

FAQ on Life Insurance Tax Reserve Methods and Assumptions

**Prepared by the Tax Work Group of the Life Practice Council of the
American Academy of Actuaries**

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Introduction

The purpose of this frequently asked questions (FAQ) paper is to discuss the concepts of “life insurance tax reserve method” and “life insurance tax reserve assumptions” as used in determining life insurance company taxable income in 2017 and prior tax years following Internal Revenue Code (IRC) §§ 807(d) and (f) as those sections existed at the end of 2017. This paper also provides Academy Tax Work Group comments on those tax reserve assumptions that affect contract tax compliance and thus policyholder taxation under the definition of life insurance rules (IRC § 7702) and the modified endowment contract (MEC) rules (IRC § 7702A). This paper focuses on the methods and assumptions involved in determining only the IRC § 807(c)(1) items, i.e., life insurance reserves (meaning reserves for life insurance, annuity, and noncancellable and guaranteed renewable accident and health insurance contracts). This paper does not discuss the rules applicable to the other categories of reserves included in IRC § 807(c).

The answers included in this paper represent the views of the Academy’s Tax Work Group members who have participated in the development of the paper. This document is not an interpretation of actuarial standards of practice nor is it meant to be a codification of generally accepted actuarial practice. Actuaries are not in any way bound to comply with the views expressed herein nor to conform their work to the practices described herein.

The American Academy of Actuaries has assembled this information as a general reference tool to assist actuaries who wish to explore these concepts. This paper is not intended to be a substitute for the practitioner’s thorough review of the federal and state laws, rules, or regulations applicable to his or her actuarial services. In addition, this document does not constitute tax advice and any tax information contained in this document (including any attachments, enclosures, or other accompanying materials) is not intended or written to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties. Any party seeking tax advice should consult with an independent tax adviser/expert.

Many of the issues addressed in this paper have no clear formal guidance, and practitioners can reasonably disagree on answers including those provided herein. The answers are intended to describe tax reserve principles of general applicability, but are not intended to be comprehensive or address exceptions that may apply to particular types of policies or benefits or company-specific situations. Answers to the tax reserve questions provided below may depend on formal guidance issued by the Department of the Treasury and the Internal Revenue Service (IRS) and perhaps court interpretation.

A number of questions about tax reserve methods and assumptions arise when considering evolving statutory and tax concepts of principle-based reserves (PBR), including Actuarial Guideline (AG) 43/VM-21 and VM-20. PBR in the United States insurance statutory regulatory regime reflects an increased focus on valuation assumptions that are more company- and risk-specific, as well as more dynamic. The PBR valuation method includes some components that are based on industry-based rules and formulaic methods, and some components that are based on multiple scenario testing. In addition, some assumptions under PBR may use industry-based experience and trends, and some may be based on company-specific experience and trends and future estimates. This is different from the industry-level reserve assumptions in prior years that only have limited company assumption modifications, other than asset adequacy reserves.

Appendix 1 of this report includes:

- IRC § 807(d)—for the reader’s information on the tax code in effect as of the end of 2017 addressing determination of methods and assumptions.
- IRC § 807(f)—which describes how reserve changes due to changes in methods and assumptions are to be spread over a 10-year period instead of only in the year of change, pursuant to the tax code in effect as of the end of 2017.

General Background on the Calculation of Tax Reserves

The Internal Revenue Code (IRC) in effect as of the end of 2017, specifically IRC § 807(d)(1), provides that the tax reserve with respect to any contract is the greater of (i) the net surrender value of the contract, and (ii) the reserve determined under IRC § 807(d)(2). Furthermore, the amount of the tax reserve for any contract (the annual change in which affects taxable income) may not exceed the statutory reserve for that contract (appropriately adjusted), a concept known as “the stat cap.”

The federally prescribed reserve (FPR)—the amount of reserve determined per IRC § 807(d)(2)—must be determined using the prescribed tax reserve method, the prescribed interest rate, and the prescribed table for morbidity or mortality. All are determined as of the date of issue of the contract. Life insurance tax reserves are determined on an individual contract basis.

IRC § 807 as of the end of 2017 is the result of the Deficit Reduction Act of 1984 and the Omnibus Budget Reconciliation Act of 1987. The legislative history to the Deficit Reduction Act of 1984 (“1984 Act”) states that the starting point for the computation of the federally prescribed reserve is the statutory reserve, which is then adjusted for the prescribed method, interest rate, and table. To provide some of the legislative history of the 1984 Act, pages from the General Explanations of the Deficit Reduction Act of 1984 concerning life insurance reserve methods and assumptions have been included as Appendix 2. The Omnibus Budget Reconciliation Act of 1987 amended parts of IRC § 807 to introduce the applicable federal interest rate.

List of FAQs (expressions and terms in quotes are from IRC § 807 unless otherwise specified). Where appropriate, the answers to the questions are preceded by a date that indicates the time when the answer is applicable under the then current tax code. Because the tax code has changed since 2017, some of the answers presented herein may not be appropriate under the changed tax code.

1. What is an insurance reserve?
2. What is a reserve method?
3. What is a tax reserve method?
4. What are currently prescribed tax reserve methods?
5. Are all statutory reserves included in the calculation of the federally prescribed reserve?
6. What is “the NAIC-prescribed method in effect at the time the contract was issued” if the National Association of Insurance Commissioners (NAIC)-prescribed method is changed after the contract was issued but with an effective date retroactive to a date that is on or before the contract issue date?
7. What is “the NAIC-prescribed method in effect at the time the contract was issued” if there are multiple NAIC-prescribed methods that are permitted at the date of contract issuance?
8. When is a factor or an assumption required to be used in the tax reserve method?
9. When is a non-specified factor or assumption that is used in the calculation of the statutory reserve permitted to be used in the tax reserve method?
10. When is a factor or an assumption that is used in the calculation of the statutory reserve not permitted to be used in determining the federally prescribed reserve?
11. What is “the prevailing State assumed interest rate in effect at the time the contract was issued” when the NAIC-prescribed reserve calculation pursuant to the Standard Valuation Law (SVL) provides that the maximum statutory valuation interest rate will change at a specified time after contract issuance?
12. When there is a choice or range of reserve factors or assumptions that were permissible in the NAIC-prescribed method at the time the contract was issued, and a change is made by the company to adopt, after the contract is issued, another factor or assumption for statutory reserves that was also permissible at the time the contract was issued, should the factors or assumptions used to determine the federally prescribed reserve (FPR) be changed to conform with statutory reserve factors or assumptions?
13. When there is a change in the factors, the assumptions, or the method used to calculate statutory reserves, and such change results in a change in the tax-deductible amount due to a change in the stat cap, would the change in the tax-deductible amount be considered as a change in basis for computing reserves under IRC § 807(f)?

14. Do any of the tax reserve assumptions prescribed in IRC § 807(d) directly affect the policyholder taxation of life insurance contracts?
15. Would life insurance contracts be unable to comply with the requirements of IRC § 7702 if the mortality tables used for valuation purposes differed from the tables used for purposes of state nonforfeiture laws?

Frequently Asked Questions on Tax Reserve Methods and Assumptions

1. What is an insurance reserve?

- A. In general, a reserve for insurance contracts represents at any point in time an insurance company's liability for the future guaranteed (and in some methods nonguaranteed) benefits and in some methods expenses that an insurance company assumes to incur minus the amount of future premium payments and considerations it assumes to receive. Reserves need to be supported by sufficient assets to assure company solvency.

In actuarial literature [*Life Contingencies*, C.W. Jordan], the concept of a reserve for life insurance and annuities arises from the necessity of measuring an insurer's net liability with respect to a policy or a group of policies at times subsequent to the date of issue. In an early insurance tax reserve case [*Maryland Casualty v U.S.*, 1920], the U.S. Supreme Court observed that "the term 'reserve' or 'reserves' in the law of insurance means in general a sum of money variously computed or estimated, which, with accretions from interest, is set aside, 'reserved,' as a fund with which to mature or liquidate either by payment or reinsurance with other companies, future unaccrued and contingent claims, and claims accrued but contingent and indefinite as to amount or time of payment."

While the amount of insurance reserve is a balance sheet item for financial reporting, the change in the reserve is an income statement item that serves to limit the amount of revenue that can be recognized for financial reporting.

