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Insurance: IRS LB&I directive, elective treatment for principle-based reserves for variable annuity contracts and life insurance contracts

The IRS Large Business and International (LB&I) division on August 24, 2018, publicly released a directive to provide guidance on the federal income tax treatment of AG 43 reserves for all open tax years, and principle-based reserves for the 2017 tax year.

Read the **LB&I directive**[1]

IRS LB&I directive

Background

For the past two years, the IRS and the life insurance industry have been working on an "Industry Issue Resolution" (IIR) project under sections 807 and 816 regarding the determination of life insurance reserves for life insurance and annuity contracts using principle-based methodologies, including stochastic reserves based on "Conditional Tail Expectations" (CTE).

The IRS released a directive (LB&I-04-0818-015 (August 24, 2018)) to address the IIR project.

Scope

The directive is focused on the tax reserve calculations applicable to: (1) variable annuity contracts subject to the reserve method in Actuarial Guideline XLIII (AG 43)

[1] An LB&I directive is a memorandum from the LB&I Division Commissioner within the Internal Revenue Service (IRS) to IRS directors and field specialists in order to provide notice and field direction on the application of a particular section or concept within the Internal Revenue Code.

and Valuation Manual, part 21 (VM-21) for statutory accounting purposes; and (2) life insurance contracts subject to the reserve method in Valuation Manual, part 20 (VM-20) for statutory accounting purposes and for which the insurance company implemented VM-20 in 2017.

The directive includes a glossary of defined terms. Unless otherwise designated, the defined terms in this TaxNewsFlash are consistent with the directive. If an insurance company does not satisfy the requirements of this directive for such variable annuity and life insurance contract, then regular audit procedures would apply.

The directive is elective and distinguishes between reserves for three types of contracts:

1) Eligible AG 39 variable annuity contracts issued prior to December 31, 2009 ("Eligible AG 39 VA Contracts");

2) Eligible variable annuity contracts issued after December 30, 2009 ("Eligible VA Contracts"); and

3) Eligible life insurance contracts issued on or after January 1, 2017, for which the taxpayer has elected to adopt VM-20 ("Eligible Life Insurance Contracts").

If an insurance company implements the Accepted Method for Eligible VA Contracts, it must also implement the Accepted Method for Life Insurance contracts for any Eligible Life Insurance Contracts.

For the 2017 tax years that end before January 1, 2018, under section 807(d)(3), the tax reserve method that applies to a variable annuity contract is the "Commissioners' Annuity Reserve Valuation Method" (CARVM) prescribed by the National Association of Insurance Commissioners (NAIC) that is in effect on the date the contract was issued. Similarly, the tax reserve method that applies to a life insurance contract is the "Commissioners' Reserve Valuation Method" (CRVM) prescribed by the NAIC that is in effect on the date the contract was issued.

CARVM for variable annuities is interpreted in AG 43, which clarifies the assumptions and methodologies that comply with the intent of the “Standard Valuation Law” (SVL). AG 43 became effective on December 31, 2009, for all variable annuity contracts issued on or after January 1, 1981. AG 43 was effectively incorporated in part 21 of the Valuation Manual (VM-21) adopted by the NAIC on December 2, 2012. VM-21 is effective for all variable annuity contracts issued on or after January 1, 2017.

Part 20 of the Valuation Manual (VM-20) prescribes minimum reserve valuation standards for individual life insurance contracts. VM-20 incorporates a principle-based reserve standard similar in concept to the AG 43 standard for variable annuity contracts. The requirements of VM-20 constitute the CRVM requirements effective for certain life insurance contracts issued on or after January 1, 2017. Life insurance companies have a three-year period (i.e., until January 1, 2020) to adopt VM-20. The directive provides guidance on the calculation of tax reserves for the covered contracts under section 807. [The directive states that no inferences are to be drawn that any deduction is allowed for asset adequacy reserves or deficiency reserves.]

Directive's treatment for Eligible VA Contracts

The "Federally Prescribed Reserve" for an eligible VA contract equals the sum of: (1) the tax "Standard Scenario Amount"[2] (SSA) (factoring in tax interest and mortality assumptions); and (2) 96% of the excess (if any) of the "Allocated Conditional Tail Expectation Amount" over the SSA (not tax adjusted).

