

Part III -- Administrative, Procedural, and Miscellaneous

Life Insurance Reserves -- Proposed AG VACARVM and Life PBR

Notice 2008-18

SECTION 1. PURPOSE

The purpose of this notice is to alert life insurance companies to federal income tax issues that may arise as a result of the adoption of proposed Actuarial Guideline VACARVM (Proposed AG VACARVM) and/or a proposed principles-based approach for calculating statutory reserves for life insurance (Proposed Life PBR). This notice identifies areas in which the Treasury Department and Internal Revenue Service (IRS) have concerns, and invites comments on these and other issues.

SECTION 2. BACKGROUND

.01 In general, a life insurance company must pay tax on its life insurance company taxable income, which is defined in section 801(b) to mean life insurance gross income less life insurance deductions. Life insurance gross income is defined in section 803(a) to mean the sum of (i) premiums, (ii) net decreases in certain reserves under section 807(a), and (iii) other amounts generally included by a taxpayer in gross income. Section 805(a)(2) authorizes a deduction for the net increase in certain reserves under section 807(b). The reserves taken into account under section 807(a) and (b) include life insurance reserves. Accordingly, clear reflection of taxable income of a life insurance

company requires an appropriate measurement of the company's life insurance reserves.

.02 Methods of computing life insurance reserves are set forth section 807(d). Section 807(d)(1) provides generally that the amount of the life insurance reserve for any contract shall be the greater of the net surrender value of such contract under section 807(e)(1) or the federally prescribed reserve determined under section 807(d)(2). This amount cannot, however, exceed the amount that would be taken into account with respect to that contract in determining statutory reserves (i.e., the aggregate reserve amount set forth in the issuer's annual statement). Section 807(e)(1) states that the net surrender value of any contract shall be determined with regard to any penalty or charge that would be imposed on surrender but without regard to any market value adjustment on surrender. Section 807(d)(2) provides that the federally prescribed reserve for a contract is computed using (a) a tax reserve method, (b) the greater of the applicable Federal interest rate or the prevailing State assumed rate, and (c) the prevailing commissioners' standard tables for mortality and morbidity.

.03 With respect to annuity contracts, section 807(d)(3)(A)(ii) and 807(d)(3)(B)(ii) requires the use of a tax reserve method that is the Commissioners' Annuity Reserve Valuation Method (CARVM) prescribed by the National Association of Insurance Commissioners (NAIC) which is in effect on the date of the issuance of the contract. Likewise, with respect to life insurance contracts, section 807(d)(3)(A)(i) and 807(d)(3)(B)(i) requires the use of a tax

reserve method that is the Commissioners' Reserve Valuation Method (CRVM) prescribed by the NAIC which is in effect on the date of the issuance of the contract. Other parameters, such as the interest rate and appropriate mortality tables, are likewise generally determined as of the date the contract is issued.

.04 Under section 816, an insurance company is a life insurance company if the sum of (1) its life insurance reserves, plus (2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, accident, or health policies not included in life insurance reserves, comprise more than 50 percent of its total reserves. Life insurance reserves are defined as amounts (1) computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and (2) set aside to mature or liquidate, either by payment or reinsurance, future unaccrued claims arising from life insurance, annuity, and noncancellable accident and health insurance contracts (including life insurance or annuity contracts combined with noncancellable accident and health insurance) involving, at the time with respect to which the reserve is computed, life, accident, or health contingencies. Reserves must be required by law to qualify as life insurance reserves.

.05 Section 7702(a) defines a life insurance contract as any contract that is a life insurance contract under the applicable law, but only if such contract (1) meets the cash value accumulation test of section 7702(b); or (2)(A) meets the guideline premium requirements of section 7702(c), and (B) falls within the cash value corridor of section 7702(d). A contract meets the guideline premium requirements if the sum of the premiums paid under such contract does not at

any time exceed the guideline premium limitation as of such time. The term "guideline premium limitation" means, as of any date, the greater of the guideline single premium, or the sum of the guideline level premiums to such date. The term "guideline single premium" means the premium at issue with respect to future benefits under the contract. The determination of the guideline single premium is based, in part, on reasonable mortality charges that meet the requirements (if any) prescribed in regulations and that (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued.

