VM-20 Deterministic Reserves in Federally Prescribed Reserves

By Peter H. Winslow

The March 2016 edition of *Taxing Times* contained this author's article[1] that presented actuarial and legal analysis to support the conclusion that the stochastic components of Actuarial Guideline 43 and VM-20 principle-based reserves (VM-20 or PBR) are, and will be, properly included in federally prescribed reserves under I.R.C. § 807(d). In that article, I left consideration of the deterministic gross premium reserve component of PBR (Section 4 of VM-20) for another day. That day has come.

Much of the legal analysis in my article relating to stochastic reserves applies equally to the deterministic reserve component of VM-20. Two points in that article need to be reemphasized as we consider the deterministic reserve component of VM-20. The first important point is that the plain language of I.R.C. § 807(d)(3) requires the deterministic reserve to be taken into account as part of the VM-20 tax reserve method. Federally prescribed reserves must be computed using CRVM as prescribed by the NAIC. Because the deterministic reserve is an integral part of NAIC-prescribed CRVM, it cannot be ignored in the tax reserve computation. Statements found in the legislative history that some have interpreted to suggest that CRVM for tax purposes must be interpreted to have an 1984-era meaning cannot override the clear statutory language that requires post-1984 NAIC changes to CRVM to be the updated tax reserve method for newly issued contracts.

The second point made in my prior article is that a CRVM provision in a reserve for moderately adverse conditions does not mean that a portion of the reserve can be considered a nondeductible "surplus reserve." Most NAIC-prescribed reserves deductible as federally prescribed reserves incorporate prudent assumptions, and the deterministic reserve contains prudent assumptions in the same sense as other in deductible CRVM reserves. Rather than rehash these points in more detail, this article will focus on two other matters. First, I will debunk a myth: gross premium reserves are not included in deductible life insurance reserves because only net premium reserves qualify. In fact, I will point out how several other types of gross premium reserves are taken into account in federally prescribed reserves. After that, I will offer suggestions as to how to incorporate the VM-20 deterministic reserve in federally prescribed reserves.

IRS NOTICE 2008-18

Several arguments have emerged to support the contention that gross premium reserves cannot be deducted. Some of these arguments are suggested in Notice 2008-18,[2] and others have been raised informally by IRS personnel and other tax professionals, but the IRS has never issued formal guidance on how or whether gross premium reserves are taken into account in federally prescribed reserves under I.R.C. § 807(d). In general, the objections to gross premium reserves fall into three categories: (1) the reserve may include a nondeductible provision for unaccrued expenses; (2) the reserve fails to satisfy prescribed computational requirements for life insurance reserves in I.R.C. § 816(b); and (3) the reserve may contain nondeductible deficiency reserves. Upon examination, none of these objections bears up well to scrutiny to deny a tax reserve deduction for most gross premium reserves, and particularly not for the deterministic component of VM-20. Let's examine these objections one at a time.

RESERVE FOR EXPENSES

One commonly expressed concern with qualification of gross premium reserves for a tax reserve deduction is that they take into account expenses. Treasury regulations provide that reserves for unaccrued expenses are not deductible insurance reserves.[3] These regulations are derived from the seminal Supreme Court case of *Maryland Casualty Co. v. United States*,[4] from which the definition of life insurance reserves in I.R.C. § 816(b) was developed. In Notice 2008-18, the IRS questioned whether the deterministic reserve component of VM-20 implicitly includes a provision for ordinary business expenses and, therefore, does not qualify in whole or in part as an insurance reserve.[5] My March 2016 *Taxing Times* article explained in some detail why the stochastic component of VM-20 does not include a reserve for future expenses. The same considerations apply equally to the deterministic reserve component of VM-20. In short, the inclusion of future expenses in VM-20 is comparable to the "loading" factor implicit in net premium reserves, *i.e.*, the difference between the gross premium and the valuation net premium. Future gross premiums less future estimated expenses in the gross premium reserve formula are the actuarial corollary to net premiums in a net premium reserve. That is, gross premiums less expenses can be considered net premiums, just as net premiums in a traditional net premium reserve method are net of loading for assumed expenses (and profit). Consideration of expenses in gross premium reserves, therefore, does not mean that a portion of the reserve is held for extra-contractual ordinary business expenses within the meaning of Treas. Reg. § 1.801-4(e).

In analyzing this issue it is important to make a distinction between two types of reserves, both of which may be simplistically

labeled "gross premium reserves": (1) gross unearned premium reserves, and (2) gross premium reserves that use gross premiums instead of net premiums as the funding source for future benefits. These two are very different reserves actuarially and, as a result, require different tax analysis.