The implementation of the acceptable method under the directive ("Accepted Method") for Eligible AG 39 VA Contracts depends on whether a 10-year spread is required. In general, the Accepted Method requires a 10-year spread **unless**:

- There would be no section 807(f) adjustment if the taxpayer were to apply the accepted method in the earliest open year that is subject to VM-21/AG 43 and consistently in subsequent years;
- The first VM-21/AG 43 year in which the Allocated Conditional Tail Expectation Amount exceeds the SSA (not tax adjusted) is an open year; or
- Certain situations where there is an operations loss carryforward in the earlier open years.

If no 10-year spread is required, then for computing taxable income on the 2017 tax return, the beginning-of-year 2017 reserves for these contracts should equal the end-of-year 2016 reserves reported on the insurance company's originally filed 2016 return. End-of-year 2017 reserves should be computed factoring in the Federally Prescribed Reserve described above.

If a 10-year spread is required, then the insurance company has a choice of two options (described below). However, if an insurance company has a tax year that is not an open year after the earliest open year that is a VM-21/AG 43 year tax, then the first option must be used.

- **Option 1:** The reserve adjustments are computed as if the insurance company implemented the Accepted Method for Eligible VA Contracts in 2016. The 10-year spread is computed as if the Accepted Method had been implemented in 2016, and the computation of the 10-year spread included contracts issued in 2016.
- **Option 2:** The insurance company computes the reserve adjustments as if the insurance company implemented the Accepted Method in each open year, but takes the aggregate amount of such adjustments on the 2017 tax return.

[2] The SSA means the reserve determined by applying the standard scenario method as described in AG43 or VM-21, as applicable to an Eligible VA Contract.

Under the directive, taxpayers generally calculate a tax SSA as if the method prescribed in the Accepted Method was adopted in the earliest open year that is a VM-21/AG 43 year. The difference in the end-of-year tax reserves calculated based on the old method and the Accepted Method represents a section 807(f) change in reserve basis adjustment. The cumulative hypothetical section 807(f) amount that would have been amortized through December 31, 2017, is then included in 2017 taxable income, and the remaining unamortized balance as of December 31, 2017, is amortized ratably over the remainder of the 10-year period.

Directive's treatment of Eligible AG 39 VA Contracts

For these contracts, life insurance companies generally follow methodology and implementation procedures similar to the methodology and implementation procedures for Eligible VA Contracts.

Directive's treatment of Eligible Life Insurance Contracts

The Federally Prescribed Reserve for an Eligible Life Insurance Contract equals the sum of: (1) The tax adjusted "Net Premium Reserve," as described in VM-20 and adjusted for factoring in tax interest and mortality assumptions; and (2) 96% of the excess (if any) of the "Allocated Deterministic Reserve / Stochastic Reserve" (if any) over the Net Premium Reserve (not tax adjusted).

Other considerations

The directive contains several other useful pieces of information, including:

- The eight-year transition relief period provided by the new tax law (Pub. L. No. 115-97, enacted December 22, 2017) takes into account the 2017 end-of-year tax reserves as adjusted by the directive.

- To the extent that the IRS field agents plan to audit the calculations of the tax reserves covered by the directive, the directive directs field agents to focus on those reserves reflected on taxpayers' 2017 returns and not to audit the reserve calculations for earlier tax years.

- Each taxpayer must complete, sign, and attach a certification statement to its 2017 return. If a taxpayer is under audit, and the auditor requests a copy of the statement, then the taxpayer must provide a copy of the statement within 30 days of such request. For a consolidated tax return, a separate certification statement may be requested for each insurance company.

KPMG observation

Tax professionals were anticipating release of the directive and appreciate that it has been issued in conjunction with the 2017 tax return filing season. The directive indicates that the IRS now accepts that the stochastic portions of statutory reserves (e.g., the CTE for AG 43) qualify as tax reserves even though stochastic computations do not use the prescribed interest rate or the accepted actuarial table. The 4% haircut appears to reflect an estimate of the difference between AG 43/VM-21 and VM-20 provisions and the requirements of section 807 (before January 1, 2018). If the statutory cap applies, the CTE should be included in full.

The new tax law substantially modified the reserve deduction calculation for life and annuity reserves. As a result, many of the tax issues associated with principle-based reserves have been eliminated, including the use of a prescribed interest rate and accepted actuarial table. The directive provides a clear, elective methodology for taxpayers to resolve the issues associated with the pre-2018 tax years.

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