AMERICAN ACADEMY *of* ACTUARIES

Report regarding Federal Tax Reserves and the Life PBR Elective Three-Year Statutory Transition Period of the American Academy of Actuaries' Tax Work Group

Presented to the National Association of Insurance Commissioners' Life Actuarial Task Force

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Tax Work Group

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The American Academy of Actuaries Life Practice Council Tax Work Group has prepared this report regarding the expected application of the federal income tax reserve rules to those life insurance companies that elect to use the three-year statutory transition provision for Life Principle-Based Reserves (Life PBR). Tax reserves would be calculated using Life PBR for issues on and after the Effective Date of Life PBR, independent of whether the company elects the three-year statutory Life PBR transition.

The Statutory and Regulatory Environment

The National Association of Insurance Commissioners (NAIC) has adopted a revised model Standard Valuation Law (SVL) necessary to implement Life PBR and is in the process of finalizing the related Valuation Manual that contains requirements for Life PBR. The Valuation Manual is scheduled to be finalized in 2011. After the Valuation Manual is adopted by the NAIC, the revised SVL will then require adoption by: (1) states representing at least 75% of 2008 total direct premiums[1] written; and (2) 42 of the 55 applicable jurisdictions.[2] Life PBR will become effective on January 1 of the year following the first July 1 once these thresholds are reached (Effective Date). The process of state adoption is likely to take at least two to three years to achieve the thresholds. Accordingly, Life PBR could become effective as early as 2014 but more likely in 2015 or 2016. This timetable would give most life insurance companies adequate time to address the administrative and data processing changes that will be required for statutory reporting.

The Valuation Manual also includes a three-year statutory transition period that would allow a life insurance company to elect not to implement Life PBR for up to three years from the Effective Date. Thus, a company could choose to wait to implement PBR for statutory reserves until policies are issued in 2017 at the earliest, and possibly as late as policies issued in 2019.

This is a different transition framework from the one stipulated in Actuarial Guideline 43 (AG43 or VA CARVM). The three-year elective transition period under AG43 grades statutory reserves for the entire in-force portfolio of contracts issued from 1981 forward into AG43 reserves over the three-year period. For Life PBR, the three-year elective transition period does not require restating reserves to a Life PBR basis for business issued either before the Effective Date or after the Effective Date and prior to the end of that three-year transition period.

While restatement is not required, it could be possible, with State of Domicile Insurance Department approval, to restate statutory reserves to a Life PBR basis on policies issued from the Effective Date forward, accounting for the reserve adjustment in the Surplus Account.

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[1] See Section 11B. of the revised SVL, adopted by the Life Insurance and Annuities (A) Committee on 9/9/09.

[2] The 50 states, American Samoa, the American Virgin Islands, the District of Columbia, Guam and Puerto Rico.

The Tax Environment

The Internal Revenue Code requires the tax reserve method used to calculate the Federally Prescribed Reserve (FPR)[3] to be CRVM in the case of contracts covered by CRVM (see Section 807(d)(3)(A)(i)). Section 807(d)(3)(B)(i) further defines CRVM as "the Commissioners' Reserve Valuation Method prescribed by the National Association of Insurance Commissioners which is effect on the date of issuance of the contract." Thus, for all contracts issued on or after the Effective Date, the FPR must be calculated under Life PBR, even if the statutory reserves are not yet being determined using Life PBR due to a company's election to adopt the three-year transition rule.

For example, assume the tax basis equivalent of the Net Premium Reserve method is prescribed by the Department of the Treasury and IRS as the FPR. Thus, even though a company may elect to defer adoption of Life PBR for statutory reporting purposes, the company will nevertheless have to calculate the tax basis Net Premium Reserve without deferment for such contracts issued from the Effective Date forward. To derive the final deductible tax reserve as indicated by the Code for such contracts, the tax basis Life PBR Net Premium Reserve for any contract must be compared to that contract's net surrender value and statutory reserve.[4] If we assume that a greater portion of the Life PBR reserve would qualify as a tax basis reserve, then in order to obtain the full tax reserve deduction, a company would need to do additional calculations.

An open tax issue is what happens if a company uses the three-year elective statutory Life PBR transition and later restates statutory reserves on in-force policies issued from the Effective Date forward. Would the resulting statutory capping or uncapping be subject to a Code section 807(f) 10-year spread for tax purposes, and, if so, in what manner?

It should be noted the Treasury Department and the IRS have yet to issue formal guidance on any Life PBR transition issues.

[3] The Federally Prescribed Reserve is the tax basis reserve, calculated using the mortality assumption, valuation interest rate, and tax reserve method prescribed in Code section 807(d), but prior to the section 807(d)(1) comparison with the net surrender value and statutory reserve.

[4] In this situation, while the PBR statutory reserve calculation may require calculation of alternative (stochastic and deterministic) reserves, which could cause the statutory reserve to exceed the Net Premium Reserve, such alternative reserve calculations would not need to be performed to obtain the FPR.