The first type of "gross premium reserve" is a reserve held for the unexpired term of the policy and is computed as the unearned portion of the gross premium paid at the beginning of the policy period. This type of gross premium reserve uses previously-received unearned gross premiums as a surrogate for the value of future contract benefits in the reserve formula. To the extent the prudently estimated value of future benefits is less than the value of unearned gross premiums, the reserve could be considered to include an implicit provision for future expenses (*i.e.*, what would otherwise be the ignored loading portion of the premium in a net premium reserve).

This can be illustrated by the case of *Union Mutual Life Ins. Co. v. United States.*[6] In that case, the district court held that gross unearned premium reserves for term life insurance contracts were not life insurance reserves because they exceeded net unearned premium reserves computed on the basis of recognized mortality tables and assumed rates of interest. The court determined as a factual matter that the company's gross unearned premium reserves implicitly included a reserve for expenses. The court did not say that gross premiums can never be used in a life insurance reserve calculation if the reserve otherwise satisfies the computational requirements of what is now I.R.C. § 816(b). In fact, in a subsequent case, *Central National Life Ins. Co. v. United States,*[7] the Court of Claims held that gross unearned premium reserves qualified as life insurance reserves because they were a reasonable estimate of reserves computed using a recognized mortality table and assumed rate of interest. In the *Central National* case, there was no implicit reserve for expenses.

There is an important distinction between a gross unearned premium method that uses previously-received undiscounted gross premiums and a gross premium reserve methodology, such as the deterministic reserve in VM-20, that uses the present value of future gross premiums less estimated future expenses in lieu of hypothetical net premiums to measure the reduction in reserves for revenue available to fund benefits. There is no reason why this second type of gross premium reserve should be deemed to include a nondeductible reserve for expenses. Unlike a gross unearned premium reserve, the deterministic reserve component of VM-20 will rarely exceed the present value of future benefits and, therefore, would not include an implicit reserve for expenses as in the *Union Mutual* case.

I.R.C. § 816(B) COMPUTATIONAL ISSUES

Notice 2008-18 also cites Rev. Rul. 77-451,[8] which held that gross premium reserves do not qualify as life insurance reserves

under former I.R.C. § 801(b), the predecessor of I.R.C. § 816(b). The rationale for the conclusion stated in Rev. Rul. 77-451 was of questionable merit even when it was published. The facts in the ruling state that the gross premium reserve was computed using a recognized mortality table and an assumed rate of interest. These facts demonstrate that the reserve actually did satisfy the computational requirements of a life insurance reserve in what is now I.R.C. § 816(b). Despite this, Rev. Rul. 77-451 concluded that there is an additional computational requirement implicit in the need to use a recognized mortality table and an assumed rate of interest. That additional requirement, according to the ruling, is that the reserve method must yield a single unique amount whether it is computed retrospectively or prospectively, which can be achieved only by using a traditional net premium reserve method. This additional computational requirement of Rev. Rul. 77-451—that a life insurance reserve must be computed in such a way that the same reserve amount can be derived whether computed prospectively or retrospectively—was entirely new. It was not found in any case law prior to the ruling, nor has any subsequent court adopted the ruling's position.

In any event, in today's world, it would be unreasonable for the IRS to rely on the rationale of Rev. Rul. 77-451 to conclude that gross premium reserves do not qualify as life insurance reserves. Several net premium valuation methods prescribed by the NAIC, and required for use as the tax reserve method under I.R.C. § 807(d), would now fail the ruling's test that retrospective reserves must equal prospective reserves. For example,

under the rationale of Rev. Rul. 77-451, CARVM reserves for variable annuities would not qualify as life insurance reserves. It would be surprising if the IRS were to attempt to superimpose the outmoded theory of Rev. Rul. 77-451 as a requirement for federally prescribed reserves.

It has been suggested that a gross premium reserve may not be deductible because the list of allowable insurance reserves in I.R.C. § 807(c)(1) includes "life insurance reserves (as defined in section 816(b)." Because I.R.C. § 816(b) contains computational requirements for life insurance reserves that may not be satisfied by gross premium reserves, the argument goes, they are not covered in the list of deductible reserve items.

That is, the cross-reference in I.R.C. § 807(c)(1) is an identification of the type of contract ... it is I.R.C. § 807(d), not I.R.C. § 816(b), that specifies the computational requirements ...

