERVES ARE SUBJECT TO THE 7.19% HAIRCUT?

- IRC §807(c)(1) life insurance reserves are subject to the 7.19% haircut (certain cancellable A&H contracts are included via cross reference to IRC §846(e)(6)(A))
- IRC §816(b) defines “life insurance reserves” in relevant part as reserves which are set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies
- Therefore –
 - 7.19% haircut applies to life insurance held with respect to –
 - Life insurance contracts, annuities contracts, noncancelable and guaranteed renewable accident and health contracts
 - Cancellable disability income contracts (other than credit)



WHAT RESERVES ARE SUBJECT TO THE 7.19% HAIRCUT? (CONT'D)

- Under a special rule, the 7.19% haircut only applies to a portion of the NAIC-prescribed reserve for variable contracts
- IRC §807(c)(2) – 807(c)(6) – haircut does not apply
 - The 7.19% haircut does not apply to reserves unless the contract has mortality or morbidity contingencies on the valuation date. For a contract without mortality or morbidity contingencies, other tax reserve rules may apply depending on the nature of the contract and the risks for which the reserve is held
 - In general, the 7.19% haircut does not apply to reserves for incurred, but unpaid claims except for disability income and long-term care claim reserves which qualify as life insurance reserves or are computed in the same manner

WHAT RESERVE METHOD MUST BE USED FOR TAX RESERVES THAT QUALIFY AS LIFE INSURANCE RESERVES FOR TAX PURPOSES?

- IRC §807(d)(2) requires life insurance reserves for any contract be computed for tax purposes in accordance with the “tax reserve method” applicable to such contract in effect as of the date the reserve is determined
- In general, tax reserve methods are:
 - Life insurance contracts – CRVM prescribed by the NAIC for contracts covered by CRVM
 - Annuities – CARVM prescribed by the NAIC for contracts covered by CARVM
 - Other contracts – NAIC-prescribed reserve method or, if there is no prescribed method, the most appropriate method consistent with another NAIC-prescribed method



WHAT IS A TAX RESERVE METHOD?

- IRC §807(d)(2) specifies the required tax reserve method; it does not contemplate the use of a method that either is only a part of CRVM or CARVM, and thus not CRVM or CARVM, or does not satisfy the requirements of CRVM or CARVM as prescribed by the NAIC
- In general, NAIC-prescribed reserve methods:
 - Take into account all future contract-related cash flows either explicitly or implicitly (*i.e.*, premiums, investment income, benefits, expenses)
 - Specify the methodology used to integrate the assumptions for future cash flows to arrive at a value of contract-related liabilities net of contract-related revenues



HOW IS THE NAIC-PRESCRIBED TAX RESERVE METHOD IDENTIFIED?

The tax reserve method is the NAIC-prescribed method for a particular contract as of the date the reserve is determined. Therefore:

- NAIC guidance determines the tax reserve method – which can be found in the Standard Valuation Law, Model Regulations, Valuation Manual, Accounting Practices and Procedures Manual, Actuarial Guidelines, or a combination of these NAIC sources.
- The applicable tax reserve method is determined as of the valuation date.
- If the NAIC adopts a new method or updates an existing method, whether the application of the new or updated method will apply for tax reserves to previously-issued contracts will follow NAIC guidance. Application of the new method or the updated method to previously-issued contracts likely will result in a change in basis computing reserves for tax purposes subject to IRC §807(f).
- The NAIC may provide several options for complying with the CRVM or CARVM. The option used for statutory reserves should be used as the basis of tax reserves subject to the 7.19% haircut provided it is one of the NAIC's permissible methods for the contract on the valuation date.



WHEN ARE STATUTORY RESERVE ASSUMPTIONS REQUIRED TO BE USED WITHIN THE NAIC-PRESCRIBED TAX RESERVE METHOD?