.06 Two reserve methodology projects are underway with the American Academy of Actuaries (AAA) and National Association of Insurance Commissioners (NAIC). Proposed AG VACARVM would set forth a new Actuarial Guideline that would constitute CARVM for variable annuities. See "Actuarial Guideline VACARVM--CARVM for Variable Annuities Redefined," NAIC, 9/29/2007. An Actuarial Guideline is an interpretation by the NAIC of existing state valuation law and regulations. Proposed Life PBR would set forth a principles-based approach for calculating statutory reserves on life insurance contracts. This second project would take the form of a section of a proposed valuation manual that would be adopted pursuant to a proposed change to the standard valuation law. See "VM-20: Requirements for Principles-Based Reserves for Life Products," NAIC, 9/29/2007.

.07 The purpose of Proposed AG VACARVM is to interpret the standards for the valuation of reserves for variable annuity and other contracts involving certain guaranteed benefits similar to those offered with variable annuities. The aggregate reserve for contracts falling within the scope of Proposed AG VACARVM would equal the greater of a standard scenario amount and a conditional tail expectation (CTE) amount. The standard scenario amount would be the aggregate amount of the reserves determined by applying a standard scenario to each of the contracts falling within the scope of the guideline. The CTE amount would represent the average of a specified percent of the largest accumulated deficiencies produced by a projection of the contracts falling within the scope of the guidance (and the assets supporting those contracts) over a range of stochastically generated scenarios using prudent estimate assumptions. For example, CTE (70) would equal the average of the largest 30 percent of the present value of accumulated deficiencies. Proposed AG VACARVM would include a methodology for allocating the aggregate reserve to the contracts falling within the scope of the Guideline. Once effective, Proposed AG VACARVM would affect all contracts issued on or after January 1, 1981.

.08 The purpose of Proposed Life PBR would be to define the minimum valuation standard under a principles-based approach for individual life insurance policies. The reported aggregate reserve for policies falling within the scope of Proposed Life PBR would equal an amount computed using a stochastic method (stochastic reserve), but not less than an amount calculated using a seriatim, deterministic method (deterministic reserve). The deterministic reserve would be

determined using a seriatim (i.e., contract-by-contract) approach based on a projection of net cash flows over a single scenario, using prudent estimate assumptions for parameters or variables that are not prescribed. The stochastic reserve would be calculated in the aggregate based on a projection of net cash flows over a range of stochastically generated scenarios, using prudent estimate assumed values for all parameters and variables that are not prescribed or stochastically modeled, and then applying a prescribed CTE level. Proposed Life PBR would require that a reserve based on company-specific and industry experience serve as the basis for identifying (i.e., mapping to) the NAIC prescribed table that must be used. Like Proposed AG VACARVM, Proposed Life PBR would include a methodology for allocating the aggregate reserve to the contracts falling within the scope of Life PBR. A company would be permitted to exclude certain policies from the stochastic modeling requirement if the policies met certain prescribed conditions.

SECTION 3. DISCUSSION

The Treasury Department and IRS are mindful that if sections 807, 816 and 7702 are not amended by Congress in anticipation of Proposed AG VACARVM and Proposed Life PBR, taxpayers will need timely guidance on how to file their federal income tax returns once Proposed AG VACARVM and Proposed Life PBR have been adopted. The Treasury Department and IRS believe that the issues raised in this notice are most appropriately considered together to the extent they affect both projects. Although these projects remain in development, the following paragraphs set forth a preliminary, nonexclusive list

of federal income tax issues that have been identified. The paragraphs also identify some of the approaches that the Treasury Department and IRS may consider to address these issues, subject to further study and public comment.