This is a misunderstanding of the meaning of the cross-reference to I.R.C. § 816(b). The purpose of the cross-reference is to identify the types of reserves that are classified as life insurance reserves and required to be subject to the tax reserve computational rules for life insurance reserves in I.R.C. § 807(d). Thus, properly read, the cross-reference means that reserves "which are set aside to mature or liquidate … future unaccrued claims arising from life insurance, annuity and noncancellable accident and health insurance contracts … involving, at the time with respect to which the reserve is computed, life, accident or health contingencies"[9] will be classified as life insurance reserves. That is, the cross-reference in I.R.C. § 807(c)(1) is an identification of the type of contract for which the reserve is held, and a specification of the purpose for which the reserve is held, not a computational requirement; it is I.R.C. § 807(d), not I.R.C. § 816(b), that specifies the computational requirements for life insurance reserves.

The legislative history confirms this interpretation:

> The statutory listing of items to be taken into account in computing the net increase or net decrease in reserves refers to life insurance reserves "as defined in section 816(a)." Section 816(a) requires a proper computation of reserves under State law for purposes of qualifying as a life insurance company. This cross reference is intended merely to identify the type of reserve for which increases and decreases should be taken into account and is not intended to superimpose the requirement of proper computation of State law reserves for purposes of allowing increases in such reserves to be recognized. Conceivably, a similar reference in prior law required proper computation under State law in order for deductions to be allowed, because prior law used the statutory reserves as the basis for measuring deductions and income for tax purposes. The Act, however, takes a new approach by prescribing specific rules for computing life insurance reserves for tax purposes, and as a consequence, the amount of the deduction allowable or income includible in any tax year is prescribed regardless of the method employed in computing State statutory reserves. Thus, a company cannot improperly compute a reserve for a liability involving a life contingency to avoid the Federally prescribed reserve computation, and for example claim treatment as unearned premiums, in order to use statutory reserve amounts for tax purposes.

This quote from the legislative history also highlights the inappropriate consequences of an overly broad reading of I.R.C. § 807(c)(1)'s cross-reference to I.R.C. § 816(b). If a reserve for policy benefits fails to qualify as a life insurance reserve, it would still be deductible as an insurance reserve, probably as an unearned premium reserve under I.R.C. § 807(c)(2). The circumstances in Rev. Rul. 77-451 are a good illustration of the type of situation this legislative history was addressing.

Rev. Rul. 77-451 did not conclude that gross premium reserves fail to qualify as deductible insurance reserves. Instead, as the General Counsel Memorandum[10] underlying the ruling makes clear, the ruling merely concluded that the gross premium reserve at issue was not computed or estimated on the basis of recognized mortality tables and assumed rates of interest. The effect of this conclusion under pre-1984 Tax Act law was that the reserve could not be taken into account as a life insurance reserve in taxable investment income—so-called Phase I. What is not explicitly stated in the ruling, but was clear to tax practitioners at the time, is that the gross premium reserve in the ruling was still deductible as an insurance reserve in gain from operations—so-called Phase II. In fact, in this author's experience, gross premium reserves were routinely allowable as deductible insurance reserves by the IRS (usually as unearned premium reserves under the predecessor of I.R.C. § 807(c)(2)). The 1984 Tax Act eliminated the Phase I taxable investment income provisions from Subchapter L of the Code and based current law on Phase II gain from operations. As a result, a tax reserve deduction is available if statutory gross premium reserves are held similar to those in Rev. Rul. 77-451, but adjustments would be required by I.R.C. § 807(d).

A related argument sometimes offered is that I.R.C. § 807(d) implicitly prevents a tax reserve deduction for gross premium reserves because it requires the use of specified mortality and interest assumptions that contemplate that statutory reserves that qualify for a tax reserve deduction must use a net premium reserve methodology. There are many problems with this argument. The most important is that the plain language of the statute requires use of the NAIC-prescribed reserve method for the contract as the tax reserve method under I.R.C. § 807(d)(3) without limitation as to how that reserve is initially computed. Basic rules of statutory construction do not permit a perceived congressional intent based on an implied meaning derived from other statutory language to trump unambiguous provisions of the law that in this case defer to the NAIC-prescribed method to determine federally prescribed reserves. In addition, I.R.C. § 807(d) itself recognizes that in appropriate circumstances gross premium reserves are deductible as life insurance reserves. Gross premium reserves reported on the annual statement would be deductible, for example, if they were held for qualified supplemental benefits.[11] In any event, the argument that gross premium reserves are not deductible because they do not use mortality and interest rate assumptions does not even apply to the deterministic reserve component of VM-20; it has these characteristics and is capable of being recomputed for tax purposes under the provisions of I.R.C. § 807(d).

