ACSW presentation

Tax considerations of Principal Based Reserves (PBR)

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Background

Sheryl is a Managing Director in the Financial Services Tax Practice of KPMG Washington National Tax. She has over fifteen years' experience in the technical aspects of insurance law.

Professional industry experience

Sheryl previously served as the Chief of the Insurance Branch within the Financial Institutions and Products office of the Office of Chief Counsel of the Internal Revenue Service. As the Branch Chief, Sheryl was responsible for tax law implementation, tax law interpretation, and focusing on new and emerging issues in insurance tax.

Sheryl is experienced with providing IRS guidance on issues that have a broad impact on insurance company taxpayers or on those who purchase insurance products.

Sheryl has experience with IRS examination audits of insurance companies, private letter rulings on the federal tax treatment of proposed transactions and new insurance products, closing agreements between life insurance companies and the IRS, and change in method of accounting requests related to Subchapter L issues.

Sheryl is experienced with the requirements for determining reserves for life insurance products under Section 807 of Subchapter L. Additionally, Sheryl is knowledgeable about determining non-life insurance company taxable income under Section 832 of Subchapter L.

Sheryl is a frequent public speaker on insurance tax matters at many insurance tax related programs including programs sponsored by American Bar Association, Federal Bar Association, Insurance Tax Conference and Society of Actuaries.

Background and discussion of tax reserve rules

Policy reserves – Statutory

Insurance contracts are agreements to provide future benefits in exchange for premiums or other consideration received.

Life insurance contracts are fundamentally different from other forms of insurance

— Death is certain to occur as opposed to uncertain events such as disability, fire, or floods that may or may not occur.

— Life insurance contracts may contain cash accumulation benefits, where cash may be withdrawn by the contract holder.

When an insured event occurs, the face amount of the contract becomes a "claim liability" and the previously recorded liability for future benefits is released.

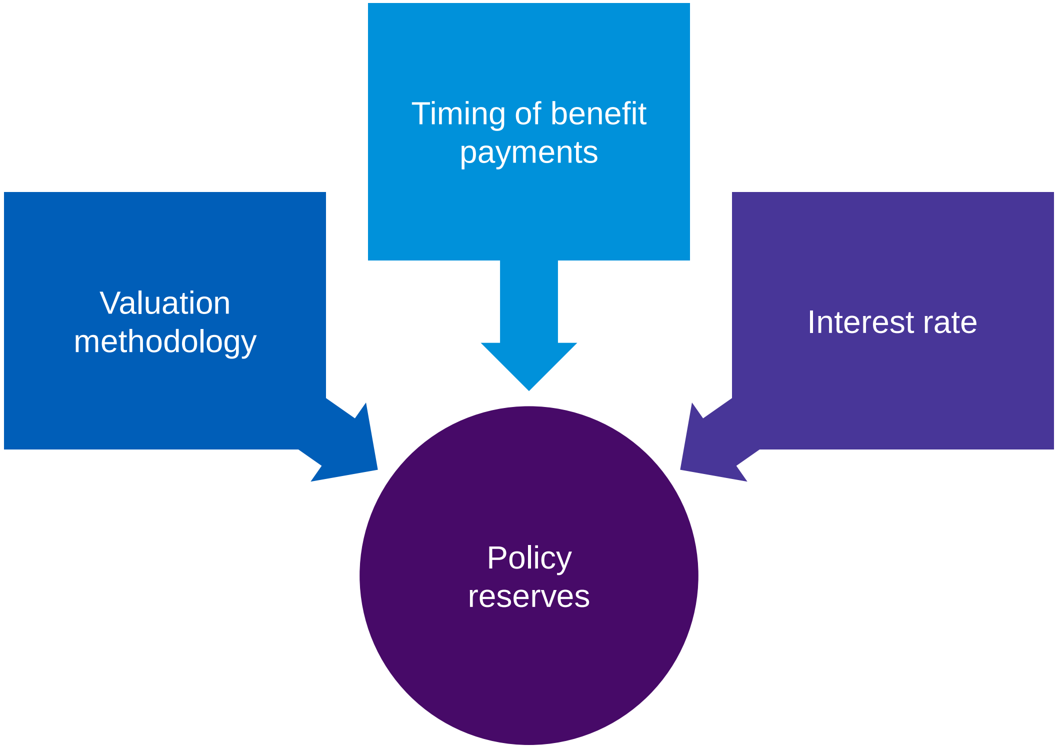
The liability for life benefits and claims is usually the most significant liability on the balance sheet of an insurance entity.