- To determine whether assumptions must be used for tax reserves that differ from those used to determine statutory reserves, the statute requires an analysis of whether the assumption is prescribed by the specified NAIC method (e.g., CRVM or CARVM)
- If the NAIC prescribes a particular assumption as part of the method or prescribes a range of acceptable values for a particular assumption as part of the method, and the company uses the prescribed assumption or a value that falls within the prescribed range, then the assumption is consistent with the NAIC-prescribed method and, therefore, part of the tax reserve method
- However, if the assumption falls outside a range prescribed by the NAIC method (*i.e.*, is unreasonable in the context of, or incompatible with, the method) or otherwise conflicts with the prescribed requirements of the NAIC method (e.g., because the reserves are computed using a permitted practice authorized by its state insurance regulator), IRC § 807 may require the use of a different assumption for tax purposes to comply with the NAIC-prescribed method



WHEN ARE STATUTORY RESERVE ASSUMPTIONS REQUIRED TO BE USED WITHIN THE NAIC-PRESCRIBED TAX RESERVE METHOD? (CONT'D)

- An assumption in tax reserves must be consistent with an assumption specified by, or permitted within, the NAIC's definition of the reserve method or in any other provision of NAIC reserve guidance applicable to the NAIC-prescribed method. That is, tax reserves must be computed using assumptions that are permissible by the NAIC for the contract regardless of whether the assumptions are described specifically as part of the NAIC-prescribed method or are prescribed by the NAIC outside of the method's definition.
- If statutory reserves are computed using the NAIC-prescribed method applicable to the contract, but use an assumption that is not permitted by the NAIC to be used within the NAIC-prescribed method, or is unreasonable in the context of the NAIC-prescribed method, the assumption should be adjusted to conform with NAIC reserve requirements. This is so whether the assumption results in statutory reserves that are smaller or greater than minimum NAIC-prescribed reserves. And, this is so whether or not the NAIC-prescribed assumption is included in the NAIC's definition of the applicable reserve method or elsewhere in NAIC guidance.



WHAT IS THE CONTRACT'S NET SURRENDER VALUE?

Under I.R.C. §807(e)(1) the “net surrender value” of the contract is not specifically defined by the Code except to exclude any penalty or charge which would be imposed on surrender and without regard to any market value adjustment. For qualified plan contracts, the net surrender value is defined by reference to the balance in the policyholder fund, again without further definition. The legislative history states that the net surrender value represents “the current contractual cash benefit payable under the contract.” 1984 Blue Book, page 599. The “cash benefit payable” test is applied from the perspective of the company not the policyholder. The net surrender value is not necessarily the same as the nonforfeiture value of the contract. Therefore:

- The net surrender value is the amount the company would have to pay if the contract is terminated by the policyholder on the valuation date. The net surrender value may differ from the non-forfeiture value or the account value and can apply to contracts without specific cash surrender values as long as the contract provides for a cash benefit upon surrender.
- The net surrender value is determined with regard to surrender charges, but without regard to market value adjustments (other than for modified guaranteed contracts).
- For reserves with respect to qualified retirement plans, the net surrender value is the policyholder fund, which presumably is the fund value, if any, reported to the policyholder.
- For a ceding company, the net surrender value is reduced if the company's liability to the policyholder in the event of termination by the policyholder would be reimbursed by the reinsurer. Similarly, the reinsurer's net surrender value is the amount of the liability to the ceding company in the event the underlying reinsured contract is terminated.

WHAT IS A CONTRACT'S STATUTORY RESERVES CAP?

“Statutory reserves” are defined in IRC §807(d)(4) as the aggregate amount of reserves set forth in the annual statement with respect to the categories of deductible insurance reserves specified in IRC §807(c). Although there is little guidance as to the reserves that qualify as statutory reserves the legislative history and purpose of the cap suggest a broad definition was intended. Appropriate guidelines that the IRS has not necessarily endorsed include:

- Statutory reserves are the liabilities related to future contract-related claims and reported on the financial statement filed with the applicable regulator. They likely include statutory reserves held pursuant to state regulators' permitted practices.
- Statutory reserves must be reflected in both the balance sheet and the profit and loss statement.
- Statutory reserves include all types of contract-related reserves (including deficiency reserves) for the applicable contract for purposes of the stat cap, not just the life insurance reserves which are capped. However, it is unclear what other types of reserves for the contract are included in the cap and, presumably, they are included only to the extent they are not otherwise deductible (e.g. a claim liability is deductible under IRC § 805(a)(1) and is not part of the statutory reserves cap).
- Statutory reserves for the contract are included in the cap regardless of where they appear or how they are labeled in the financial statement.



