

# Issue Brief

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## KEY POINTS

- Prior legislative tax reform proposals have included language requiring the interest rate used to discount the value of future claim payments for disability insurance benefits be determined as of the calendar year of issue rather than the calendar year of incurral.
- To be consistent with current statutory accounting regulations, the assumptions for calculating tax-deductible claim reserves would need to be based on the calendar year in which a claim is incurred and not the calendar year in which the policy was issued.
- The incurral date is both the date as of which the insurer is obligated to pay disability payments and is first required to establish claim reserves. By setting the claim reserves assumptions on the incurral date, the valuation actuary is able to reflect all of his/her current information.



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## Claim Reserve Assumption Basis for Long-Term Disability Policies

### Use of Date of Incurral Versus Date of Issue

#### Overview

In the 113<sup>th</sup> Congress, H.R. 1, the *Tax Reform Act of 2014*, was introduced, based on a discussion draft circulated by the House Ways and Means Committee majority earlier that year. One of the provisions in the legislation would have required that the interest rate used to discount the value of future claim payments for disability insurance benefits be determined as of the calendar year of issue rather than the calendar year of incurral. While that legislation was not passed, it is important to understand the implications of any future tax reform on long-term disability insurance policies.

The Tax Work Group of the American Academy of Actuaries' Life Practice Council developed this issue brief to provide an overview of private sector disability insurance, the current tax rules for long-term disability reserves, and the implications of calendar year versus incurral year as the basis for determining the interest rate used to calculate the present value of future payments for claims incurred. The assumptions used in calculating tax claim reserves for disability insurance should be consistent with the established rules of statutory accounting as required by state insurance regulations. To be consistent with current statutory regulations, the assumptions for calculating the tax-deductible claim reserves would need to be based on the calendar year in which a claim is incurred and not the calendar year in which the policy was issued.

## Background

### Disability Insurance

Long-term disability (LTD) insurance provides for the payment of a monthly benefit to an insured in the event that the insured becomes disabled under the contractual definition of disability and remains disabled through a period of time called the elimination period. The date on which the insured first becomes disabled as defined in the policy is the “incurral date.” Benefit payments are made while the insured remains disabled until the end of a stated benefit period. The maximum benefit period can be specified as a stated number of years (e.g., five years), attainment of a stated age (e.g., 65 or Social Security Normal Retirement Age), or the lifetime of the insured.

LTD can be sold under a group contract or an individual contract. The following is a general description of LTD products; occasionally there are exceptions. Group contracts typically are cancellable at the end of the guarantee period (typically one to three years) and have premiums that change as the characteristics of the group, such as age distribution and emerging experience, change (these will be referred to as “typical group” throughout). (Note that reserves are still held for the future benefits payable to those individuals who are disabled as of the date of cancellation.) There are other group policies with level premiums (these will be referred to as “hybrid group” throughout). Individual contracts typically provide for the periodic payment of premiums and are either noncancellable (renewability and the premium schedule are

guaranteed at issue), or guaranteed renewable (renewability is guaranteed but premium rates may change). Noncancellable policies and guaranteed renewable policies that meet the tax definition<sup>1</sup> of guaranteed renewable are treated in the same way for tax reserve purposes.

Insurance companies with LTD policies enforce generally establish two types of reserves:

1. **Claim reserves** (the focus of this paper)—reserves meant to fund future obligations for policyholders who are currently disabled. These arise for individual policies and for group policies. Claim reserves are calculated as the present value of the expected series of future claim payments. The obligation to make these payments is long term in nature and typically extends many years beyond the current year. At the end of any reporting period, the insurer must establish a claim reserve for every claim that is incurred, whether or not the claim has been reported. Thus, claim reserves consist of two pieces. One is for claims that have been reported; the other is for claims that have been incurred but not yet reported, known as incurred but not reported (IBNR). Critical assumptions in computing claim reserves are benefit level, claim termination rates (recovery, mortality and benefit period expiry) and interest rates.
2. **Active life reserves**—reserves that, when combined with future net premiums and interest, fund future claim obligations for claims that have not yet been incurred.

<sup>1</sup> The tax definition of “guaranteed renewable” is different from the statutory definition. A full explanation of the differences may be found in the textbook *U.S. Tax Reserves for Life Insurers* (Society of Actuaries, 2005).