DEFICIENCY RESERVES

Notice 2008-18 expresses a concern that the deterministic reserve component of VM-20 may include a nondeductible deficiency reserve. As in the case of gross premium reserves, there are two types of reserves commonly referred to as "premium deficiency reserves." The first type of premium deficiency reserve most often arises in health and property/casualty insurance and is an aggregate reserve held when anticipated losses and expenses exceed the unearned premium reserve and the contract reserves plus future contract premiums.[12] The IRS's position is that this type of premium deficiency reserve is not deductible because it is not an unearned premium reserve and is not a reserve for unaccrued claims.[13] In the case of long-term care insurance, this type of premium deficiency reserve would not be included in federally prescribed reserves because it would not be part of the one-year full preliminary term tax reserve method under I.R.C. § 807(d)(3).

The second type of premium deficiency reserve is what is more relevant to VM-20—the deficiency reserve described in I.R.C. § 807(d)(3)(C). This type of deficiency reserve arises as a result of a net premium method; it is established upon issuance of the contract and amortizes down to zero at the end of the premium-paying period. Only this technical definition of deficiency reserve was disallowed as a deduction under pre-1984 law.[14]

Because neither the deterministic nor stochastic reserve in VM-20 is determined using a net premium reserve method, there is nothing in the reserve methodology that compares to a deficiency reserve. Nevertheless, it has been suggested that I.R.C. § 807(d)(3)(C) provides a tax reserve disallowance for something beyond technical deficiency reserves. I.R.C. § 807(d)(3)(C) provides as follows:

> No additional reserve deduction allowed for deficiency reserves. Nothing in any reserve method described under this paragraph shall permit any increase in the reserve because the net premium (computed on the basis of assumptions required under this subsection) exceeds the actual premiums or other consideration charged for the benefit.

This section of the Code was intended to maintain pre-1984 tax law and disallow a tax deduction for only technical deficiency reserves. The legislative history reflects this congressional intent. Prior to the enactment of the 1984 Tax Act, former I.R.C. § 801(b)(4) provided that life insurance reserves did not include deficiency reserves. A deficiency reserve was defined in the Code in traditional actuarial terms as follows:

> [An amount] equal to the amount (if any) by which –
>
> (A) the present value of the future net premiums required for such contract, exceeds
>
> (B) the present value of the future actual premiums and consideration charged for such contract.[15]

The pre-1984 Code's definition of deficiency reserves created an issue because in 1976 the NAIC amended the Standard Valuation Law (SVL) to remove an explicit reference to deficiency reserves. Instead, under the 1976 amendment, if future gross premiums for a policy were less than future net premiums, CRVM reserves were required to be computed by substituting the gross premium for net premiums in the reserve calculation. After the amendment, minimum CRVM reserves were defined as the greater of (a) or (b), as follows:

> (a) the reserve calculated according to the method, mortality table, and interest rate actually used for the policy, and
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> (b) the reserve calculated by the method actually used for the policy, but using the minimum valuation standards of mortality and interest, and replacing the valuation net premium by the actual gross premium in each year that the actual gross premium is less than the valuation net premium.

After New York adopted the 1976 NAIC amendment, the question arose for life insurance companies doing business in New York whether deductible tax reserves continued to exclude deficiency reserves. Some taxpayers argued that there no longer were deficiency reserves because the gross premium was actually

the same as the net premium under the 1976 NAIC amendment. The IRS disagreed and issued a private letter ruling holding that, despite the changes in the SVL, a portion of the reserve was still a deficiency reserve.[16]

In the 1984 Tax Act, Congress wanted to resolve the issue raised in PLR 8117033. Under I.R.C. § 807(d)(3), Congress adopted the CRVM as prescribed by the NAIC as the tax reserve method, but CRVM incorporated deficiency reserves. To ensure that prior law, as interpreted by the IRS, continued under the 1984 Tax Act, Congress enacted I.R.C. § 807(d)(3)(C) to require that the NAIC's reserve method be adjusted to eliminate any "increase in the reserves" because the net premium exceeds the actual gross premium.

The legislative history indicates that I.R.C. § 807(d)(3)(C) was only intended to disallow technical deficiency reserves as interpreted by the IRS in PLR 8117033. The Blue Book states as follows:

> The new provision specifies that the reserve methods prescribed do not incorporate any provisions which increase the reserve because the net premium (computed on the basis of Federally prescribed assumptions) exceeds the actual premiums or other consideration charged for the benefit. Thus, the computation of the tax reserves will not take into account any State law requirements regarding "deficiency reserves" (whether such reserves are as defined under prior law or whether the NAIC prescribed method otherwise requires a company's reserves to reflect a gross premium charge that is less than the net premium based on minimum reserve standards).[17]

As the legislative history states, the purpose of I.R.C. § 807(d)(3)(C) was to clarify that deficiency reserves continue to be nondeductible regardless of the NAIC's prescribed method incorporating deficiency reserves in the CRVM calculation.