2. What is a reserve method?

- A. A reserve method defines a calculation of an appropriate amount for an insurer's net liability using a stated set of actuarial formulas or models, including stochastic modeling, which may utilize, among other factors and assumptions:
 - certain prescribed industry-wide factors or assumptions, or
 - prescribed industry-wide ranges of factors or assumptions, or
 - company-specific factors or assumptions, or
 - prescribed industry-wide or company-specific model parameters.

A reserve method is determined by the prescribing entity's specific regulatory or economic purpose, such as the GAAP (generally accepted accounting principles) reserve method determined by the Financial Accounting Standards Board (FASB), the statutory reserve method determined by the National Association of Insurance Commissioners (NAIC), and the tax reserve method determined by federal law as prescribed in the Internal Revenue Code (IRC).

The various reserve methods develop reserve amounts that can vary, and the results of one method may not be relevant or appropriate for another method.

3. What is a tax reserve method?

- A. A tax reserve method is a reserve method that has been prescribed in the Internal Revenue Code (IRC) or has been interpreted as a tax reserve method by the secretary of the Treasury through regulations, notices, rulings, advice, court cases, etc. [December 2017] The IRC specifies tax reserve methods (e.g., CRVM (Commissioners' Reserve Valuation Method), CARVM (Commissioners Annuity Reserve Valuation Method), and 1-year and 2-year full preliminary term methods) to be used to determine tax reserves for life insurance, annuity, and accident and health contracts. These methods were defined in actuarial literature and the Standard Valuation Law (SVL) when this part of the tax code was enacted. In general, IRC § 807(d)(3) specifies the applicable tax reserve method by referring to the statutory method prescribed by the NAIC that is in effect for a contract on its date of issue.

It should be noted that labeling a reserve method with one of these names may be a factor in determining the tax deductibility of reserves computed under that method. However, such labeling does not guarantee the deductibility of all parts or results of the method, as will be discussed in questions and answers that follow.

4. What are currently prescribed tax reserve methods?
- A. [December 2017] The Internal Revenue Code (IRC) requires the tax reserve method used to calculate the federally prescribed reserve (FPR) to be CRVM (Commissioners Reserve Valuation Method) in the case of contracts covered by CRVM (see IRC § 807(d)(3)(A)(i)) and the tax reserve method used to calculate the FPR to be CARVM (Commissioners Annuity Reserve Valuation Method) in the case of contracts covered by CARVM (see IRC § 807(d)(3)(A)(ii)). In the case of a contract not covered by one of these methods, the tax reserve method is to be the NAIC method which is in effect on the date of the issuance of the contract. If there is no reserve method prescribed by the NAIC which is in effect on the date of the issuance of the contract, then the tax reserve method is to be a method consistent with the other statutory methods.
5. Are all statutory reserves included in the calculation of the federally prescribed reserve?
- A. [December 2017] No. While the general starting point for the federally prescribed tax reserve (FPR) is the statutory reserve, there are adjustments to develop it. In addition to specifying the tax reserve method, IRC and regulations also require (1) that adjustments be made to some statutory reserve factors or assumptions in the calculation of the federally prescribed tax reserves, and (2) that certain types of statutory reserves or portions of statutory reserves, regardless of whether they may be required by a particular statutory reserve method, be denied in the calculation of the FPR. As an example, life insurance deficiency reserves are not permitted as a component of the FPR, even though life insurance deficiency reserves are part of the statutory method and the stat cap referenced in the General Background section above.
6. What is "the NAIC-prescribed method in effect at the time the contract was issued" if the National Association of Insurance Commissioners (NAIC)-prescribed method is changed after the contract was issued but with an effective date retroactive to a date that is on or before the contract issue date?
- A. [December 2017] There is no clear guidance on the tax reserve method to use after the NAIC adopts a new reserve method or issues new guidance that has retroactive application to previously issued contracts. Certainly, the new NAIC method will apply for tax reserve purposes to contracts issued after adoption of the new method. However, for contracts issued prior to adoption of a new NAIC method or prior to issuance of new guidance for a method, it is not clear whether the method required to be used for tax reserves is the new method or the method that was in effect at the time the contracts were originally issued. For example, a new NAIC method will not apply to tax reserves for

previously issued contracts if the Standard Valuation Law (SVL) itself is changed. On the other hand, new NAIC guidance could apply to tax reserves for contracts issued prior to the date of issuance of the guidance if the guidance would have been one of several permissible interpretations of the SVL at the time the contract was issued.

7. What is “the NAIC-prescribed method in effect at the time the contract was issued” if there are multiple NAIC-prescribed methods that are permitted at the date of contract issuance?
- A. [December 2017] The Internal Revenue Code (IRC) specifies tax reserve methods for life insurance, annuity and accident and health contracts. In general, IRC § 807(d)(3) defines the tax reserve method by reference to the applicable statutory method prescribed for the contract by the NAIC which is in effect on the date of the issuance of the contract.

For example, the IRC requires the tax reserve method used to calculate the FPR to be CRVM in the case of contracts covered by CRVM (see IRC § 807(d)(3)(A)(i)) and the tax reserve method used to calculate the federally prescribed reserve (FPR) to be CARVM in the case of contracts covered by CARVM (see IRC § 807(d)(3)(A)(ii)).

The issue of multiple NAIC-prescribed methods arises when the NAIC considers several methods to be consistent with CRVM or CARVM. Examples of multiple NAIC-prescribed methods include:

- The use of various NAIC-adopted Actuarial Guidelines (AGs); e.g., AG 35, which is part of CARVM for equity indexed annuities, and AG 36, which is part of CRVM for equity indexed life insurance policies. Both of these guidelines have different computational methods defined as Type 1 and Type 2.
- Under PBR for life insurance products, there is a three-year transition period during which a company may choose the method to reserve for certain new issues using either CRVM for policies subject to a principle-based valuation or CRVM for policies not subject to a principle-based valuation.

The final answer to this question will likely depend on guidance issued by the Department of the Treasury and the IRS. However, many tax experts consider the correct answer to be that, when at the date of issue of a contract, the NAIC specifies more than one permissible method of computing statutory reserves, each of which is designated as a permissible interpretation of CARVM or CRVM, then the method elected for statutory reserves for a specific contract should govern for tax reserves. The Tax Work Group has presented both a report¹ (March 1, 2011) and a supplemental report² (July 27, 2012) that reflect the thoughts outlined in the next paragraph.

This position is supported by the case of *American Financial Group v United States*, 678 F.3d 422 (6th Cir. 2012). In that case (in which the NAIC filed an *amicus* brief³), the Sixth Circuit Court of Appeals confirmed⁴ that the NAIC’s definition of CARVM (or CRVM by extension) at the time of the contract’s issuance, including a subsequent clarification of that definition, determines the NAIC-prescribed method for tax purposes. However, *American Financial* also has been interpreted by some tax experts to support the following rule: Where the NAIC specifies more than one permissible method of computing reserves at the time of issue of the contract, each of which is designated as a permissible interpretation of CARVM or CRVM, then the method elected for statutory reserves would govern for determining the federally prescribed tax reserves.

¹ http://www.actuary.org/files/publications/Life_PBR_3-year_final.pdf

² http://www.actuary.org/files/publications/3-YearTransitionSupplementalLetter_TaxWG_7-27-12.pdf

³ http://www.naic.org/documents/legal_amicus_american_financial_group_usa.pdf

⁴ <http://www.opn.ca6.uscourts.gov/opinions.pdf/12a0117p-06.pdf>

There is also the question of what happens if a company uses one of the acceptable interpretations of CRVM or CARVM when a contract is issued and then restates statutory reserves to another interpretation that was acceptable at the date of issue of the contract. There is no clear guidance on a requirement to change the tax reserve method. However, in the experience of the work group's members, many tax experts think that the method of calculating the federally prescribed tax reserves most likely could also be subject to a change, and the resultant change in tax reserve amount would be subject to the 10-year spread rule under IRC § 807(f) applicable to changes in basis of computing tax reserves. Note that Appendix 1 of this FAQ includes a copy of IRC § 807(f).

8. When is a factor or an assumption required to be used in the tax reserve method?

A. [December 2017] IRC § 807(d) prescribes the use of specified interest and mortality or morbidity assumptions within the NAIC-prescribed method used for determining the federally prescribed reserves (FPR). Other factors or assumptions specified in the NAIC-prescribed method at the time the contract was issued—e.g., lapse rates as referenced in NAIC-adopted AG 38 as part of CRVM—are required to be used in determining the FPR to the extent they are not inconsistent with the interest and mortality or morbidity assumptions and method prescribed by IRC § 807(d). Besides the interest and mortality or morbidity assumptions, other factors or assumptions required to be used for determining the FPR are the ones used by insurers for statutory reserves. This requirement to use the other factors or assumptions used by insurers for statutory reserves assumes those statutory factors or assumptions are equal to factors or assumptions expressly specified or are within the limited range of factors or assumptions permitted in the NAIC-prescribed reserve method in effect at the time the contract was issued.