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Typically, active life reserves arise only for individual and hybrid group policies and not for typical group policies. The need for an active life reserve arises because the premium is level over the term of the policy but the incidence of disability increases with age. While premiums may be increased under a guaranteed renewable policy, the same level premium concept applies because in the calculation of the active life reserves, future premiums are assumed to be level. Hence, some of the premium paid in the early policy years must be retained to fund the higher expected claim costs as the insured ages. The active life reserve continues to be held, when a claim is incurred and the claim reserve is established, as it is possible for an insured to recover from a disability and become disabled again in the future. Critical assumptions in computing active life reserves are benefit level, premium level, claim incidence rates, claim termination rates (recovery, mortality, and benefit period expiry), and interest rates.

### **Current Statutory Regulations for LTD Claim Reserves**

The National Association of Insurance Commissioners (NAIC) promulgates rules to be followed for “statutory reserving.” These rules prescribe minimum reserves that a company must hold. The rules for health reserves are codified in the model regulation “Minimum Reserve Standards for Individual and Group Health Insurance Contracts” (“Health Insurance Reserve Model Regulation”). Actuaries employed by the state insurance departments, insurance companies, universities, and consulting firms all have input in drafting the rules established by the NAIC. Actuaries who are members of the five U.S.-based actuarial organizations are bound by the Code of Professional Conduct.<sup>2</sup>

In 1981, the NAIC adopted statutory reserving rules that require that assumptions for calculating Individual LTD claim reserves be determined as of the calendar year of claim incurral. There was no specific NAIC guidance on this issue prior to 1981 and practices varied from company to company. Proceedings of the NAIC related to the 1981 amendment to the Health Insurance Reserve Model Regulation state the rationale for using incurral date rather than issue date. At that time, the chairperson of a special Academy subcommittee established to address health insurance reserving issues stated in a letter incorporated into the NAIC Proceedings that, if one uses the issue date in setting the interest rate assumption, “companies could be obliged to set up new claim reserves, at any given time, on a variety of interest rates.” The chairperson also stated that the use of the incurral date is a “practical and obviously desirable improvement in the rules.”

Prior to the NAIC’s adoption of the 1987 Commissioners Group Disability Table (CGDT), there was no specific regulatory guidance for the valuation of group LTD claim reserves. When the 1987 CGDT was adopted by the NAIC, the NAIC specified that the valuation interest rate for claim reserves be determined as of the calendar year of incurral.

The current Health Insurance Reserve Model Regulation, included in the NAIC’s Accounting Practices and Procedures Manual and required by the Valuation Manual (VM-25), states that the incurral year is the required basis for setting the interest and morbidity assumptions for statutory claim reserves for individual and group disability contracts.

### **Current Tax Rules for LTD Claim Reserves**

The Internal Revenue Code requires that insurance companies report and pay taxes on the basis of “tax reserving.”

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<sup>2</sup> The five U.S.-based organizations—American Academy of Actuaries, American Society of Pension Professionals and Actuaries, Casualty Actuarial Society, Conference of Consulting Actuaries, and the Society of Actuaries—adopted the Code individually, and it took effect on Jan. 1, 2001.

The calculation of reserves for noncancellable and guaranteed renewable LTD policies for federal income tax purposes starts with the calculation of the Federally Prescribed Reserve (FPR). Under current law, the FPR is to be computed using the “prevailing commissioners’ standard tables for mortality and morbidity” and the greater of the “applicable federal interest rate” (AFR) and the “prevailing state assumed interest rate” (PSAR).

For noncancellable and guaranteed renewable insurance policies, the mortality and morbidity tables, the AFR, and the PSAR for active life reserves are to be determined when the contracts are issued. However, it is not specifically stated in the Internal Revenue Code that tax reserving should follow statutory reserving conventions and use the calendar year of incurral in establishing assumptions for claim reserves.

Typical group policies are deemed “cancellable” because they can be canceled at the end of any relatively short guarantee period. Prior to the addition of Section 846 in the Tax Reform Act of 1986, tax claim reserves for cancellable policies were equal to the statutory reserves.

Section 846 defined the newly created term “discounted unpaid losses” as it applied to property and casualty losses and also to “cancellable” accident and health contracts. Paragraph (f)(6) of Section 846 requires that, in determining a claim reserve for a cancellable disability income policy, the date of incurral of the claim be used to determine the PSAR rather than the date of issue of the contract. Some have interpreted this to imply that, for noncancellable and guaranteed renewable disability income (most individual and hybrid group policies), the interest rate used to determine tax basis claim reserves should be based on the date of issue of the underlying contracts. However, it is still an unresolved issue under current tax law for noncancellable and guaranteed renewable policies whether the original issue date or the claim incurral date (the NAIC rule for statutory

reserving) should be considered the issue date of the contract (as defined in Section 807(d)) for tax claim reserves.