The intent of Congress to merely disallow a deduction for technical deficiency reserves was reconfirmed in the legislative history of the Tax Reform Act of 1986.[18] Section 1821(l) of the 1986 Tax Act added I.R.C. § 816(h) as a technical correction to the 1984 Tax Act amendments to Subchapter L. The purpose of the technical correction was to make it clear that the change in the statutory provisions dealing with deficiency reserves (including pre-1986 I.R.C. § 807(d)(3)(C)) was not intended to reflect a change in prior law. The Senate Finance Committee Report states as follows:

> **Present Law**
>
> Because of a general change in State law, as well as new rules for computing tax reserves, a prior law provision that specifically excluded derficiency reserves from the definition of life insurance reserves and total reserves was eliminated. Instead, the present law rules for computing tax reserves prohibit a company from taking into account any State requirements for "derficiency [sic] reserves" caused by a premium undercharge for purposes of computing the company's increases or decreases in life insurance reserves.
>
> **Explanation of Provision**
>
> The bill reinstates the prior-law exclusion of deficiency reserves from the definition of life insurance reserves and total reserves for purposes of section 816, which defines a life insurance company, and section 813(a)(4)(B), which defines surplus held in the United States for foreign lifes [sic] insurance companies doing business in the United States. The exclusion of deficiency reserves under DEFRA was not intended to have a substantive effect on the qualification of a company as a life insurance company or on the computation of surplus held in the United States for foreign life insurance companies.[19]

The legislative history of the 1984 Tax Act also states that where the concepts of prior law are carried over (such as the disallowance of deficiency reserves), the interpretation under pre-1984 Tax Act law should continue to apply. The committee reports state:

> **Relationship to the 1959 Act**
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> Although the bill amends the Internal Revenue Code by repealing the life insurance company taxation provisions of the 1959 Act and replacing them with an entire new Part I of subchapter L, the committee intends that the provisions of the new Part I which are based on present law be interpreted in a manner consistent with present law. Thus, where provisions of existing law are incorporated in the bill, the committee expects- that, in the absence of contrary guidance in this report, the regulations, rulings, and case law under existing law may serve as interpretative guides to the new provisions.[20]

Despite this legislative history, it is arguable that, to comply with I.R.C. § 807(d)(3)(C), VM-20 reserves must be reduced for tax purposes if the present value of future net premiums taken into account in the tax-adjusted net premium reserve component of VM-20 exceeds the present value of future gross premiums.

Another potential deficiency reserve issue could arise under Section 6.B.2. of VM-20. A group of certain types of policies will pass the deterministic reserve exclusion test under this section if the company demonstrates that the sum of the valuation net premiums for all future years is less than the sum of the corresponding guaranteed gross premiums for the group of policies. It could be argued that the deterministic reserve component of

VM-20 for any group of policies that has such reserve solely because it flunked the exclusion test is an increase in reserves because the net premium exceeds the gross premiums within the meaning of I.R.C. § 807(d)(3)(C).[21] This argument has a logical inconsistency, however. It would mean that the deterministic reserve components for some policies are insurance reserves properly taken into account in federally prescribed reserves, while similarly computed reserves for other policies are disallowed.

Later in this article I offer an option to comply with I.R.C. § 807(d) for VM-20 that avoids a need to resolve whether the scope of I.R.C. § 807(d)(3)(C) extends beyond technical deficiency reserves.

RECOMPUTATION OF GROSS PREMIUM RESERVES AS TAX RESERVES

It is demonstrably incorrect to say that when gross premium reserves are reported as statutory reserves no tax reserve deduction is available. In general, life insurance companies are accrual basis taxpayers, which for most taxpayers would mean that a reserve deduction is not allowable. However, I.R.C. § 811(a) provides that computations shall be made in a manner required for purposes of the NAIC annual statement to the extent not inconsistent with accrual accounting or other provisions of Part 1 of Subchapter L, which are the provisions of the Internal Revenue Code that relate to life insurance company taxation. This has been interpreted by the Supreme Court to mean that NAIC annual statement accounting principles apply to insurance reserves because concepts of tax accrual accounting do not apply.[22]