.01 Continued taxation of issuers under Part 1 of Subchapter L. Some commentators have asked whether reserves determined under Proposed AG VACARVM or Proposed Life PBR would constitute "life insurance reserves" within the meaning of section 816(b). The Treasury Department and IRS think it would be inappropriate to apply a literal application of the 50-percent reserve ratio test of section 816(a), such that all life insurance companies would be taxed under part 2 of subchapter L, rather than part 1 of that subchapter, due solely to changes in the methodology of determining such reserves for purposes of statutory accounting. To prevent this result, if Proposed AG VACARVM or Proposed Life PBR is adopted, the Treasury Department and IRS may publish guidance that would (i) require the continued use of statutory reserves for purposes of the reserve ratio test, even if those reserves are determined under Proposed AG VACARVM or Proposed Life PBR; (ii) require the continued use of CARVM or CRVM, as applicable, under such terms as applied before the adoption of Proposed AG VACARVM or Proposed Life PBR; (iii) apply principles similar to those of Prop. Reg. §1.801-4(g) to ensure that reserves with respect to life insurance and annuity contracts are appropriately accounted for in the reserve ratio test of section 816(a); or (iv) require the use of only the standard scenario amount (in the case of Proposed AG VACARVM) or deterministic reserve (in the case of Proposed Life PBR) for purposes of the reserve ratio test.

.02 Qualification of contracts as life insurance contracts. Likewise, some commentators have asked whether the adoption of Proposed Life PBR would render it impossible for issuers of life insurance contracts to satisfy the requirement of section 7702(c)(3)(B) that reasonable mortality charges not exceed the mortality charges specified in "the commissioners' standard mortality tables" as defined in section 807(d)(5). The Treasury Department and IRS think it inappropriate for a change in statutory accounting under section 807(d) to effect a wholesale change in the standards for qualification of contracts as "life insurance contracts" under section 7702. To prevent this result, if Proposed Life PBR is adopted, the Treasury Department and IRS may (i) exercise the authority under section 7702(c)(3)(B) either to prescribe mortality tables or to permit the continued use of the 1980 Commissioners' Standard Ordinary mortality and morbidity tables (1980 CSO tables) or the 2001 Commissioners' Standard Ordinary mortality and morbidity tables (2001 CSO tables), as appropriate, to satisfy the reasonable mortality charge requirement of that section; or (ii) provide a reasonable interpretation of the prevailing commissioners' standard mortality tables under section 807 that would not render the cross reference in section 7702(c)(3)(B) meaningless. See section 3.05, below.

.03 Contract-by-contract versus aggregate reserves. The Treasury Department and IRS believe that the standard scenario or deterministic reserve determined under Proposed AG VACARVM or Proposed Life PBR would more closely resemble the methodology in effect when Congress enacted section 807 in 1984 than would the CTE amount or stochastic reserve. For example, a

reserve determined under the standard scenario or under the deterministic reserve methodology (i) would be determined on a contract-by-contract basis; (ii) would be based upon an expected value, rather than the worst case tail of a distribution of outcomes; and (iii) in the case of Proposed AG VACARVM, would be determined based on standard, industry-wide interest rate and mortality factors, rather than on prudent estimates that vary from company to company. Both Proposed AG VACARVM and Proposed Life PBR would provide a methodology for apportioning stochastically-determined reserve amounts among individual contracts. The Treasury Department and IRS, however, are concerned more fundamentally that because the CTE amount (under Proposed AG VACARVM) or stochastic reserve (under Proposed Life PBR) would not represent an expected value of a company's obligations with respect to the underlying contracts, some or all of these amounts are nondeductible "solvency" or "contingency" reserves. If this concern is not satisfied, the Treasury Department and IRS may (i) permit a contract-by-contract apportionment of a stochastically-determined reserve, but with appropriate adjustments so that reserve reflects an expected value of the company's obligations (for example, by adjusting the CTE from 65 to 0, assuming that the chosen scenarios have a uniform probability distribution and the scenarios not chosen have a zero probability); (ii) conclude that the methodology of Proposed AG VACARVM or Proposed Life PBR is so different from that which was in effect when Congress enacted section 807 in 1984 that taxpayers must continue to apply section 807 as if Proposed AG VACARVM or Proposed Life PBR had not been adopted; or