9. When is a non-specified factor or assumption that is used in the calculation of the statutory reserve permitted to be used in the tax reserve method?

A. [December 2017] The legislative history of the 1984 Tax Act⁵ indicates that if, at the time of issuance of the contract, the NAIC-prescribed method does not specify the use of a particular factor or assumption, then the factor or assumption required to be used by a majority of states at the time the contract was issued must be used in determining the federally prescribed reserves. Generally, the factor or assumption used for statutory reserves should be used in the tax reserve method, as long as the factor or assumption was permissible (i.e., not prohibited) under the NAIC-prescribed method at the date of the issuance of the contract. An example of a non-specified factor or assumption is the timing of life insurance payment of premiums (beginning of policy year premiums or during a policy year, known as curtate versus continuous functions). Because the Standard Valuation Law (SVL) does not specify the use of the curtate versus continuous formulas, companies could use whichever method they prefer for statutory reserving, but must use the same assumptions for tax reserving.

10. When is a factor or an assumption that is used in the calculation of the statutory reserve not permitted to be used in determining the federally prescribed reserve?

A. [December 2017] A factor or an assumption generally is not permissible for use in determining the federally prescribed reserves even if it is used for statutory reserves if:

- i) it is not a prescribed or permissible factor or assumption in the NAIC-prescribed method (or mandated by at least 26 states) at the time the contract is issued (e.g., prior to AG 43, the large asset drop required only by Connecticut for valuing certain variable annuity benefits has been deemed by the IRS to not be a prevailing practice and the method was not allowed for the tax reserve method);

⁵ The Deficit Reduction Act (DEFRA) of 1984—<https://www.congress.gov/bill/98th-congress/house-bill/4170>

- ii) it is not compatible with, or is unreasonable in the context of, the structure of assumptions contemplated by the NAIC-prescribed method at the time the contract is issued (e.g., a company uses a lapse rate for statutory reserves with domiciliary commissioner approval, but the lapse rate is outside the range specified in the NAIC-prescribed method); or
- iii) it is not compatible with, or is unreasonable in the context of, the structure of assumptions contemplated by the NAIC-prescribed method at the time the contract is issued when considered in conjunction with other assumptions required by the Internal Revenue Code (IRC) (e.g., interest and mortality or morbidity assumptions).

11. What is “the prevailing State assumed interest rate in effect at the time the contract was issued” when the NAIC-prescribed reserve calculation pursuant to the Standard Valuation Law (SVL) provides that the maximum statutory valuation interest rate will change at a specified time after contract issuance?

- A. [December 2017] The prescribed interest rate required to be used for determining the federally prescribed reserves is based, in part (due to the comparison of the statutory rate with the applicable federal rate), on the maximum statutory valuation interest rate prescribed by a majority of states at the time the contract is issued.

When the NAIC-prescribed reserve calculation provides that the interest rate will or may change at a specified time after contract issuance, it is unclear which appropriate statutory rate should be used in determining the federally prescribed reserve for the contract—for example, whether the rate to use is always the rate at contract issuance or reflects the changed rate as of the time of the change or some blending of rates. To the extent that the NAIC-prescribed calculations clearly define a post-issuance interest rate change, the argument that the changed rate should be used in determining the FPR is stronger. It is less clear that the changed rate should be used where the NAIC-prescribed rate change and its implementation are less well defined.

In such cases of a changing maximum statutory valuation interest rate, it is noted that it may be an open issue in certain cases as to the date of the determination of the choice of the applicable federal rate.

12. When there is a choice or range of reserve factors or assumptions that were permissible in the NAIC-prescribed method at the time the contract was issued, and a change is made by the company to adopt, after the contract is issued, another factor or assumption for statutory reserves that was also permissible at the time the contract was issued, should the factors or assumptions used to determine the federally prescribed reserve (FPR) be changed to conform with statutory reserve factors or assumptions?

- A. [December 2017] The consensus of opinion of the Tax Work Group is that if the factor or assumption is not otherwise prescribed for tax reserves (i.e., other than interest, mortality or morbidity), and if the factor or assumption is used in the computation of the FPR, the factor or assumption should be changed to conform to the statutory reserve factor or assumption.

13. When there is a change in the factors, the assumptions, or the method used to calculate statutory reserves, and such change results in a change in the tax-deductible amount due to a change in the stat cap, would the change in the tax-deductible amount be considered as a change in basis for computing reserves under IRC § 807(f)?

- A. [December 2017] There is an open tax issue of how such a change in the tax-deductible amount attributable to the change in factors or assumptions or method in the calculation of the statutory reserve should be reported for tax purposes, i.e., as a change in estimate or as a change in basis.

14. Do any of the tax reserve assumptions prescribed in IRC § 807(d) directly affect the policyholder taxation of life insurance contracts?

- A. [December 2017] Yes, the mortality table assumption is used in IRC § 7702, the federal tax definition of “life insurance contract,” and in IRC § 7702A, the modified endowment contract rules. Specifically, IRC § 7702 and IRC § 7702A require the computation of the guideline single premium, guideline level premium, net single premium, and the 7-pay premium for a contract to be based *inter alia* on “reasonable mortality charges which . . . do not exceed the mortality charges specified in the prevailing commissioners’ standard tables (as defined in IRC § 807(d)(5)) as of the time the contract is issued.” This quoted rule reflects the U.S. Congress’ assumption that the mortality tables used for valuation purposes apply as well for purposes of state nonforfeiture laws. However, IRC § 7702(c)(3)(B)(i) authorizes the issuance of regulations permitting the use of mortality charges that are different from those specified in the prevailing commissioners’ standard tables.

While IRC §§ 7702 and 7702A make references to the tables used under IRC § 807(d)—that is, the prevailing commissioners’ standard mortality tables used for tax reserves—the Treasury Department has authority to use another table for these sections when appropriate.

15. Would any life insurance contract be unable to comply with the requirements of IRC § 7702 if the mortality tables used for valuation purposes differed from the tables used for purposes of state nonforfeiture laws?

- A. [December 2017] To the extent that the mortality tables used in valuation are decoupled from those used in determining minimum nonforfeiture values, traditional life insurance contracts will not be able to continue to comply under the cash value accumulation test (CVAT) with the requirements of IRC § 7702, by virtue of the IRC § 7702(c)(3)(B)(i) rule. By way of example, assume that in 2018 the new 2017 Commissioners’ Standard Ordinary (CSO) tables were required for valuation under state law and thus constituted the prevailing commissioners’ standard tables at issue as defined in IRC § 807(d)(5), but the 2001 CSO tables continued to be used in determining minimum nonforfeiture values. In such a case, the minimum cash values of a traditional contract issued in 2018 would be based on the 2001 CSO tables, while the net single premiums (limiting those cash values) would be based on the 2017 CSO tables by virtue of the IRC § 7702(c)(3)(B)(i) rule. For this reason, the contract would not be able to meet the requirements of IRC § 7702.

As stated in the answer to Question 14, IRC § 7702(c)(3)(B)(i) authorizes the issuance of regulations permitting the use of mortality charges that exceed those specified in the prevailing commissioners’ standard tables. Such regulations could resolve the issues described above where the prevailing commissioners’ standard tables used for valuation are not the same as those used for nonforfeiture.

APPENDIX I

Sections 807(d) and 807(f) as of 12/31/17

807(a) DECREASE TREATED AS GROSS INCOME.— If for any taxable year—

807(a)(1) the opening balance for the items described in subsection (c), exceeds

807(a)(2)

807(a)(2)(A) the closing balance for such items, reduced by

807(a)(2)(B) the amount of the policyholders' share of tax-exempt interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies,

such excess shall be included in gross income under section 803(a)(2).

807(b) INCREASE TREATED AS DEDUCTION.— If for any taxable year—

807(b)(1)

807(b)(1)(A) the closing balance for the items described in subsection (c), reduced by

807(b)(1)(B) the amount of the policyholders' share of tax-exempt interest and the amount of the policyholder's share of the increase for the taxable year in policy cash values (within the meaning of section 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which section 264(f) applies, exceeds

807(b)(2) the opening balance for such items,

such excess shall be taken into account as a deduction under section 805(a)(2).