Section 846(f)(6) refers only to the PSAR, not to the greater of the AFR and the PSAR. Section 846 was first effective for tax years 1987 forward, pursuant to the 1986 Tax Reform Act. It dealt primarily with property and casualty loss reserves, with a small subsection for cancellable health claim reserves and liabilities (Section 846(f)(6)). At that time, the reference to disability income other than credit disability (Section 846(f)(6)(A)) cited only the PSAR in its requirement to follow the section 807(d) rules for noncancellable and guaranteed renewable accident and health insurance contracts, with the specific exception to use the PSAR as of the incurral date rather than as of the contract issue date. This was because at that time there was no AFR in use for Section 807(d) noncancellable and guaranteed renewable accident and health insurance contracts, thus there was no need for Section 846(f)(6) to cite the AFR in that “excepting” section.

The Omnibus Budget Reconciliation Act (OBRA) of 1987 introduced the AFR as the comparative interest rate to the PSAR for contracts falling under Section 807(d) and issued beginning in 1988. Thus, it would have been a logical conclusion for the 1987 act to change Section 846(f)(6)(A)(i) to read as follows:

“the prevailing state assumed interest rate and the applicable federal interest rate shall be the rates in effect for the calendar year in which the loss occurred rather than the calendar year in which the contract was issued...”

Unfortunately, the 1987 act did not make that clarifying change, the result being an ambiguity regarding the calendar year as of which the AFR should be determined. Without that change, there could be an interpretation that the AFR would be determined as of the calendar year of contract

issuance while the PSAR would be determined as of the calendar year of loss incurral. That is not a logical conclusion from an economic perspective and certainly would be inconsistent with the treatment of the two interest rates for those contracts falling under Section 807(d). Moreover, it would directly contradict the general structure of Section 846, which uses the AFR as of the loss incurral date for all other contracts covered under that section. In view of the above, it seems more reasonable to use the AFR as of the calendar year of incurral.

#### **2014 Proposed Legislative Change**

One of the proposals in H.R. 1 was to remove the PSAR altogether, changing the valuation interest rate to a function of just the AFR. In so doing, the draft would have removed all references to the PSAR, including the sentence from Section 846(f)(6) requiring the determination of the interest rate for claim reserves for cancellable LTD to be based on the incurral date.

#### **Actuarial Considerations in 1981 NAIC Model Regulation**

Under a net premium reserve method, the assumptions for interest and morbidity are made at the time of contract issuance and are locked-in thereafter. Conceptually, the interest assumption (the discount rate) in reserves is intended to bear a relationship to the return on assets backing the reserves so that an appropriate investment yield emerges for statutory reporting over the duration of the contract. The underlying assumption in a net premium reserve method that uses a locked-in discount rate is that future premiums will be invested at a yield that will continue for the duration of the contract to bear a reasonable relationship to the assumed discount rate. Of course, for a long-term contract with level premiums, such as LTD, the discount rate applicable at the time of claim may vary widely from the rate applicable at the time of issue.

In adopting the 1981 amendment to the Model Regulation, the NAIC made the determination that a continued locking-in of the discount rate assumption is not appropriate when new claim reserves are established, and that updated forward-looking interest and morbidity assumptions as of the claim incurral date are a more accurate measure of future investment yield. Where reserves have been funded by the investment of premiums received over many years, and by asset reinvestments at various times over a long period of time, the NAIC considered whether it is better to use the previous locked-in discount rate that was applicable at the time the first premium was received on the contract or whether it is better to use a current interest rate when new claim reserves are established. The NAIC chose the latter approach.

At least two other considerations supported the NAIC's 1981 amendment to the Model Regulation. First, the claim incurral date for morbidity assumptions clearly is preferable to ensure that claim reserves reflect up-to-date assumptions, and there would be an inconsistency to use updated morbidity assumptions as of the claim incurral date while using the discount rate assumption as of the original contract issue date. Second, as indicated in the NAIC Proceedings, it would be inconsistent to use different discount rate assumptions for reserves for similar claims incurred in the same year.