Source: Insurance Companies Committee And The Life Insurance Audit Guide Task Force. (2016) *AICPA Audit and Accounting Guide: Life and Health Insurance Entities.* American Institute of CPAs. Chapter 7.

Reserve calculations: Overview

The calculation of policy benefit reserves is essentially a present value calculation using actuarially prescribed valuation methodology.

— The calculation is based on the estimated timing of future benefits payments and specified interest rate assumption.



Key assumptions include:

Policyholder behavior:

— Mortality

— Mortality improvements

— Morbidity

— Lapses and withdrawals

— Premium payments/increases

— Benefits utilization rates

— Expense payments

Economic assumptions:

— Discount rate or earned rate

— Fair Value Assumptions (GMWB embedded derivatives)

The valuation manual

- National Association of Insurance Commissioners (NAIC) amended the Model Standard Valuation Law (MSVL) and Standard Nonforfeiture Law in 2009, *enabling* the Valuation Manual (VM)
  - Effective January 1, 2017
  - 3 year phase-in, during which companies can choose when to adopt
  - Applies only to new business sold after the company adopts
- The VM sets forth the minimum reserve and related requirements. Key sections include the following:
  - VM-20 – new Life Principle-Based Reserves (PBR)
  - VM-21 – existing Actuarial Guideline (AG) 43 for variable annuities
  - VM-22 – adopted for interest rate only on fixed annuity, PBR portion still in development

Past vs. future

Pre-PBR statutory for life insurance	VM-20 PBR for life insurance
— Commissioners' Reserve Valuation Method (CRVM) – formulaic and rules-based - Prescribed mortality and interest - Implicit provisions for adverse deviation in prescribed assumptions - Lapse only considered in special cases	— Less prescriptive, principles-based — Three components - Net premium reserve (NPR) — Seriatim and formulaic — Prescribed assumptions (mortality, interest, lapse) — Floored at net surrender value - Deterministic reserve (DR) — Aggregate, using cash flow modeling — Company-specific assumptions - Stochastic reserve (SR) — Aggregate, using cash flow modeling — Company-specific and stochastic assumptions — CTE 70 (average of 30% worst scenarios), like AG 43 — Assumptions based on company and/or industry experience — Annual unlocking of assumptions — Explicit prudent estimates included on individual assumptions

Reserve components under Life PBR (VM20)

Minimum reserve = **NPR** + Excess { Greater of **DR** or **SR** over **NPR** minus due/deferred premium }

AG 43/VM-21

- VM-21 – existing Actuarial Guideline (AG) 43 for variable annuities
  - The requirements constitute the Commissioners' Annuity Reserve Valuation Method (CARVM) for variable annuities by defining the assumptions and methodologies that will comply with the MSVL.
  - The contracts subject to these requirements are aggregated with the contracts subject to AG43 for purposes of performing and documenting the reserve calculations.
  - VM-21 requirements mirror the requirements of AG 43.
  - Industry Issue Resolution (IIR) to address questions related to tax years before 2018 (i.e., before Tax Cuts and Jobs Act was enacted).

Reserves included in taxable income

Reserves are recomputed for tax purposes

— Life and annuity reserves shown on annual statement exhibits 5 through 7, including non-cancellable and guaranteed renewable accident and health reserves, are recomputed for tax purposes under Code §807.

Changes reserves result in income or deductions

— A life insurance company includes as income or expense the decrease or increase in life and annuity reserves.

— Section 803(a)(2): decreases in reserves result in taxable income.