(iii) interpret the statutory cap under section 807(d)(1) and CARVM/CRVM under section 807(d)(2) to encompass only the standard scenario amount (in the case of Proposed AG VACARVM) or the deterministic reserve (in the case of Proposed Life PBR).

.04 Prevailing state assumed interest rate. Section 807(d)(2)(B) requires that the tax reserve with respect to a contract be determined using the greater of the applicable Federal interest rate (AFR) or the prevailing State assumed rate. It has been suggested that in the case of Proposed Life PBR, the absence of a single, prescribed interest rate means that taxpayers should be allowed to determine tax reserves simply using the AFR. This approach, however, would nullify an important safeguard against situations where the AFR is an inappropriately low rate for determining a fair valuation of the tax reserve with respect to a contract. Rather than interpret the term "prevailing State assumed interest rate" to refer to a null set, the Treasury Department and IRS may require the use of a rate that is the greater of the AFR and some other objective rate or rates, such as (i) the rate implicit in the aggregate reserves that are determined stochastically; (ii) the rate used by the company in pricing the contract; or (iii) the rate used to determine the deterministic reserve.

.05 Prevailing mortality tables. The Treasury Department and IRS are concerned that determining an aggregate reserve stochastically and, after the fact, using the reserve so determined to "map" to one of a large number of NAIC-approved mortality tables would not satisfy the requirement of section 807(d)(2) that the prevailing commissioners' standard tables be used for purposes of

determining the tax reserve for a contract. If this concern is not satisfied, the Treasury Department and IRS may interpret the prevailing commissioners' standard mortality tables under section 807(d)(5) to mean either (i) the 2001 CSO mortality tables; (ii) the mortality tables, if any, which served as the basis for pricing the particular contract; (iii) if more than one standard mortality table or option could apply to a particular contract, whichever table generally would yield the lowest reserve for the contract (see section 807(d)(5)(E)); or (iv) in the case of Proposed AG VACARVM, the mortality tables used for purposes of determining the standard scenario amount with respect to a contract,

.06 Transition rules: application to in-force contracts. If Proposed AG VACARVM or Proposed Life PBR is adopted, it is anticipated the new rules would apply for federal income tax purposes only to contracts that are issued after the date of adoption and not to previously issued contracts that are in force on that date, regardless of the applicability of the new rules to previously issued contracts for regulatory purposes. The Treasury Department and IRS assume this approach would render moot any issue concerning the applicability of a 10-year spread under section 807(f) for adjustments resulting from the adoption of these proposed rules.

.07 Tax principles that override statutory accounting. Notwithstanding the deference accorded statutory accounting under subchapter L, the Treasury Department and IRS do not anticipate changes to existing guidance that requires that tax principles override statutory accounting principles in appropriate cases.

See, e.g., §1.801-4(e) (enumerating reserves and liabilities that do not qualify as life insurance reserves for federal income tax purposes).

.08 Tax administration. As a matter of tax administration, the Treasury Department and IRS are concerned that the degree of discretion that would be vested in taxpayers to determine the CTE amount (under Proposed AG VACARVM) or the stochastic reserve (under Proposed Life PBR) could render those amounts difficult or impossible for examiners to audit. These concerns will weigh heavily in the resolution of the issues identified in sections 3.01 through 3.07, and may weigh in favor of recognizing only the standard scenario amount (in the case of Proposed AG VACARVM) or the deterministic reserve (in the case of Proposed Life PBR).