WHAT IS A CONTRACT'S STATUTORY RESERVES CAP? (CONT'D)

- The portion of statutory reserves attributable to deferred and uncollected premiums is excluded from the cap.
- When annual statements filed in two states reflect different statutory reserve amounts, the company is permitted to use the highest amount for purposes of the cap. However, the same annual statement presumably must be used for all other tax purposes when annual statement accounting is relevant.
- When a company does not file an NAIC annual statement, statutory reserves are the contract-related liabilities reflected on the financial statement filed with the company's applicable regulator.
- Where statutory reserves are computed on an aggregate basis, they must be allocated to particular contracts in a consistent, actuarially sound basis for statutory reserves capping.
- Because of the 7.19% haircut to life insurance reserves for tax purposes, the statutory reserves cap likely will not come into play as frequently under current law as in pre-2018 year.



VARIABLE CONTRACTS

- For variable contracts that meet the requirements of IRC §817, the 7.19% haircut is only applied to the excess of the contract's CRVM or CARVM over the greater of (1) the contract's net surrender value or (2) the portion of the CRVM or CARVM reserve allocable to variable benefits.
- Under the separate variable formula, the final tax reserve equals the greater of the net surrender value or separate account portion of the reserve plus 92.81% of the excess (if any) of the CRVM or CARVM reserve at the valuation date over that amount, subject to the statutory cap for the contract.
- The portion of the CRVM or CARVM reserve allocable to variable benefits is not necessarily the separate account's cash value, account value or the amount actually reported as a reserve in the Green Book. The CRVM or CARVM attributable to variable benefits must be computed, and allocated to the separate account, in accordance with any relevant NAIC guidance and must be actuarially appropriate to reflect only the variable benefits.
- The net surrender value is determined for the entire contract as reported in both the Blue and Green books.



CONTRACTS WITH SUPPLEMENTAL BENEFITS

- Qualified supplemental benefits (QSB) reserves are not taken into account in the comparison to the net surrender value floor for the base contract
- Qualified supplemental benefits include –
 - guaranteed insurability
 - accidental death or disability benefit
 - convertibility
 - disability waiver benefit
- Supplemental benefits are only qualified if there is a separately identified premium for the benefit and the contract's cash surrender value does not fund the benefit.
- The QSBs are, however, treated as separate contracts, which are subject to the 7.19% haircut and a separate statutory cap of the statutory reserve for the benefit



Tax Reserves Method (Other)

TERM CERTAIN IMMEDIATE ANNUITIES

- IRC §807(c)(3) reserves – not life insurance reserves
- Tax reserves must be computed using the highest rate or rates permitted to be used for the obligations under NAIC guidance at the valuation date.
- The 7.19% haircut does not apply.
- Discount rate updated if NAIC changes highest permitted rate for previously-issued contract



CANCELLABLE ACCIDENT AND HEALTH CONTRACTS

- Unearned premium reserves with respect to cancellable accident and health contracts are subject to an 20% haircut (and not a 7.19% haircut) because they do not qualify as life insurance reserves. **Authority:** IRC §807(e)(5).
- Tax reserves for unearned premium reserves are not subject to a net surrender value floor or statutory reserves cap. **Authority:** IRC § 807(c)(2), §807(e)(5).
- Claim reserves (**other than disability income**) are adjusted for tax purposes using a discount rate determined by the Treasury Department based on the corporate bond yield curve and a one-half year deferred payment convention. **Authority:** IRC §846(e)(6).
- Disability income claim reserves (other than credit disability) are adjusted for tax purposes in the same manner as for similar claim reserves for noncancellable disability income claim reserves (*i.e.*, with a 7.19% haircut) **Authority:** IRC §807(c), §846(e)(6).
- Credit disability income claim reserves are adjusted for tax purposes using a discount rate determined by the Treasury Department based on the corporate bond yield curve but using loss payment patterns specified in the Internal Revenue Code. **Authority:** IRC §807(c), §846(e)(6).