Therefore, under I.R.C. § 811(a) a gross premium reserve prescribed by the NAIC held for insurance benefits is deductible in full unless something in the other provisions of Subchapter L requires the reserve to be recomputed or partially disallowed for tax purposes. I.R.C. § 807(d) may do just that. As the legislative history confirms, the computation of the federally prescribed reserve begins with the company's statutory reserve and modifies that reserve to take into account three requirements of I.R.C. § 807(d): (1) the tax reserve method applicable to the contract; (2) the prevailing state assumed interest rate or the applicable federal interest rate (AFIR), whichever is larger; and (3) the prevailing commissioners' standard tables for mortality or morbidity.[23] Other related Code sections require further adjustments, eliminating from the federally prescribed reserve any portions attributable to net deferred and uncollected premiums, excess interest guaranteed beyond the end of the table year, and deficiency reserves. Except for these prescribed adjustments and several other miscellaneous adjustments applicable to specific types of contracts, the methods and assumptions employed in computing tax reserves should be consistent with those used in computing the company's statutory reserves.

Consequently, gross premium reserves reported as statutory reserves are deductible in full except to the extent adjustments are required by specific provision of Subchapter L of the Internal Revenue Code. Sometimes a reserve provision for the risks for which statutory gross premium reserves are held must be reflected as adjustments to mortality or morbidity tables and other times to the tax reserve method itself. For example, the provision for substandard risks held in Rev. Rul. 77-451 as gross premium reserves would be reflected as an adjustment to the prevailing commissioners' standard table and the gross unearned premium reserves in *Union Mutual* would be recomputed as CRVM net premium reserves as the applicable tax reserve method. In

the case of statutory gross premium reserves for qualified supplemental benefits, no adjustment is required and the statutory reserves are deductible.[24]

RECOMPUTATION OF VM-20 DETERMINISTIC RESERVES

In the case of the deterministic reserve component of VM-20, as with other insurance reserves, I.R.C. § 811(b) provides that the starting place is the statutory reserve, and I.R.C. § 807(d) provides for the adjustments to arrive at the federally prescribed reserve. Unlike the gross unearned premium reserves in *Union Mutual*, no adjustment is required for the tax reserve method under I.R.C. § 807(d)(3) because the deterministic reserve is an integral part of NAIC-prescribed CRVM. Therefore, the deterministic reserve is allowable as part of the tax reserve method, but other tax reserve adjustments need to be considered.

> It is likely that the drafters did not foresee in 1984 that statutory reserves would evolve into a principle-based regime ... but they nevertheless had the foresight to defer to the NAIC in the tax reserve method so that the tax law could accommodate future reserving methodologies ...

As in the case of the stochastic component of VM-20, the issues that need to be resolved are how to implement I.R.C. § 807(d)'s requirements to use the prevailing commissioners' standard tables for mortality and the interest rate assumption mandated for federally prescribed reserves. Because the deterministic reserve is based on a single scenario, a straightforward option could be to use the I.R.C. § 807(d) adjustments for the prevailing commissioners' standard table and the interest rate used for the tax-adjusted net premium reserve component of VM-20. These assumptions could be substituted for the prudent mortality assumption in Section 9.C. and the discount rates Section 7.H.4. used for the deterministic reserve component of VM-20. There are several problems with this seemingly simple approach. First, it is not clear that any adjustments for the VM-20 mortality assumptions are required under I.R.C. § 807(d)(5) in the first place. The NAIC has prescribed mortality assumptions in Section 9 of VM-20. These assumptions are required to be constructed using specified standards and can be viewed as resulting in mortality tables. These NAIC-prescribed mortality tables require separate mortality segments for standard risks, and therefore, also could be considered "standard" tables prescribed for federally prescribed reserves by I.R.C. § 807(d)(5)(A). The reference to "standard" tables, which are prescribed for tax reserves by I.R.C. § 807(d)(5), does not refer to uniform tables applicable to all contracts; rather, it refers to tables applicable to standard risks. Contrary to an oft-expressed view of many tax practitioners, there is no requirement in I.R.C. § 807(d) that precludes a "commissioners' standard table" prescribed by the NAIC from being based on company-specific factors. In fact, since 1942 it has been established that "recognized mortality or morbidity tables" applicable to life insurance reserves under I.R.C. § 816(b) include tables authorized by the NAIC and state insurance regulators based on a single company's own experience.[25] Tables based on company experience are "recognized" under I.R.C. § 816(b);[26] there is no reason why they should not also be considered "prescribed" by the NAIC under I.R.C. § 807(d)(5). The statute does not specify how mortality tables are to be constructed, who is assigned to construct them, or what data are to be used in their development. Nor does the statute, nor even the legislative history, say that the tables must be uniform and cannot take into account individual company experience.