SECTION 4. REQUEST FOR COMMENTS

.01 The Treasury Department and IRS request comments on the issues raised in this notice, and on any other issues that will need to be addressed if Proposed AG VACARVM or Proposed Life PBR are adopted by one or more states and Congress has not amended sections 807, 816 and 7702. In addition, comments are requested regarding the following issues: (i) What is the status of any efforts to model the effects of Proposed AG VACARVM or Proposed Life PBR, either on a company-by-company basis, a product-by-product basis, or industry-wide? (ii) What is the relevance of a tax or regulatory characterization of Proposed AG VACARVM and Proposed Life PBR as CARVM or CRVM, respectively, for purposes of applying section 807? Does such a characterization limit or broaden the discretion of the Treasury Department and IRS to provide

guidance? (For example, if Proposed AG VACARVM and Proposed Life PBR are characterized as CARVM or CRVM, respectively, for regulatory purposes, could the Treasury Department and IRS nevertheless conclude they do not constitute CARVM or CRVM as Congress envisioned those terms to apply in 1984; alternatively, if Proposed AG VACARVM and Proposed Life PBR were not characterized as CARVM or CRVM, respectively, for purposes of applying section 807, could Proposed AG VACARVM and Proposed Life PBR nonetheless be required as the appropriate tax reserve method under the authority of section 807(d)(3)(A)(iv)); (iii) what criteria or other parameters would limit the selection of scenarios taken into account in determining the CTE amount (under Proposed AG VACARVM) or the stochastic reserve (under Proposed Life PBR); and (iv) In the case of Proposed Life PBR, what is the appropriate treatment of company-specific expense, lapse and margin assumptions for purposes of applying section 807? For example, are such assumptions permitted to be taken into account at all, either for purposes of the federally-prescribed reserve or the statutory reserve cap? If so, what limits apply to a taxpayer's discretion with respect to those assumptions, and would a 10-year spread result under section 807(f) from the unlocking of those assumptions in later years?

.02 The Treasury Department and IRS are concerned about the use of a gross premium valuation methodology in the case of Proposed Life PBR, because such a methodology generally is not permitted under existing authorities. See, e.g., Maryland Casualty Co. v. U.S., 251 U.S. 342 (1920), §1.801-4(e), Rev. Rul. 77-451, 1977-2 C.B. 224. In general, a gross premium

valuation takes into account the present value of all cash flows under the contract, including future death benefits, future surrender benefits, premiums, future profits, and future expenses. Thus, a reserve determined using a gross premium valuation may include amounts, such as future expenses and margins, that are not now included in life insurance reserves for federal income tax purposes. How will a gross premium valuation under Proposed Life PBR differ from current valuation methods? Is the discretion to permit a gross premium valuation methodology for federal income tax purposes limited by sections 461 and 811, or by the deficiency reserve rule of section 807(d)(3)(C)? Are similar issues raised in the case of Proposed AG VACARVM? If not, are expense, policy owner behavior, surrender rates, and other parameters nonetheless included in the valuation of reserves under Proposed AG VACARVM?

03. The Treasury Department and the IRS are concerned that, except in the case of the standard scenario under Proposed AG VACARVM, the proposed methods contemplate revising certain parameters and assumptions on an annual basis. How is this procedure consistent with the existing statutory framework that contemplates that such parameters and assumptions are determined as of the date a contract is issued, and, in general, are not adjusted thereafter? Would such annual changes in assumptions constitute a change of basis subject to a 10-year spread under section 807(f)?

.04 Comments should be submitted in writing on or before May 5, 2008, and should contain a reference to this Notice 2008-18. Comments may be submitted to CC:PA:LPD:PR (Notice 2008-18), Room 5203, Internal Revenue

Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

Alternatively comments may be submitted electronically via the following e-mail address: Notice.Comments@irs.counsel.treas.gov. Please include "Notice 2008-18" in the subject line of any electronic communications.

.05 Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2008-18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is James A. Polfer of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Mr. Polfer at (202) 622-3970 (not a toll-free call).