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The Government's Thoughts on Life PBR: Notice 2008-18

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Agenda

- Tax Requirements for Deductible Reserves
- Issuance of Notice 2008-18
- Industry Comments on the Notice
- Conclusion

Opening Observations

- Work on PBR reserve tax issues is continuing, as PBR rules evolve.
- Objective of PBR to reach a level of reserves that closely reflect risks is consistent with the tax policy objective.
- However, the fisc is also a consideration by IRS/Treasury.
- Treasury has been careful not to make any declarations as to the tax implications of a shift to a PBR reserving system, but Notice 2008-18 provides some clues as to the issues on which it is focused.

Tax Requirements for Deductible Reserves: Technical Issues

- Definition of life insurance reserves
- “Federally prescribed reserve” rules in section 807:
  - Contract-by-contract determination and comparison
  - Reserve method
  - Interest rates
  - Mortality tables
- Annual Statement “Cap”

Life Insurance Reserves Definition

- "Life Insurance Reserves" are defined in section 816(b).
- Significance of satisfying this definition: to do so results in the treatment of a company as a life insurance company and determines the category of tax deductible reserves.

Criteria for Satisfying Definition

- Held with respect to a life insurance contract;
- Held to mature or liquidate future unaccrued claims;
- Computed or estimated on basis of recognized mortality tables and assumed rates of interest; and
- Required by law.

Federally Prescribed Reserves

- Federally prescribed reserve (FPR) for a life insurance contract is its statutory (annual statement) reserve adjusted to use:
  - The reserve method prescribed by the NAIC for that type of contract;
  - The greater of the applicable federal interest rate or the prevailing state assumed interest rate; and
  - The most recent prevailing Commissioners' standard mortality tables.

Deductible Amount of Reserve per Contract

- Under section 807(d)(1), the deductible amount of life insurance reserves per contract equals the greater of:
  - (1) the contract’s net surrender value, AND
  - (2) the federally prescribed reserve, BUT
  - (3) not in excess of the “annual statement cap” (the reserve amount for a contract reported on the annual statement).

Tax Reserve Method

- Section 807(d)(3) currently uses CRVM at issuance for purposes of computing life insurance contracts' FPR.

- If there is no CRVM, section 807 looks to the method prescribed by the NAIC. Adoption of PBR would make it an NAIC-prescribed method.

Interest Rates

- Section 807(d)(4) bases FPR on an interest rate equal to the greater of the applicable federal interest rate or the prevailing state assumed interest rate.

Mortality Assumptions

- Section 807(d)(5) provides for use of "prevailing commissioners' standard" mortality tables in FPR computation.

- Prevailing tables for this purpose are mortality tables most recently prescribed by the NAIC and permitted for use by at least 26 states.

Annual Statement Cap

- Deductible reserves are limited to the amount of the statutory reserves on the annual statement, commonly referred to by tax practitioners as the “annual statement cap.”

Section 807(f) and Unlocking of Assumptions under PBR

- Generally, reserve methodology and assumptions are set at contract issuance for tax purposes.

- Under section 807(f), differences in tax reserves due to changes in reserve assumptions are spread over 10 years.

Background to Issuance of Notice 2008-18

- Over the past couple of years, Treasury and the IRS have been educating themselves on PBR and monitoring the development of NAIC proposals.

- ACLI and AAA have both been in discussions with Treasury on PBR issues.

- In January, Treasury and the IRS issued Notice 2008-18, which identifies areas in which they have concerns relating to the adoption of PBR and/or AG VACARVM.

- Comments on the issues raised in the Notice were requested by May 5, 2008.

Themes of Notice 2008-18

- Willingness to seek reasonable resolution of certain issues:
  - Section 816(a) reserve ratio test
  - Section 7702 mortality table issue
- For other issues, presentation of alternative approaches Treasury and the IRS may take in guidance to be issued after adoption of PBR.

Section 816(a) Reserve Ratio Test

- Notice 2008-18 proposes a few alternatives to ensure that companies are not inappropriately taxed as nonlife companies for tax purposes:

  - Use statutory reserves as is;
  - Require continued use of CRVM in its current form;
  - Use Prop. Reg. § 1.801-4(g) to recalculate; or
  - Use only the deterministic reserve.

Contract-by-contract requirement

- Treasury and the IRS are concerned about the stochastic portion containing some contingency reserves.

- If concern is not alleviated, guidance may:

  - Permit a contract-by-contract apportionment of a stochastically-determined reserve, but with "appropriate" adjustments;

  - Conclude the methodology of PBR is so different than that in effect when Congress enacted section 807 that taxpayers must apply section 807 as if PBR had not been adopted; or

  - Interpret the annual statement cap to encompass only the deterministic reserve.

Interest Rates

- Treasury and the IRS are uncomfortable with the lack of a prevailing state assumed interest rate in the PBR proposal.

- The Notice states that the companies may be required to compute tax reserves using a rate that is the greater of the applicable federal interest rate and some other objective rate or rates, such as:
  - Rate assumed in computing the stochastic reserves;
  - Rate used by company in pricing the contract; or
  - Rate used to calculate the deterministic reserve.

Mortality Tables

- Treasury and the IRS are concerned that PBR as adopted will not satisfy the tax requirement that the prevailing commissioners' standard tables be used to compute tax reserves.

- In this regard, the Notice proposes three options for PBR:
  - Use the 2001 CSO mortality tables to compute tax reserves anyway;
  - Use the mortality tables which served as the basis for pricing the particular contract; or
  - If more than one table could apply to a contract, use the one that generates the lowest reserve for the contract.

Qualification of Contracts as Life Insurance Contracts

- Treasury and IRS indicate an intention to prevent a change in the section 7702 standards.
- Specifically, there is a concern that PBR would render impossible the requirement under section 7702(c)(3)(B) that reasonable mortality charges not exceed the mortality charges specified in the commissioners' standard mortality tables.
- The Notice indicates that it may either:
  - Exercise authority pursuant to section 7702(c)(3)(B) to prescribe mortality tables;
  - Permit the use of the 1980 or 2001 CSO tables to satisfy the reasonable mortality charge requirement; OR
  - Provide a reasonable interpretation of the prevailing mortality tables that would not render the cross reference in section 7702(c)(3)(B) meaningless.

Tax Administration

- Treasury and the IRS are concerned that the degree of discretion that would be vested in taxpayers to determine the stochastic reserve under PBR could render those amounts difficult or impossible for IRS agents to audit.

- This concern "may weigh in favor of recognizing only . . . the deterministic reserve" in the case of PBR.

Comments Filed on Notice 2008-18

- NAIC
- AAA
- ACLI (AG VACARVM issues only)

What Next?

- Treasury and IRS officials have said informally that they will continue to contemplate the issues set forth in Notice 2008-18, but that guidance would not be forthcoming until PBR is adopted by the NAIC.

- ACLI intends to submit comments on the PBR issues raised in the Notice.

Questions?