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FAQ on Certain Insurance Reserves Held by Insurance Companies for the Purpose of Determining U.S. Taxable Income after the Passage of the Tax Cuts and Jobs Act of 2017

Prepared by the Tax Work Group of the Life Practice Council of the American Academy of Actuaries

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Introduction

The primary purpose of this Frequently Asked Questions (FAQ) paper is to discuss the concepts of calculating tax reserves and reporting tax reserve changes under the Tax Cuts and Jobs Act (TCJA) passed at the end of 2017. This paper discusses the provisions in the tax code that govern both 1) the calculations of tax reserves under Internal Revenue Code (IRC) § 807(c)(1) - (6) and 2) what constitutes a change in tax reserves, the required approvals, and its impact on reported taxable income. These provisions apply regardless of the type of insurance company that issues the contracts that produce the tax reserves under IRC 807(c).

This FAQ paper is the second FAQ paper prepared by the American Academy of Actuaries (Academy) Tax Work Group. It follows the first paper released in early 2018, which dealt with life insurance tax reserve methods and assumptions under IRC § 807(d) and (f) as those sections existed at the end of 2017. This paper also provides Academy Tax Work Group comments on those tax reserve assumptions that affect contract tax compliance and thus policyholder taxation under the definition of life insurance rules (IRC § 7702) and the modified endowment contract (MEC) rules (IRC § 7702A).

The answers included in this paper represent the views of the Academy's Tax Work Group members who have participated in the development of the paper. This document is not an interpretation of actuarial standards of practice, nor is it meant to be a codification of generally accepted actuarial practice. Actuaries are not in any way bound to comply with the views expressed or to conform their work to the practices described herein. Certain issues addressed in this paper have no clear formal guidance, and practitioners can reasonably disagree on answers including those provided herein. The answers are intended to describe tax reserve principles of general applicability but are not intended to be comprehensive or address exceptions that may apply to particular types of policies or benefits or company-specific situations. Answers to the tax reserve questions provided below may depend on formal guidance issued by the Department of the Treasury and the Internal Revenue Service (IRS) and perhaps court interpretation.

The American Academy of Actuaries has assembled this information as a general reference tool to assist actuaries who wish to explore these concepts. This paper is not intended to be a substitute for the practitioner's thorough review of the federal and state laws, rules, or regulations applicable to his or her actuarial services. In addition, this document does not constitute tax advice, and any tax information contained in this document (including any attachments, enclosures, or other accompanying materials) is not intended or written to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties. Any party seeking tax advice should consult with a tax advisor/expert.

A number of terms referred to in this paper are found in actuarial literature. However, some of these terms may be defined differently in the IRC. The tax definitions of certain terms are provided in footnotes throughout this paper. If there are additional questions about the meanings of terms, the reader should consult with a tax advisor.

General Background on the Calculation of Tax Reserves Under IRC § 807(c)

The tax reserves included in IRC § 807(c) are:

(1) Life insurance reserves,[1] which includes life, annuity, and certain health insurance.
(2) Unearned premiums and unpaid losses.
(3) The amounts (discounted at the appropriate rate of interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies.
(4) Dividend accumulations, and other amounts, held at interest in connection with insurance and annuity contracts.
(5) Premiums received in advance and liabilities for premium deposit funds.
(6) Reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance which are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.

The Tax Code as revised under the TCJA, specifically IRC § 807(d)(1), continues the provision that the tax reserve with respect to any contract is not to be less than the net surrender value[2] of the contract, and the amount of the tax reserve for any contract (the annual change in which affects taxable income) may not exceed the statutory reserve for that contract (appropriately adjusted), a concept known as "the stat cap."

The 2017 Tax Cuts and Jobs Act has introduced two major changes in the determination of tax reserves. The tax reserves used to determine taxable income are now based on a National Association of Insurance Commissioners- (NAIC-)prescribed reserve method as of the valuation date versus the previous rule to use an NAIC-prescribed reserve method at the time of a contract's issue date. In addition, there are no longer rules requiring that tax reserves be calculated using the prescribed interest rate and mortality tables, but prescribed interest rates and mortality tables still affect other parts of the tax code.

List of FAQs (expressions and terms in quotes are from IRC § 807 unless otherwise specified).

1. What is an insurance reserve?
2. What is a tax insurance reserve?
3. What is a reserve method?
4. What are the currently prescribed tax reserve methods?

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[1] IRC § 816(b): **(1)In GENERAL** For purposes of this part, the term "life insurance reserves" means amounts—
(A) which are computed or estimated on the basis of recognized mortality or morbidity tables and assumed rates of interest, and
(B) which are 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.

[2] The net surrender value for tax purposes is the cash surrender value after deducting surrender charges, but before applying any market value adjustment. The cash surrender value is to be determined without regard to policy loans or reasonable termination dividends.