— Section 805(a)(2): increases in reserves result in tax deductions.

Computation of tax reserves

Section 13517 of the Tax Cuts and Jobs Act	
General	— Deduction for 92.81% of the reserve computed as required by the NAIC at the time the reserve is determined. For PBR, DR and SR should be included. — Maintains requirement that tax reserves cannot be less than the contract's cash surrender value or greater than the statutory reserve for the contract. — Transitional rule: impact on reserves for contracts issued prior to effective date would be taken into account over the next 8 years
Revenue estimate	JCT: $15.2B over ten years
KPMG observation	— Largest revenue raiser under the changes to the subchapter L provisions — The elimination of the current law requirement that the reserve method be set at the time the contract is issued will also eliminate any question about whether changes made by the NAIC to reserve methods should be reflected in the tax reserve.

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Issues

Valuation manual

- Life PBR exemption permits companies to use existing requirements if they meet defined criteria
  - Ordinary premium of less than $300 million (or $600 million for a group), excludes:
    - Premium for preneed life contracts; and
    - Transfers of reserves in-force as of the effective date of a reinsurance assumed transaction
  - Total Adjusted Capital of at least 450%
    - Excludes small companies
    - Allows certain companies that fall below this requirement to seek exemption from their commissioner
  - Unqualified actuarial opinion on reserves
  - No universal life policies issued or assumed with material secondary guarantees, after January 1, 2020
- Not all states have adopted PBR

Potential issues

- IRS policy not to provide "retroactive" guidance (January 2017, ABA Taxation Section Insurance Companies Committee, Helen Hubbard)
- If a company defers implementation or is exempt from Life PBR, when (if at all) must it implement Life PBR for purposes of computing reserves for federal tax purposes?
- If a company is not subject to Life PBR because it operates only in states that have not enacted the current MSVL, when (if at all) must it implement Life PBR for purposes of computing reserves for federal tax purposes?
- PBR is determined on an aggregate basis, so how will the reserve be allocated by contract?
- Does PBR include asset adequacy reserves?

Policy tax compliance

- Section 7702: Qualification as a life insurance contract
  - Contract must be a life insurance contract under the applicable law
  - Contract must either:
    - Meet the cash value accumulation test, or
    - Meet the guideline premium requirements AND fall within cash value corridor

Reasonable mortality charges

- Section 7702(c)(3)(B) sets forth basis for determining the guideline single premium
  - Determination is based on “reasonable mortality charges” that meet the requirements (if any) prescribed by regulations
- Previous guidance issued as new mortality tables become “prevailing”
  - Notice 88-128 provides guidance upon the adoption of 1980 CSO tables
  - Generally relies upon section 7702 effective date rules to determine when a contract is treated as newly issued and therefore tested under most recent tables

Reasonable mortality charges (continued)

- Notice 2006-95 provides guidance upon the adoption of the 2001 CSO tables
  - Generally builds upon the approach of Notice 88-128
  - Optional three-year transition period
  - Sets forth as safe harbors a number of circumstances that are not treated as resulting in the issuance of a new contract or as requiring testing under new tables
- Guidance needed to address 2017 CSO transition – Notice 2016-63 addresses many issues, but permanent mortality transition guidance preferable

Routine changes versus “Pursuant to the terms of the contract”

— Accommodation of routine, non-tax motivated changes that are pursuant to policyholder expectations

  - Changes in death benefit
  - Reconsideration of ratings (smokers who stop smoking)
  - Reinstatements
  - Addition of qualified additional benefits, change in death benefit option, addition/removal of rider

Notice 2016-63

- Issued by IRS on October 19, 2016
- Supplements Notice 88-128 and updates Notice 2006-95
- Addresses prevailing tables for section 7702 purposes
  - Provides safe harbors concerning the use of the 2017 CSO tables as prevailing tables
- Provides guidance as requested by the industry concerning reductions in death benefits
  - If the only change to an existing contract is a reduction or deletion in benefits, the change will not affect the determination of the contract's issue date for purposes of the safe harbor

Questions

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