To the extent VM-20 also prescribes mortality assumptions for nonstandard risks, it also would seem that these assumptions could be viewed as either standard tables for the specified risk categories or as tables "adjusted as appropriate" as permitted under I.R.C. § 807(d)(1). In short, there are good arguments for the position that the prevailing commissioners' standard tables for the deterministic component of VM-20 are the same mortality assumptions prescribed by the NAIC (and 26 states) in Section 9 of VM-20.

The more difficult problem with the straightforward approach of making I.R.C. § 807(d) adjustments directly to the deterministic reserve is that substitution of the I.R.C. § 807(d)(4) interest rate assumption for the discount rate in Section 7.H.4. of VM-20 would depart from the intent of VM-20 to align the discount rates with the net asset earned rates. This disconnect between the asset-earnings rate and the discount rate would call into question whether the tax reserve method has been implemented appropriately, *i.e.*, in the manner prescribed by the NAIC, as required by I.R.C. § 807(d)(3).

For these reasons, this author prefers another approach to comply with I.R.C. § 807(d)—the Option 1 approach described for the stochastic reserves component of VM-20 in my March 2016 article. Here is how the computation of federally prescribed reserves would work. We would first make all the adjustments required by I.R.C. § 807 to the net premium reserve component of VM-20. The excess of the greater of the statutory stochastic reserve component or the deterministic reserve component over the *statutory* net premium reserve component then would

be added to the tax-adjusted net premium reserve component of VM-20. The federally prescribed reserve would be the sum of these two amounts and would thereby provide for a tax/stat reserve differential that has taken into account all of the adjustments required for federally prescribed reserves in an appropriate manner. Under this approach, we would not have to resolve the issue as to whether VM-20 mortality assumptions qualify as prevailing commissioners' standard tables or whether substitution of the I.R.C. § 807(d)(4) discount rates in the deterministic or stochastic reserve components is required.[27]

We also would not have to resolve whether I.R.C. § 807(d)(3)(C) disallows more than just technical deficiency reserves. An appropriate tax adjustment for deficiency reserves already has been made implicitly in the net premium reserve component (because it is not increased by a net premium deficiency) and this implicit reduction in tax reserves would not be recovered by the addition of the deterministic and/or stochastic reserve components. This is another reason why I prefer the option for compliance with I.R.C. § 807(d) described above. The usual deficiency reserve adjustment would be considered to have been made to the net premium reserve component of VM-20; and, under the suggested approach, no separate deficiency-reserve-type adjustment for the deterministic or stochastic reserve component of VM-20 would be necessary.

CONTRACT-BY-CONTRACT RESERVE COMPARISON

There is a feature of both the stochastic and deterministic reserve components of VM-20 that was not discussed in my March 2016 article that merits consideration. In general, the Code contemplates a contract-specific calculation of tax reserves. This is necessary because the "amount of the life insurance reserves for any contract" under I.R.C. § 807(d) is capped by the statutory reserve and floored by the net surrender value of the contract. It has been suggested that this required contract-by-contract comparison necessarily means that statutory reserves must be computed on a seriatim basis to qualify as deductible life insurance reserves. There is little merit to this argument. As indicated earlier in this article, the determination of tax reserves begins with statutory reserves. There was nothing in pre-1984 Tax Act law that prevented a tax reserve deduction when statutory reserves were computed using aggregate assumptions and the 1984 amendments did not change that result. What the 1984 Tax Act did do, however, is require statutory reserves to be recomputed under I.R.C. § 807(d) and then be allocated appropriately to individual contracts so that the required contract-by-contract comparisons can be made.

Fortunately, the contract-level comparisons required for tax reserves are facilitated by VM-20 because it requires that a method be adopted to allocate the minimum aggregate reserves back to individual contracts. Section 2.C. of VM-20 provides that the minimum reserve for each contract is equal to the net premium reserve less the contract's portion of any credit for reinsurance ceded plus the contract's allocated portion of any deterministic reserve excess plus the contract's allocated portion of any stochastic reserve excess. The fact that an aggregate reserve allocation methodology is provided in VM-20 is yet another reason why my preferred option for compliance with I.R.C. § 807(d) would work well. By first recomputing the net premium reserve under I.R.C. § 807(d) on a seriatim basis and then adding the *statutory* excess of the deterministic and stochastic reserves to arrive at federally prescribed reserves, it is a simple matter to allocate the statutory excess to individual contracts using the method adopted under VM-20.