807(c) ITEMS TAKEN INTO ACCOUNT.— The items referred to in subsections (a) and (b) are as follows:

807(c)(1) The life insurance reserves (as defined in section 816(b)).

807(c)(2) The unearned premiums and unpaid losses included in total reserves under section 816(c)(2).

807(c)(3) 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 (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies.

807(c)(4) Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.

807(c)(5) Premiums received in advance, and liabilities for premium deposit funds.

807(c)(6) 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.

For purposes of paragraph (3), the appropriate rate of interest for any obligation is whichever of the

following rates is the highest as of the time such obligation first did not involve life, accident, or health contingencies: the applicable Federal interest rate under subsection (d)(2)(B)(i), the prevailing State assumed interest rate under subsection (d)(2)(B)(ii), or the rate of interest assumed by the company in determining the guaranteed benefit. In no case shall the amount determined under paragraph (3) for any contract be less than the net surrender value of such contract. For purposes of paragraph (2) and section 805(a)(1), the amount of the unpaid losses (other than losses on life insurance contracts) shall be the amount of the discounted unpaid losses as defined in section 846.

807(d) METHOD OF COMPUTING RESERVES FOR PURPOSES OF DETERMINING INCOME.—

807(d)(1) IN GENERAL.— For purposes of this part (other than section 816), the amount of the life insurance reserves for any contract shall be the greater of—

807(d)(1)(A) the net surrender value of such contract, or

807(d)(1)(B) the reserve determined under paragraph (2).

In no event shall the reserve determined under the preceding sentence for any contract as of any time exceed the amount which would be taken into account with respect to such contract as of such time in determining statutory reserves (as defined in paragraph (6)).

807(d)(2) AMOUNT OF RESERVE.— The amount of the reserve determined under this paragraph with respect to any contract shall be determined by using—

807(d)(2)(A) the tax reserve method applicable to such contract,

807(d)(2)(B) the greater of—

807(d)(2)(B)(i) the applicable Federal interest rate, or

807(d)(2)(B)(ii) the prevailing State assumed interest rate, and

807(d)(2)(C) the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

807(d)(3) TAX RESERVE METHOD.— For purposes of this subsection—

807(d)(3)(A) IN GENERAL.— The term “tax reserve method” means—

807(d)(3)(A)(i) LIFE INSURANCE CONTRACTS.— The CRVM in the case of a contract covered by the CRVM.

807(d)(3)(A)(ii) ANNUITY CONTRACTS.— The CARVM in the case of a contract covered by the CARVM.

807(d)(3)(A)(iii) NONCANCELLABLE ACCIDENT AND HEALTH INSURANCE CONTRACTS.— In the case of any noncancellable accident and health insurance contract (other than a qualified long-term care insurance contract, as defined in section 7702B(b)), a 2-year full preliminary term method.

807(d)(3)(A)(iv) OTHER CONTRACTS.— In the case of any contract not described in clause (i), (ii), or (iii)—

807(d)(3)(A)(iv)(I) the reserve method prescribed by the National Association of Insurance Commissioners which covers such contract (as of the date of issuance), or

807(d)(3)(A)(iv)(II) if no reserve method has been prescribed by the National Association of Insurance Commissioners which covers such contract, a reserve method which is consistent with the reserve method required under clause (i), (ii), or (iii) or under subclause (I) of this clause as of the date of the issuance of such contract (whichever is most appropriate).

807(d)(3)(B) DEFINITION OF CRVM AND CARVM.— For purposes of this paragraph—

807(d)(3)(B)(i) CRVM.— The term “CRVM” means the Commissioners' Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract.

807(d)(3)(B)(ii) CARVM.— The term “CARVM” means the Commissioners' Annuities Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is in effect on the date of the issuance of the contract.

807(d)(3)(C) NO ADDITIONAL RESERVE DEDUCTION ALLOWED FOR DEFICIENCY RESERVES.— Nothing in any reserve method described under this paragraph shall permit any increase in the reserve because the net premium (computed on the basis of assumptions required under this subsection) exceeds the actual premiums or other consideration charged for the benefit.

807(d)(4) APPLICABLE FEDERAL INTEREST RATE; PREVAILING STATE ASSUMED INTEREST RATE.— For purposes of this subsection—

807(d)(4)(A) APPLICABLE FEDERAL INTEREST RATE.—

807(d)(4)(A)(i) IN GENERAL.— Except as provided in clause (ii), the term “applicable Federal interest rate” means the annual rate determined by the Secretary under section 846(c)(2) for the calendar year in which the contract was issued.

807(d)(4)(A)(ii) ELECTION TO RECOMPUTE FEDERAL INTEREST RATE EVERY 5 YEARS.—

807(d)(4)(A)(ii)(I) IN GENERAL.— In computing the amount of the reserve with respect to any contract to which an election under this clause applies for periods during any recomputation period, the applicable Federal interest rate shall be the annual rate determined by the Secretary under section 846(c)(2) for the 1st year of such period. No change in the applicable Federal interest rate shall be made under the preceding sentence unless such change would equal or exceed $\frac{1}{2}$ of 1 percentage point.

807(d)(4)(A)(ii)(II) RECOMPUTATION PERIOD.— For purposes of subclause (I), the term “recomputation period” means, with respect to any contract, the 5 calendar year period beginning with the 5th calendar year beginning after the calendar year in which the contract was issued (and each subsequent 5 calendar year period).

807(d)(4)(A)(ii)(III) ELECTION.— An election under this clause shall apply to all contracts issued during the calendar year for which the election was made or during any subsequent calendar year unless such election is revoked with the consent of the Secretary.

807(d)(4)(A)(ii)(IV) SPREAD NOT AVAILABLE.— Subsection (f) shall not apply to any adjustment required under this clause.

807(d)(4)(B) PREVAILING STATE ASSUMED INTEREST RATE.—

807(d)(4)(B)(i) IN GENERAL.— The “prevailing State assumed interest rate” means, with respect to any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance contracts or annuity contracts (as the case may be) under the insurance laws of at least 26 States. For purposes of the preceding sentence, the effect of nonforfeiture laws of a State on interest rates for reserves shall not be taken into account.

807(d)(4)(B)(ii) WHEN RATE DETERMINED.— The prevailing State assumed interest rate with respect to any contract shall be determined as of the beginning of the calendar year in which the contract was issued.

807(d)(5) PREVAILING COMMISSIONERS' STANDARD TABLES.— For purposes of this subsection—

807(d)(5)(A) IN GENERAL.— The term “prevailing commissioners' standard tables” means, with respect to any contract, the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued.

807(d)(5)(B) INSURER MAY USE OLD TABLES FOR 3 YEARS WHEN TABLES CHANGE.— If the prevailing commissioners' standard tables as of the beginning of any calendar year (hereinafter in this subparagraph referred to as the “year of change”) is different from the prevailing commissioners' standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.

807(d)(5)(C) SPECIAL RULE FOR CONTRACTS FOR WHICH THERE ARE NO COMMISSIONERS' STANDARD TABLES.— If there are no commissioners' standard tables applicable to any contract when it is issued, the mortality and morbidity tables used for purposes of paragraph (2)(C) shall be determined under regulations prescribed by the Secretary. When the Secretary by regulation changes the table applicable to a type of contract, the new table shall be treated (for purposes of subparagraph (B) and for purposes of determining the issue dates of contracts for which it shall be used) as if it were a new prevailing commissioner's standard table adopted by the twenty-sixth State as of a date (no earlier than the date the regulation is issued) specified by the Secretary.

807(d)(5)(D) SPECIAL RULE FOR CONTRACTS ISSUED BEFORE 1948.— If—

807(d)(5)(D)(i) a contract was issued before 1948, and

807(d)(5)(D)(ii) there were no commissioners' standard tables applicable to such contract when it was issued,

the mortality and morbidity tables used in computing statutory reserves for such contracts shall be used for purposes of paragraph (2)(C).

807(d)(5)(E) SPECIAL RULE WHERE MORE THAN 1 TABLE OR OPTION APPLICABLE.— If, with respect to any category of risks, there are 2 or more tables (or options under 1 or more tables) which meet the requirements of subparagraph (A) (or, where applicable, subparagraph (B) or (C)), the table (and option thereunder) which generally yields the lowest reserves shall be used for purposes of paragraph (2)(C).