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 uses 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 is aggregate reserves for the contract (not just life insurance reserves)



RECENT REGULATIONS & GUIDANCE



2020 Virtual Insurance Tax Conference

IRC §807 REGULATIONS

- Effective October 13, 2020
- Treas. Reg. §1.807-1 Computation of life insurance reserves
- Tax Reserve Method
 - Commissioners' Reserve Valuation Method (CRVM)
 - Commissioners' Annuities Reserve Valuation Method (CARVM)
 - Other reserve method prescribed by NAIC
 - No asset adequacy reserve
 - Additional reserve based upon an analysis of the adequacy of reserves that would otherwise be established in accordance with the requirements set forth in the NAIC Valuation Manual, such as the CRVM or CARVM as applicable, or a similar reserve [as VM-30 existed on December 22, 2017]



IRC §807 REGULATIONS

- Treas. Reg. §1.807-3 Reporting of Reserves
- IRS may require:
 - Reporting with respect to opening and closing balance of reserves under IRC §807(c)
 - Method of computing reserves
 - Reporting requirements may include separate accounts



IRC §807 REGULATIONS

Treas. Reg. §1.807-4 Adjustment for change in computing reserves

- IRC §807(f) Adjustment for change in computing reserves
 - Prior to TCJA:
 - If the basis for determining any item under IRC §807(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year the difference is taken into account over a 10-year period 1/10 each year.
 - After TCJA:
 - If the basis for determining any item under IRC §807(c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year the difference is taken into account under section 481
 - Requires consent of the Secretary
 - Consent obtained by filing form 3115 – Application for a Change in Accounting Method
 - Currently automatic consent for a change in method relating to IRC §807(c) – 26.04 Rev. Proc. 2019-43 (including life reserves for a nonlife insurance company)



IRC §807 REGULATIONS

Treas. Reg. § 1.807-4 Adjustment for change in computing reserves, ctd.

- Facts: Insurance Company (IC)
 - Life insurance Company
 - Calendar year taxpayer
 - Reserves exceed CSV floor and are less than the statutory reserve
- Example (1)
 - IC changed basis of computing life insurance reserves in 2021

	Old Basis 12/31/2021	New Basis 12/31/2021	IRC §481 Adjustment
Issued prior to 2021	(\$110)	(\$120)	(\$10)
Issued during 2021		(\$15)	

- §807(a) decrease treated as gross income or 807(b) increase treated as deduction computation
- 12/31/2021 closing reserves \$125
- 12/31/2022 opening reserves \$135



IRC §807 REGULATIONS

Treas. Reg. §1.807-4 Adjustment for change in computing reserves, ctd.

- Facts: Insurance Company (IC)
 - Non-Life insurance Company
 - Calendar year taxpayer
 - Reserves exceed CSV floor and are less than the statutory reserve
- Example (2)
 - IC changed basis of computing life insurance reserves in 2021

	Old Basis 12/31/2021	New Basis 12/31/2021	IRC §481 Adjustment
Issued prior to 2021	(\$110)	(\$120)	(\$10)
Issued during 2021		(\$15)	

- §832(b)(4) premiums earned
- 12/31/2021 closing reserves \$125
- 12/31/2022 opening reserves \$135



IRC §807 REGULATIONS

Applicability Date

- Years beginning after October 13, 2020
- Choose to apply for tax years beginning after December 31, 2017
- Consistently apply the rules of the regulation to that year and all subsequent



IRC §816 REGULATIONS

Treas. Reg. §1.816-1 Life Insurance Reserves

- A reserve that meets the requirements of IRC §816(b)(1) [amount computed on the basis of recognized mortality or morbidity tables and assumed rates of interest] & §816(b)(2) [reserves required by law] will not be disqualified as a life insurance reserve solely because the reserve takes into account other factors, provided the method is CRVM or CARVM and not an asset adequacy reserve