#### **Rationale for Incurral Year for Tax Claim Reserves**

In addition to the actuarial reasons for use of claim incurral year assumptions underlying the NAIC Model Regulation, there are several interrelated reasons as to why the assumptions for interest rates and termination rates for LTD tax claim reserves should be determined as of the calendar year in which the claim is incurred.

- In the absence of specific rules in the Internal Revenue Code, it is reasonable for tax accounting to follow statutory accounting. The current statutory rules for the determination of the interest rate assumptions and the termination rate assumptions require that they be based on the date of incurral of the claim.
- There are other examples of life and health insurance where, within the same contract, there is a significant event that causes a fresh set of assumptions for statutory reserves. LTD claim reserves could be viewed similarly as the result of a significant event that takes place on the incurral date, with the incurral date of the claim used to set assumptions. Examples include:
  - Life contracts exercising supplemental contract options on a current basis (e.g., periodic payments in lieu of a lump sum death benefit)—a new reserve is established for the supplemental contract using the calendar year of issue of the supplemental contract as a basis for the reserve.
  - Deferred annuities converting to payout annuities on a current basis—a new reserve is established for the payout annuity using the calendar year of issue of the payout annuity as a basis for the reserve.
- The incurral date is both the date as of which the insurer becomes obligated to pay to the claimant any disability benefits that may become due and the date as of which the insurer is first required to establish a claim reserve. Incurral of a claim triggers the details of the claim (key drivers of reserve assumptions such as termination rates, market interest rates, and the cause of disability) and the establishment of new reserves for the present value of the future contingent claim payments. By setting the claim reserves assumptions on the incurral date, the valuation actuary is able to reflect all of his/her current information. Furthermore, as indicated in the NAIC Proceedings, it would be inconsistent to use different discount rate assumptions for reserves for otherwise similar claims incurred in the same year.
- For typical group LTD insurance, the premium paid for the current year provides coverage only for disabilities that occur during that year. The current year premium provides no coverage related to disabilities that may occur in future contract years. This is true regardless of how many years ago the policy was originally issued to the group. In other words, the current year premium is the only source of funding available for benefits that become payable due to disabilities incurred in the current year. This premium will be used to acquire assets that will be available for purchase when the claim is incurred. These assets will be retained in support of the claim reserves. As a result, by the end of each calendar year, the insurer has assets that will support the cost of all claims incurred during the year, regardless of when the claims are reported to the insurer. Because the assets supporting the claim reserves are acquired in the calendar year of claim incurral, the interest rate used to calculate these claim reserves should be based on the calendar year of claim incurral.

New reserves are established at the time of the significant event. Therefore, using the incurral date of the LTD claim to set the statutory assumptions is consistent with these examples.

- For individual LTD, active life reserves are funded by the level premiums paid over many years. The active life reserves help to fund the cost of new claims and the establishment of the claim reserves. However, actual conditions at the times of claims may be different, causing a mismatch between what's assumed in the active life reserves and what's established for claim reserves, which then argues for the incurral year basis, as a change in funding is needed at the time of claim incurral.

### **Rationale for Issue Year**

There is a rationale for establishing LTD claim reserves based on assumptions as of the calendar year of issue for individual policies (and some hybrid group policies). This rationale arises from the fact that, for individual policies, obligations are typically funded with premiums that are level over the entire term of the contract. As explained above, level premiums give rise to active life reserves, which accumulate with premiums and investment income. Within the formulas used to set active life reserves for individual LTD insurance, amounts are allocated each year to help fund new claims. Under the supplemental contract and payout annuity—statutory examples

noted in the previous section—there is typically an extinguishment of the original contract (life insurance or deferred annuity) and a subsequent establishment of a new contract (supplemental contract or payout annuity). However, for individual disability policies, when a claim occurs, there is no new contract, nor are the active life reserves extinguished because they may still be needed to cover future disabilities.

### **Conclusion**

The Tax Work Group of the American Academy of Actuaries' Life Practice Council believes the date of incurral rather than the date of issue is an actuarially sound basis for the valuation of group and individual LTD tax claim reserves. Furthermore, use of the date of incurral rather than the date of issue is consistent with statutory reserving, where LTD claim reserves for both individual and group insurance use the incurral year basis. While there is a rationale for using the calendar year of issue for individual policies and some hybrid group policies, the arguments are not as strong as those supporting the use of the calendar year of incurral in establishing the interest rate and other assumptions in the calculation of tax reserves for all disability insurance claims.

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