807(d)(6) STATUTORY RESERVES.— The term "statutory reserves" means the aggregate amount set forth in the annual statement with respect to items described in section 807(c). Such term shall not include any reserve attributable to a deferred and uncollected premium if the establishment of such reserve is not permitted under section 811(c).

807(f) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES.—

807(f)(1) 10- YEAR SPREAD.—

807(f)(1)(A) IN GENERAL.— For purposes of this part, if the basis for determining any item referred to in subsection (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, then so much of the difference between—

807(f)(1)(A)(i) the amount of the item at the close of the taxable year, computed on the new basis, and

807(f)(1)(A)(ii) the amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account under the method provided in subparagraph (B).

807(f)(1)(B) METHOD.— The method provided in this subparagraph is as follows:

807(f)(1)(B)(i) if the amount determined under subparagraph (A)(i) exceeds the amount determined under subparagraph (A)(ii), $\frac{1}{10}$ of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a deduction under section 805(a)(2); or

807(f)(1)(B)(ii) if the amount determined under subparagraph (A)(ii) exceeds the amount determined under subparagraph (A)(i), $\frac{1}{10}$ of such excess shall be included in gross income, for each of the 10 succeeding taxable years, under section 803(a)(2).

807(f)(2) TERMINATION AS LIFE INSURANCE COMPANY.— Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this subsection shall be taken into account for the preceding taxable year.

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d. Deductions with respect to reserves (sec. 211 of the Act and new secs. 807 and 817 of the Code) ¹⁸

Prior Law

A life insurance company is allowed to deduct (or exclude from income) increases in its year-end reserves over those for the prior year. Under prior law, there were two elements to the deduction for reserves. First, for purposes of computing its taxable investment income, a life insurance company could exclude from its investment yield (i.e., gross investment income less investment and similar expenses) the policyholders' share of that investment yield. Second, for purposes of computing gain and loss from operations, a life insurance company could deduct increases in reserves allocable to premium income (i.e., increases in reserves, adjusted to not include required interest that is credited to its reserves and excluded in the computation of taxable investment income). A life insurance company's tax reserves were based on its reserves for State regulatory purposes (i.e., statutory reserves) and, as a general rule, a company's deduction reflected an increase in its statutory reserves over its statutory reserves for the prior year.

Under prior law, life insurance reserves must have been (1) required under State law, (2) computed or estimated on the basis of recognized mortality or morbidity tables and an assumed rate of interest, and (3) set aside to mature or liquidate future unaccrued claims under life, annuity, or noncancellable accident and health insurance contracts.

Statutory reserves are calculated under a preliminary term method or the net level premium method. Generally, under a preliminary term method, first year expenses (e.g., commissions) are treated as funded out of the premiums for the first year, and only the excess of premiums reduced by such expenses is available to fund reserves. Under the net level method, the first year expenses are treated as funded out of premiums over the life of the contract. Companies using this method for State regulatory purposes have larger reserves in the early years of a contract than companies using the preliminary term method. However, because expenses not funded out of premiums must be funded out of surplus, the net level method is, for all practical purposes, not generally available to companies with limited amounts of surplus.

A life insurance company was allowed to revalue its preliminary term reserves for tax purposes to eliminate a disparity in tax treatment that otherwise would have resulted between life insurance companies with greater amounts of surplus and companies with smaller surplus accounts. Reserves computed for statutory purposes on a preliminary term basis could be revalued to a net level premium basis using either an exact revaluation or an approximate revaluation. Reserves revalued under the approximate formula (as modified by TEFRA) were revalued by increasing such re-

¹⁸ For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1411-1420; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Pt. 98-169, Vol. I (April 2, 1984), pp. 537-546; and H. Rep. No. 98-861 (June 23, 1984), pp. 1050-1056 (Conference Report).

serves by (1) \$19 per \$1,000 of insurance in force for other than term insurance, less 1.9 percent of the reserves under such contracts, and by (2) \$5 per \$1,000 of term insurance in force under such contracts which at the time of issuance cover a period of more than 15 years, less 0.5 percent of the reserves under such contracts. The approximate revaluation formula could result in greater reserves than actual net level premium reserves or reserves recomputed using exact revaluation.

Under prior and present law, if as of the close of any taxable year the basis for determining the amount of any increase or decrease in reserves differs from the basis for such determination as of the close of the preceding taxable year, any resulting income or loss is taken into account ratably over a 10-year period.

In addition to the rules described above which apply to life insurance contracts, other rules provide for unearned premium and unpaid loss reserves for accident and health insurance contracts. Under these rules, unpaid losses may be estimated and reserved for on a nondiscounted basis. For purposes of determining the amount of the deduction for the addition to the unearned premium reserve, gross premiums are considered to be earned pro rata over the life of the contract.

Explanation of Provisions

In general, life insurance companies are allowed a deduction for a net increase in reserves and must take into income any net decrease in reserves. Unlike their treatment under the 1959 Act, the deduction for increases in reserves takes into account increases due to both premiums and assumed interest credited to the reserves. In general, the net increase or net decrease in reserves is computed by comparing the closing balance for reserves to the opening balance of the reserves, with the closing balance of the reserve becoming the opening balance for the following year.

Also, in computing the net increase or net decrease in reserves, the closing balance of the reserve items is reduced by the policyholders' share of tax-exempt interest. This continues the view under prior law that a life insurance company's reserve liability to its policyholders in effect entitles the policyholders to a pro rata portion of each item of investment income.

Reserves taken into account

In computing the net increase or net decrease in reserves, the Act specifies that six items, which are all reserves or in the nature of reserves, be taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations which are obligations under insurance and annuity contracts which do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts;¹⁹ (5) premiums received in advance and liabil-

¹⁹ The investment portion of any life insurance contract which fails to meet the definition of a life insurance contract under section 7702 is treated as a reserve under section 807(c)(4).

ities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are held for retired lives, premium stabilization, or a combination of both.

The six items specified in the Act generally are the same items as under prior law. However, the Act requires that the amount of the contingency reserves held for retired lives and premium stabilization be reasonable in relation to the amount of coverage provided by, and the loss experience suffered by, the company with respect to the underlying group contract. See also changes made by the Act in the employee benefit area (new sec. 419A). Also, the Act requires that the discount rate used by the companies for a reserve amount for an insurance and annuity obligation that does not involve life, accident, or health contingencies be the higher of the prevailing State assumed interest rate or the interest rate assumed by the company in determining the guaranteed benefits. These rates are to be determined when the obligation first ceases to involve life, accident, or health contingencies.

The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in prior law required proper computation under State law in order for deductions to be allowed, because prior law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The Act, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves. Thus, a company cannot improperly compute a reserve for a liability involving a life contingency to avoid the Federally prescribed reserve computation, and for example claim treatment as unearned premiums, in order to use statutory reserve amounts for tax purposes.

Computation of reserves

For purposes of determining life insurance company taxable income, the Act provides that the life insurance reserves for any contract shall be the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules. In no event will the amount of the tax reserves at any time exceed the amount of the statutory reserves, which (given the general definition thereof in new sec. 809(b)(4)(B)(i)) include also any deficiency reserves relating to the liabilities. The net surrender value is the cash surrender value reduced by any surrender penalty except that

any market value adjustment required on surrender is not taken into account.²⁰

Generally, the comparison of the net surrender value of a contract and the Federally prescribed reserves for the benefits under the contract is made on an aggregate benefit basis; however, the comparison may be made on a benefit-by-benefit basis if the benefit is a qualified supplemental benefit or a qualified substandard risk (see discussion below on special rules). Also, the comparison of contract cash surrender values and Federally prescribed reserves can be made on a group summary basis (i.e., grouping contracts that are identical as to plan of insurance, year of issue or contract duration, age of issue, etc.) or on an individual contract (or seriatum) basis. The Act requires the comparison of tax reserves with statutory reserves as well as the comparison of the Federally prescribed reserve with the net surrender value. The net surrender value represents the current contractual cash benefit payable under a policy, while the reserves reflect all the benefits (including the net surrender value) payable under a policy. Thus, in making the comparisons prescribed in the statute, consistent assumptions must be made with respect to whether a group summary or individual basis is used, whether mean reserves are used, and what premium paid to date is used.