IRC §807 REGULATIONS - NOT ADDRESSED

- Foreign-Issued Life Insurance and Annuity Contracts
 - Contracts issued by a non-U.S. insurance company
 - Reinsured to a U.S. company
 - “The considerations surrounding the issuance of the requested regulations are complex and require further study”



REVENUE RULING 2020-19

- Facts
 - Life Insurance Company (IC)
 - Issues life and annuity contracts directly and reinsures risk
 - Computes reserves under IRC §807(d) and takes decreases in reserves into income under IRC §807(a) and increases as a deduction under IRC §807(b)
 - Reserves are computed in accordance of the net surrender value floor of IRC §807(d)(1)(A) and (B) and the statutory cap of IRC §807(d)(1)(C)



REVENUE RULING 2020-19

- Situation 1
 - IC properly computed reserves under CARVM but incorrectly applied the 92.81% to the entire amount rather than only to the excess of that amount over the greater of each contract's NSV on two consecutive returns.
 - Is this a change in basis?
- Situation 2
 - In Year 4 the NAIC changed VM-21 and imposes a new computational requirement as a component of CARVM on issuers of variable annuities with guaranteed minimum benefits. The change applies with regards to contracts issued after December 31, year 1
 - Is this a change in basis?
- Situation 3
 - Same as situation 2, except that the change to VM-21 applies to the determination of statutory reserves as of December 31, year 4, with regards to contracts issued after December 31, year 3.
 - Is this a change in basis?



REVENUE RULING 2020-19

- Situation 4

- The NAIC issues a new AG that imposes a new computational requirement for CRVM for UL contracts issued before year 1. The requirement applies to the determination of statutory reserves for contracts as of December 31, year 3.
- Is this a change in basis?

- Situation 5

- IC computes its reserves under VM-20. The contracts pass both the stochastic exclusion test and the deterministic exclusion test of VM-20. IC's reserves equal the sum of the policy net premium reserve. VM-20 prescribes the mortality standard to us when computing NPR. NAIC changes the VM to require the use of the year 1 Commissioners; standard ordinary mortality tables to compute the NPR.
- Is this a change in basis?

- Situation 6

- IC computes its reserves under VM 20. Under VM-20 the minimum statutory reserve is equal to the sum of the policy minimum net premium reserve for the contracts, plus the excess, if any, of the greater of the deterministic reserve for the contracts and the stochastic reserve for the contracts. Year 1 & 2 – deterministic reserve > stochastic and the sum of the policy net premium reserve. Year 3 the sum of the policy net premium reserves exceeded the deterministic and stochastic
- Is this a change in basis?



REVENUE RULING 2020-19

- Situation 7

- IC computes reserves under VM-20. Year 1 & 2 the deterministic reserve exceeds the stochastic and the sum of the policy net premium reserves. The excess was allocated to individual contracts. VM-20 requires company experience data for each mortality segment to be updated at least every 3 years. In this situation the experience data was updated in year 2.
- Is this a change in basis?

- Situation 8

- Year 1 IC reported tax reserves for fixed annuity contracts equal to 92.81% of the CARVM as this exceeded the NSV. Year 2 IC reported tax reserves for the same contracts at the NSV as the NSV was greater than 92.81% of CARVM.
- Is this a change in basis?



REVENUE RULING 2020-19

- Situation 9

- A computer programming error caused a group of policies to be excluded from the tax reserve computation. This error occurred in year one only.
- Is this a change in basis?

- Situation 10

- IC added additional indemnity benefits to existing policies at no additional cost if death resulted from a non-occupational vehicular accident. Additional reserves were added for the relevant contracts under the tax reserve method.
- Is this a change in basis?



CONCLUSION

Principle Based Reserves

Life Insurance Company Reserve Taxation

Tax Reserves Method

Recent Regulations & Guidance

Questions?



2020 Virtual Insurance Tax Conference