AFTERTHOUGHTS

I would like to close this second article on tax law compliance for VM-20 with two observations. The first is to note that, in my opinion, the drafters of the 1984 Tax Act adopted tax reserve rules that have stood the test of time well. It is likely that the drafters did not foresee in 1984 that statutory reserves would evolve into a principle-based regime that incorporate stochastic and gross premium reserve components, but they nevertheless had the foresight to defer to the NAIC in the tax reserve method so that the tax law could accommodate future reserving methodologies and product designs requiring new reserving standards. It is true that tax professionals and actuaries may struggle with how to fit the square pegs of the I.R.C. § 807 tax reserve adjustments into the round holes of stochastic or gross premium reserves. However, the tax law compliance issues that have been wrestled with in these PBR articles can be resolved in an appropriate manner because they start with NAIC-based statutory reserves that incorporate current actuarial practice. That statutory scheme adopted by the 1984 drafters is preferable to the compliance problems that would have resulted if Congress had mandated the use of outmoded 1984-era reserve methods for tax reserves for all time.

The second observation is that, in the event comprehensive tax reform proceeds and changes are proposed to update the tax reserve provisions for life insurance companies, it is essential to retain the basic approach of the 1984 Tax Act and have statutory reserves as the foundation for tax reserves. Adjustments to statutory reserves may be necessary, just as under current law, but if Congress wants a revised tax regime for life insurance companies to remain viable for over 30 years, as the 1984 Tax Act accomplished, the tax law must be flexible enough to accommodate future changes in products, regulatory oversight and actuarial practice. Deference to the NAIC-prescribed requirements for the tax reserve method is the best way to achieve that goal. ■

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ENDNOTES

[1] Peter H. Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *Taxing Times* Vol. 12, Issue 1 at 21 (March 2016).

[2] 2008-1 C.B. 363 (Jan. 14, 2008).

[3] Treas. Reg. § 1.801-4(e).

[4] 251 U.S. 342 (1920).

[5] Notice 2008-18, section 4.

[6] 420 F. Supp. 1181 (D. Me. 1976), *aff'd on this issue,* 570 F.2d 382 (1st Cir. 1978).

[7] 574 F.2d 1067 (Ct. Cl. 1978).

[8] 1977-2 C.B. 224.

[9] I.R.C. § 816(b)(1)(B).

[10] G.C.M. 37209 (Aug. 1, 1977).

[11] I.R.C. § 807(e)(3).

[12] *E.g.*, NAIC Health Insurance Reserves Model Regulation, Section 3.B.(2); SSAP No. 53, para. 15.

[13] *See, e.g.,* Internal Revenue Service Treasury Manual, Lesson 7, "Blue Cross and Blue Shield Organizations, and Health Insurance Issues," 7–52.

[14] *Sec. Benefit Life Ins. Co. v. United States,* 517 F. Supp. 740 (D. Kan. 1981), *aff'd,* 726 F.2d 1491 (10th Cir. 1984); *Mut. Benefit Life Ins. Co. v. Commissioner,* 488 F.2d 1101 (3d Cir. 1973); TAM 8752003 (Aug. 31, 1987).

[15] *See also* Treas. Reg. § 1.801-4(e)(4).

[16] PLR 8117033 (Jan. 27, 1981).

[17] Staff of the Jt. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 601 (1984) (1984 Blue Book).

[18] Pub. L. No. 99-514.

[19] S. Rep. No. 99-313, at 975 (1986); *see also* H.R. Rep. No. 99-426 at 955-56 (1985).

[20] S. Prt. No. 98-169, vol. I, at 524 (1984); H.R. Rep. No. 98-432, pt. 2, at 1401 (1984).

[21] If the deterministic reserve component of VM-20 were to be disallowed as a deficiency reserve under this argument, the stochastic reserve component of VM-20 presumably would increase for tax purposes.

[22] *Commissioner v. Standard Life & Accident Ins. Co.,* 433 U.S. 148 (1977).

[23] 1984 Blue Book at 599.

[24] I.R.C. § 807(e)(3).

[25] S. Rep. No. 77-1631 (1942), reprinted in 1942-2 C.B. 504, 612..

[26] Rev. Rul. 89-43, 1989-1 C.B. 213.

[27] In many economic scenarios this approach would yield a smaller tax reserve than if the I.R.C. § 807 adjustments were made to all VM-20 reserve components separately and then compared to each other following Section 2.A. of VM-20.