The Act requires that, in computing the Federally prescribed reserve for any type of contract, the tax reserve method applicable to that contract must be used, along with the prevailing State assumed interest rate and the prevailing commissioners' standard tables for mortality or morbidity. 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 (e.g., whether to use a continuous or curtate function) should be consistent with those employed in computing a company's statutory reserve. The prescribed rules for computing tax reserves are intended, generally, to allow companies to recognize at least the minimum reserve that most States would require them to set aside, but no more unless the net surrender value is greater. However, to avoid State-by-State variations, the rules prescribed in the Act are based on the general guidelines recommended by the National Association of Insurance Commissioners (NAIC) and adopted by a majority of the States.

Reserve method

With respect to the reserve method to be used, the Act prescribes specific tax reserve methods for particular types of contracts. For life insurance contracts, the prescribed method is the applicable

²⁰ As under new sec. 7702(f)(2), net surrender value is determined with regard to surrender charges, but without regard to any policy loan.

Commissioners' Reserve Valuation Method (CRVM) in effect when the contract is issued. Generally, this is the date that appears on the policy form. For annuity contracts, the prescribed method is the applicable Commissioners' Annuities Reserve Valuation Method in effect when the contract is issued. For noncancellable accident and health insurance contracts, a 2-year full preliminary term method is required.²¹ Finally, for all other contracts, the reserve method prescribed by the NAIC or, if no method is so prescribed, a method consistent with whichever of the prescribed methods that would be most appropriate for the contract must be used. An example of a life insurance contract not covered until recently by an NAIC prescribed method was a universal life insurance contract. The NAIC prescribed a CRVM for universal life insurance for the first time in December 1983. Thus, reserves for such contracts issued after 1983 must be computed using the prescribed CRVM; reserves for such contracts issued prior to the NAIC recommendation could be computed using the newly prescribed CRVM and would be considered to be computed on a method consistent with CRVM. Also, the NAIC has not prescribed any method for contracts issued by assessment companies in Texas (i.e., either mutual assessment companies or stipulated premium companies), because such life insurance companies generally are not found outside of Texas. Under Texas law, reserves for such policies are computed on a half-year full preliminary term method and such

²¹ There is also a special rule (sec. 217(n) of the Act) that allows a company to use the net level reserve method with respect to any noncancellable accident and health insurance contract for any taxable year, if the company (1) uses that method to compute its tax reserves on noncancellable accident and health contracts for such taxable year, (2) was using that method for statutory reserves on noncancellable accident and health contracts as of December 31, 1982 (as evidenced by its 1982 annual statement, as originally filed), and (3) has continuously used that method for reserves on noncancellable accident and health contracts for annual statement purposes after 1982 and through such taxable year. The reference in the qualification requirements to the annual statement filing of a company indicates that this rule was intended to be applied on a company-by-company basis.

This statutory provision was intended to be narrow in its application by requiring a complete and continuous commitment by the company to the use of the more conservative net level reserve method for its directly written noncancellable accident and health contracts as a reflection of the company's conservative business practices before a company could recognize such practices for tax purposes. Specifically, it was intended to address the factual situation of a company that had followed, and continues to follow, the business practice of computing all its reserves for directly written noncancellable accident and health contracts on a net level basis for State purposes and to allow such a company to use this more conservative reserve basis for tax purposes. It was intended that a company be considered to have all its directly written accident and health reserves on a net level basis even if *de minimis* amounts (i.e., no more than 1 percent) do not so conform. With respect to reserves for contracts covered by a reinsurance agreement a reinsuring company generally adopts the reserve method used by the ceding company and does not follow the usual reserve business practice it would use for directly written business. Accordingly, for purposes of applying this special rule and qualifying therefor, only reserves on directly written contracts were intended to be taken into account.

Because this special rule is a departure from the general tax policy adopted in statutorily prescribing life insurance tax reserves, and because of a concern that the rule be strictly narrow in its scope, the statement of managers for the conference report included additional explanatory language. The additional explanation limited the application of the rule to noncancellable accident and health contracts sold under currently marketed plans of insurance, but not under new plans of insurance. The practical consequences of this further limiting language is that no company, even one meeting the otherwise strict qualification requirements, will elect to use the special rule because the detriment of forgoing the fresh start (because noncancellable accident and health reserves are not revalued) will not be offset by any favorable future reserve treatment for new product developments. Such an explanation is inconsistent with the clear intention to allow certain companies with conservative reserve business practices to recognize those reserve practices for tax purposes. Thus, the election of the special rule must have been intended to apply for business under both existing and new plans of insurance. Given this understanding, it is anticipated that appropriate technical corrections will be made to clarify the application of this special rule.

method should be considered to be consistent with CRVMs prescribed by the NAIC.²²

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

In general, the Federally prescribed reserve methods refer to those recommended by the NAIC for the particular type of contract. There is no requirement that the method also be required based on the prevailing view of the States. Thus, as a general rule, in computing any life insurance reserve, a company must take into account any factors specifically recommended by the NAIC. If specific factors are not recommended by the NAIC prescribed reserve method, the prevailing State interpretation of such method should be considered for purposes of determining what factors can be taken into account in applying the computation method for tax purposes.

With respect to the computation of annuity reserves, it was understood that the practices of the various States differ on whether surrender charges should be taken into account (and reduce the amount of the reserve) and that the matter is currently being considered by the NAIC for a recommendation. In light of these events, the Congress specifically intended that, in the case of annuity reserves, if the NAIC acted in 1984 and clarified that surrender charge factors are to be disregarded (and not to reduce the amount of the reserve) under the CARVM for certain contracts, then this clarification is to be considered in effect on the date of issuance of such contracts. It was recognized that giving retroactive effect to a NAIC recommendation in this instance is an exception to the general rule that reserves must be computed for tax purposes under the method prescribed by the NAIC (or the prevailing State interpretation thereof) in effect on the date of issuance of the contract.

Interest rates

With respect to the assumed interest rate to be used in computing the Federally prescribed reserve, the Act looks to the "prevailing view" of the States. A view is considered to be a prevailing view if it is recognized by at least 26 States when the contract is

²² An exception from the general mortality and morbidity tables requirements for reserves for life insurance contracts issued by assessment companies is also provided as a nonCode amendment. These companies may use the table used for State law purposes if that mortality and morbidity table was developed by taking into account the particular experience of those companies and was in existence and in use by 1965. Further revisions of such unique tables will be allowed for tax purposes only if the table is revised in a manner consistent with the way in which the original table was developed. Finally, there is a nonCode amendment that allows mutual assessment companies in Texas to use their statutory reserves for tax purposes (sec. 217(f) of the Act).

issued.²³ Thus, the "prevailing State assumed interest rate" means, for any contract, the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued. If the highest assumed interest rate is actually determined by the States during the year but declared effective as of the beginning of the calendar year, that rate also will be effective for tax purposes at the beginning of the year. For nonannuity contracts, the issuing company may elect, on a contract-by-contract basis, to use the prevailing interest rate from the preceding calendar year. In determining the highest assumed rates permitted in at least 26 States, each State should be treated as permitting the use of every rate below its highest rate. Also, the highest State assumed interest rate referred to in the Act is the highest permitted to be used in computing reserves without taking into account any limitations that might be imposed by States if a different rate is assumed for computing cash surrender values under standard nonforfeiture laws.

Also, a special rule was adopted for purposes of identifying the prevailing interest rate with respect to life insurance reserves on noncancellable accident and health insurance contracts (e.g., the reserve in addition to the unearned premiums and unpaid losses on such contracts). Until States specifically prescribe an interest rate for these reserves, the prevailing interest rate for reserves on whole life policies will be used because of the analogous character of these reserves to reserves on ordinary life policies.

Mortality tables

Like the prescribed interest rate, the prevailing commissioners' standard tables for mortality or morbidity to be used for computing the Federally prescribed reserves are, with respect to any contract, the most recent tables prescribed by the NAIC and permitted to be used for that type of contract in computing reserves under the laws of at least 26 States when the contract is issued. If a table becomes a prevailing commissioners' standard table during a calendar year, the Congress intended that the new table could be used as the prevailing table from the beginning of the calendar year (this does not alter when the year of change occurs). Generally, when mortality and morbidity tables are being updated and adopted by the States, companies will have three full years after a particular set of tables becomes the prevailing view of the States before such table becomes mandatory for computing reserves for tax purposes. For example, it is the understanding of the Congress that the 1980 C.S.O. tables for life insurance contracts were adopted by at least 26 States by the end of 1983. Thus, companies will be able to use either the 1958 C.S.O. tables or the 1980 C.S.O. tables for taxable years 1984, 1985, and 1986 for computing tax reserves; however, the

²³ In the case of reinsurance under which the future liability of the reinsurer is determined on the basis of the separate experience of underlying policies (rather than the overall experience of a block of business), the issue date appropriately referred to for these purposes is that of the underlying policies and not the date of the reinsurance contract.

1980 C.S.O. tables will have to be used for contracts issued after 1986.

The Federally prescribed reserve requires the use of the prevailing commissioners' standard tables for mortality and morbidity adjusted as appropriate to reflect the risks, such as substandard risks, incurred under the contract which are not otherwise taken into account. If, for example, the commissioners' standard tables differentiate between smokers and nonsmokers, reserves relating to insureds that are otherwise standard risks except for known smoking habits must be computed using the commissioners' standard table for smokers without any adjustment to reflect substandardness due to smoking. This is appropriate because the factor of smoking is already taken into account, and any excess mortality due to such factor is implicit in the use of the smokers' table. Companies may adjust the prevailing commissioners' standard tables, as appropriate, to reflect risks incurred under the contract if such risks are not otherwise taken into account. For example, a company may use an appropriate multiple of a table to reflect the substandard classification of particular insureds because of poor health or medical condition. An appropriate multiple should reflect the greater mortality expected, for example, from a person with a known heart or diabetic condition, in excess of the mortality of the group of standard insureds that is implicit in the prevailing commissioners' standard table. Also, adjustment to the tables may be appropriate to reflect the risks involved in writing term insurance on individuals for whom the company requires no evidence of insurability (that is, if the company does not underwrite the risks);²⁴ or because the insureds reside in a foreign country known to be experiencing civil strife.

The Act also provides special rules for existing contracts where standard tables are not available or where multiple tables (or projections) are available. Generally, if there is no prevailing commissioners' standard table applicable to a contract when it is issued, the table used for purposes of computing the Federally prescribed reserve must be determined under Treasury regulations. However, for contracts issued before 1948 (when the use of commissioners' standard tables was first required), the mortality or morbidity tables used for State law purposes can be used in recomputing all reserves for tax purposes as of January 1, 1984, and thereafter in computing the Federally prescribed reserve. The Act also specifically provides that, if there are multiple mortality and morbidity tables (e.g., projections of the standard table) that meet the definition of the prevailing commissioners' standard table with respect to a certain type of contract, the table that generally yields the lowest reserve must be used in computing the Federally prescribed reserve.

Change in computing reserves

The prior law rule allowing income or loss resulting from a change in the method of computing reserves to be taken into account ratably over a 10-year period is retained under the Act. Gen-

²⁴ For example, States have recognized that some adjustment is appropriate to the standard table for computing adequate reserves on credit life insurance.

erally, the rule for a change in basis in computing reserves will be applied to life insurance tax reserves only if there is a change in basis in computing the Federally prescribed reserve (as distinguished from the net surrender value). Although life insurance tax reserves now require the use of a Federally prescribed method, interest rate, and mortality or morbidity table, changes in other assumptions for computing statutory reserves (e.g., when premiums are collected and claims are paid) may cause increases or decreases in a company's life insurance reserves that must be spread over a 10-year period. Changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

Special rules

In addition to the above described rules for computing the Federally prescribed reserves, the Act provides some special rules for life insurance reserves under pension plan contracts, group contracts, certain supplementary benefit provisions, substandard risks, and contracts issued by foreign branches of domestic life insurance companies.

Pension plan and group contracts

For purposes of computing the amount of life insurance reserves for pension plan contracts, the net surrender value of a contract is deemed to be an amount equal to the balance in the policyholder's fund (determined with regard to any penalty or forfeiture imposed upon surrender, but without regard to any market value adjustment). The term "policyholder's fund" refers generally to any experience fund, experience accumulation or asset share allocable to the contract.

For purposes of computing the Federally prescribed reserve for any group contract, the date the contract is issued is generally the date as of which the master plan is issued. However, if a benefit is guaranteed to a plan participant after such date, the company must take into account the date as of which the benefit is guaranteed in computing its reserves.

Finally, there is a transitional rule for recomputation of reserves for group contracts as of January 1, 1984, if the issuance date (or the date benefits were guaranteed) cannot be determined. In such a case, the issuance date must be determined on the basis prescribed by Treasury. It is anticipated that Treasury will develop some method for approximating the date of issuance that generally reflects the pattern of growth in the type of group business.

Supplemental benefits

Under the Act, the amount of the life insurance reserve for certain enumerated supplemental benefits is the statutory reserve. It was believed that, due to the *de minimis* nature of the enumerated supplemental benefit reserves, economic distortions caused by using statutory reserves would be minimal. The supplemental ben-

efits listed are any (1) guaranteed insurability benefit,²⁵ (2) accidental death or disability benefit,²⁶ (3) convertibility benefit, (4) disability waiver benefit, or (5) any other benefit prescribed by regulations, if such benefit is supplemental to a contract for which there is a policyholder reserve item taken into account for taxable income purposes. In extending this list, Treasury should consider any supplemental benefits it adds as being *de minimis* either because reserves for such business represent a relatively small portion of total industry reserves or because the tax effect of so enumerating it is minimal. The life insurance reserve for any other benefit provided for under the contract and not specifically so enumerated, whether or not such a benefit is considered supplemental under State law, must be computed using the Federally prescribed method (as described in section 807(d)).

If a supplemental benefit is a "qualified supplemental benefit", the life insurance reserve for such benefit must be computed separately as though such benefit were under a separate contract. A qualified supplemental benefit is a supplemental benefit as listed in the Act, if there is a separately identified premium or charge for such benefit and any cash value (i.e., net surrender value) under the contract attributable to any other benefit is not available to fund such supplemental benefit. The use of any loan provision to pay premiums or charges due for the supplemental benefit is not intended to be construed as making any net surrender value available for the purposes of this provision.

For example, if a contract provides for a qualified supplemental benefit (e.g., accidental death or disability), the net surrender value of the contract is \$4,000, and the Federally prescribed reserves are \$3,800 for the basic death benefit and \$50 for the supplemental benefit, the total reserve for tax purposes will be \$4,050 if none of the net surrender value is attributable to the qualified supplemental benefit. In essence, the supplemental benefit is considered a separate contract and the reserve is computed as the greater of the net surrender value or the tax reserve. Suppose, however, the supplemental benefit is not a qualified supplemental benefit because it is provided for under a contract that has a single policy value or fund against which all expenses and costs of insurance are charged. Under such circumstances, the total reserve for tax purposes will be \$4,000 because the supplemental benefit will not be considered a separate contract and the amount of the life insurance reserve for the contract is the greater of the net surrender value (i.e., \$4,000) or the Federally prescribed reserves amount (i.e., \$3,800 + \$50).

Substandard risks

The amount of life insurance reserve for any "qualified substandard risk" must be computed as if under a separate contract. A substandard risk is a qualified substandard risk if (1) the insurance company maintains a separate reserve for such risk, (2) there is a

²⁵ The term "guaranteed insurability benefit" is intended to include guaranteed annuity benefits.

²⁶ Because of the intended *de minimis* nature of the listed supplemental benefits, a disability income benefit provision (other than one that provides for income payments only to carry the premiums of the policy or some other incidental expenses of the insured) is not intended to be construed as a supplemental benefit.

separately identified premium charge for such risk, (3) the amount of the net surrender value under the contract is not increased or decreased by reason of such risk, and (4) the net surrender value under the contract is not regularly used to pay premium charges for such risk. It was expected that regulations could provide that a provision for the systematic borrowing based on the net surrender value of the contract to pay both the basic premium and the substandard charge will be considered to disqualify the substandard risk in certain situations. However, loan provisions that are not actually used on a regular and automatic basis to pay substandard charges will not result in disqualification of the substandard risks.

The amount of the life insurance reserve determined for any qualified substandard risk will in no event exceed the sum of the separately identified premium charges for such risk plus interest, less mortality charges. The aggregate amount of insurance in force under contracts to which these special rules for substandard risks can apply cannot exceed 10 percent of insurance in force (other than term insurance) under life insurance contracts of the company. The substandard classification of any insurance in force in excess of 10 percent can only be taken into account through an appropriate adjustment to the prevailing commissioners' standard table in computing the Federally prescribed reserve. Also, if a company computes a separate substandard reserve under the qualified substandard risk provision, the mortality assumption for purposes of computing the reserve for the basic benefit cannot take into account any substandard risk factors.

Term life insurance and annuity benefits

The Act provides a special rule for contracts issued before January 1, 1989 under plans of insurance in existence on March 15, 1984, for purposes of computing tax reserves with respect to riders for term life insurance and annuity benefits. Term life insurance and annuity benefits included in such insurance contracts will be treated as qualified supplemental benefits, for purposes of allowing the tax reserve to be computed for such benefits as though each benefit were a separate contract. However, these benefits will not be treated as qualified supplemental benefits for purposes of using the statutory reserve as the tax reserve for such benefit because riders for term life insurance and annuity benefits generally may not be *de minimis* like the specifically enumerated qualified supplemental benefits (see discussion above). Accordingly, the reserves for such benefits will be computed under the general reserve rules, as the greater of the net surrender value or the Federal tax reserve, rather than (as with other qualified supplemental benefits) the reserves used on the annual statement. Also, to be treated as a qualified supplemental benefit, the riders for the term life insurance and annuity benefits must meet all other requirements for such treatment (that is, there must be a separately identified premium or charge for such benefit and any cash value under the contract attributable to any other benefit must not be available to fund such benefit).

Reserves under foreign law

There is a special rule which allows domestic life insurance companies to recognize, in lieu of the Federally prescribed reserve, the minimum reserve required by the laws, regulations, or administrative guidance of the regulatory authority of a noncontiguous foreign country if (1) the reserves arise out of life, accident or health insurance contracts issued to residents of the foreign country and (2) the foreign country requires the domestic company (as of the time it began operations in the foreign country) to operate in such country through a branch. The reserve cannot exceed the net level reserve for a contract as determined using NAIC standards and the interest rates and mortality tables used in the contract.

Variable contracts (new sec. 817)

The Act continues to provide special rules for variable annuities and contracts with reserves based on segregated asset accounts, but conforms the tax treatment of such contracts to that of variable pension plan contracts under prior law and extends those rules to variable life insurance contracts. Thus, with respect to any variable contract, the reserve items taken into account at the close of the taxable year for purposes of determining net increases or net decreases must be adjusted by subtracting any amount attributable to appreciation in the value of assets or by adding any amount attributable to depreciation. Such adjustments for appreciation or depreciation are to be made whether or not the company has disposed of the assets during the taxable year.²⁷ The company's basis in the assets underlying all variable contracts also will be adjusted for appreciation or depreciation, to the extent the reserves are adjusted. Thus, corporate level capital gains and losses, and the tax effect thereof, are eliminated. This basis adjustment provision generally conforms the tax treatment of all variable contracts to that of variable pension plan contracts under prior law.

The Act adopts a provision that grants the Secretary of the Treasury regulatory authority to prescribe diversification standards for investments of segregated asset accounts underlying variable contracts. The diversification requirement was provided in order to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles. The Congress believed that a limitation on a customer's ability to select specific investments underlying a variable contract will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance. The Congress anticipated that any regulations prescribing diversification standards changing current practice will have a prospective effective date.

The Act defines the range of the diversification requirements within which Treasury has authority to set standards by specifical-

²⁷ In addition to the adjustment of reserves for variable contracts, an adjustment is provided for any appreciation or depreciation during a year affecting deductions for death claims, etc., under section 805. This adjustment will apply only to the extent of such appreciation or depreciation, and not in the greater amount that such appreciation or depreciation affects death benefits. Thus, if under a variable life insurance contract, appreciation in the value of separate account assets of \$100 increased death benefits by \$200, the amount of the adjustment to death benefits on account of this provision is \$100.

ly providing that any segregated asset account that is at least as diversified as one satisfying the requirements of a regulated investment company under section 851(b) will be considered to be adequately diversified without further showing, if the account has no more than 55 percent of its assets held in cash, cash items, Government securities, or securities of other regulated investment companies. There is also an exception that allows variable life insurance to be based on a segregated asset account fully invested in securities issued by the Treasury. For purposes of meeting the diversification requirements prescribed by Treasury or the regulated investment company safe harbor, ownership by a segregated asset account of beneficial interests in a regulated investment company will not be treated as a single investment (but will be considered to have the diversification of the underlying fund) so long as all shares of the underlying fund are owned by one or more segregated asset accounts of insurance companies. Although not clear in the statute, a similar rule was intended with respect to variable life insurance based on Treasury securities. That is, a segregated asset account can invest in a fund of Treasury securities in which all the beneficial interests are owned by insurance companies or the segregated asset account underlying the variable life insurance contract can own the Treasury securities directly.

The adoption of diversification requirements and the limitation of the "look through" rule to situations in which access to an underlying fund is available exclusively through the purchase of a contract from an insurance company are directed toward preventing the use of publicly available funds for variable contracts. Thus, generally, ownership of shares by an insurance company for its general account or by the fund organizer (e.g., at the start of the fund because seed money has been used or for administrative convenience in operating a fund) will not be a violation of the requirement for diversification. The fact that a similar fund is available to the public will not cause the segregated asset fund to be treated as being publicly available. Finally, the Act specifically provides that a company may use an independent investment advisor with respect to the segregated asset accounts underlying their variable contracts.

In authorizing Treasury to prescribe diversification standards, the Congress intended that the standards be designed to deny annuity or life insurance treatment for investments that are publicly available to investors and investments which are made, in effect, at the direction of the investor. Thus, annuity or life insurance treatment will be denied to variable contracts (1) that are equivalent to investments in one or a relatively small number of particular assets (e.g., stocks, bonds, or certificates of deposit of a single issuer); (2) that invest in one or a relatively small number of publicly available mutual funds; (3) that invest in one or a relatively small number of specific properties (whether real or personal); or (4) that invest in a nondiversified pool of mortgage-type investments. This new diversification authority should require a diversification of issuer related to the assets for the variable contract and was not intended to allow the imposition of any requirement that the investment fund reflect a diverse range of investment goals (e.g., short-term, long-term, or fixed income/equity securities need

not be mixed in a single fund). This diversification requirement will not apply to funds underlying pension plan contracts defined under new section 818.

If the segregated asset account does not meet the prescribed diversification standards, then a variable contract based on the account will not be treated as an annuity, endowment, or life insurance contract for purposes of subchapter L (relating to taxation of insurance companies), section 72 and section 7702(a) (relating to the definition of a life insurance contract). A variable contract will cease to be treated as an annuity, endowment or life insurance contract when and if the underlying fund fails to be adequately diversified. Apart from meeting the diversification standards, whether a contract is a variable contract depends on the terms of the contract. Generally, the fact that the benefits do not vary for a period of time because the value of the underlying assets has not changed or a minimum death benefit guarantee is in operation will not cause a contract to cease being treated as a variable contract.

The Act also continues the separate accounting requirements under prior law for various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to variable contracts. For example, with respect to variable contracts, the company's share of dividends received, and the policyholders' share of tax-exempt interest (which reduces the closing balance of the reserves), will be determined with reference to the income and deduction items attributable to the underlying separate account. Likewise, the equity base of the separate account will be determined under the separate accounting requirement and aggregated with the company's average equity base for its general account business.

In addition, Treasury has regulatory authority (under an amendment to sec. 514) to subject to tax the assets of a segregated asset account if the account is used to circumvent the acquisition indebtedness rules.

e. Policyholder dividends (sec. 211 of the Act and new secs. 808 and 809 of the Code) ²⁸

Prior Law

In general, under present and prior law, policyholder dividends are dividends and similar distributions to policyholders. Interest paid and return premiums are not policyholder dividends. This statutory language had been expanded in regulations so that the term policyholder dividends generally referred to amounts returned to policyholders that were not fixed in the contract and depended on the experience of the company or the discretion of management. However, taxpayers have taken the position that the term did not include excess interest (i.e., amounts in the nature of interest that are paid or credited to policyholders and are determined at a rate in excess of the rate used under the contract for

²⁸ For legislative background of the provision, see: H.R. 4170, committee amendment approved by the House Committee on Ways and Means on March 1, 1984, sec. 211; H. Rep. No. 98-432, Pt. 2 (March 5, 1984), pp. 1420-1426; "Deficit Reduction Act of 1984," as approved by the Senate Committee on Finance on March 21, 1984, sec. 211; S. Prt. 98-169, Vol. I (April 2, 1984), pp. 547-553; and H. Rep. No. 98-861 (June 23, 1984), pp. 1056-1059 (Conference Report).