5. What if the method used for calculating statutory reserves is not the prescribed tax reserve method *(e.g.*, Commissioners Reserve Valuation Method (CRVM), Commissioners Annuity Reserve Valuation Method (CARVM), or a method prescribed by the NAIC) in effect on the date of valuation?
6. Are all statutory reserves included in the computation of tax reserves for the purpose of determining taxable income?
7. Must tax reserves continue to be determined on an individual contract basis?
8. How are tax reserves for non-variable IRC § 807(c)(1) Life Insurance Reserves calculated?
9. How are tax reserves for variable IRC § 807(c)(1) Life Insurance Reserves calculated?
10. How are tax reserves for IRC § 807(c)(2) Unearned Premiums and Unpaid Losses calculated?
11. How are tax reserves for IRC § 807(c)(3) Amounts Discounted at Interest Only calculated?
12. How are tax reserves for IRC § 807(c)(4) Dividend Accumulations and Other Amounts Held at Interest calculated?
13. How are tax reserves for IRC § 807(c)(5) Premiums Paid in Advance and Premium Deposit Funds calculated?
14. How are tax reserves for IRC § 807(c)(6) Reasonable Special Contingency Reserves under contracts of Group Term Life Insurance or Group Accident and Health Insurance which are established and maintained for the provision of insurance on retired lives, for Premium Stabilization or for a combination thereof calculated?
15. What defines a reserve basis for statutory reporting?
16. What defines a reserve basis for tax reporting?
17. Can a reserve basis for a contract be modified or "be changed" after issue?
18. Are there differences between statutory reserve basis changes and tax reserve basis changes?
19. How are tax reserve basis changes reflected in taxable income?
20. What reporting is required for tax basis changes?
21. What are examples of reserve basis changes?
22. How are tax reserves for supplemental benefits calculated?
23. How are tax reserves calculated for supplemental benefits that are not listed in the tax law?
24. Do any of the reserve assumptions used in an NAIC-prescribed reserve method directly affect life insurance contract tax compliance and thus policyholder taxation?

Frequently Asked Questions on Certain Insurance Reserves Calculated by Insurance Companies

1. What is an insurance reserve?

   A. In general, a reserve for insurance contracts represents at any point in time an insurance company's liability for the future guaranteed (and in some methods nonguaranteed) benefits and in some methods expenses that an insurance company assumes it will incur minus the value of future premium payments and considerations it assumes it will receive. Reserves need to be supported by sufficient assets to assure company solvency.

   In actuarial literature [*Life Contingencies*, C.W. Jordan], the concept of a reserve for life insurance and annuities arises from the necessity of measuring an insurer's net liability with respect to a policy or a group of policies at times subsequent to the date of issue. In an early insurance tax reserve case [*Maryland Casualty v U.S.*, 1920], the U.S. Supreme Court observed that "the term 'reserve' or 'reserves' in the law of insurance means, in general, a sum of money variously computed or estimated, which, with accretions from interest, is set aside, 'reserved,' as a fund with which to mature or liquidate either by payment or reinsurance with other companies, future unaccrued and contingent claims, and claims accrued but contingent and indefinite as to amount or time of payment."

   While the amount of insurance reserve is a balance sheet item for financial reporting, the change in the reserve is an income statement item that serves to affect the amount of income that can be recognized for financial reporting.

2. What is a tax insurance reserve?

   A. A tax insurance reserve is a reserve that is calculated for the primary purpose of determining taxable income. Tax reserves are identified, determined, and quantified according to rules in various sections of the IRC and clarified by other Treasury rules and guidance, and perhaps court interpretations.

3. What is a reserve method?

   A. A reserve method defines a calculation of an appropriate (for the purpose) amount for an insurer's net liability using a stated set of actuarial formulas or models, including stochastic modeling that may utilize, among other factors and assumptions:

   - certain prescribed industry-wide factors or assumptions, or
   - prescribed industry-wide ranges of factors or assumptions, or

- company-specific factors or assumptions, or
- prescribed industry-wide or company-specific model parameters.

A reserve method is determined by the prescribing entity's specific regulatory or economic purpose, such as the statutory reserve method determined by the NAIC, the tax reserve method determined by federal law as prescribed in the IRC, and the Generally Accepted Accounting Principles (GAAP) reserve method determined by the Financial Accounting Standards Board (FASB).

The various reserve methods develop reserve amounts that can vary between methods, and the results of one method may not be relevant or appropriate for another method.

4. What are the currently prescribed tax reserve methods?

A. The IRC requires the tax reserve method used to calculate the tax reserves as of the date of determination: (1) to be CRVM as prescribed by the NAIC in the case of life insurance contracts covered by CRVM; (2) to be CARVM as prescribed by the NAIC in the case of annuity contracts covered by CARVM; (3) in the case of a contract not covered by one of these methods, the tax reserve method is to be the reserve method prescribed by the NAIC that covers such contract, or in the case no reserve method has been prescribed by the NAIC that covers such contract, then the tax reserve method is to be a method consistent with the other NAIC-prescribed methods.

For the purpose of computing taxable income, the results of these tax reserve methods may be further adjusted, as will be discussed in questions and answers that follow.

5. What if the method used for calculating statutory reserves is not the prescribed tax reserve method *(e.g.,* CRVM, CARVM, or a method prescribed by the NAIC) in effect on date of valuation?

A. If the statutory reserve method used in the annual statement is not the prescribed tax reserve method in effect on the date of valuation, then the first step in computing the tax reserves for the purpose of determining taxable income is to recalculate the statutory reserves using the prescribed tax reserve method. Note that statutory "permitted practices" are generally not NAIC methods for purposes of calculating tax reserves.

6. Are all statutory reserves included in the computation of tax reserves for the purpose of determining taxable income?

A. No. The starting point for the tax reserve is the statutory reserve calculated using an NAIC-prescribed method on the date of valuation. In addition, the IRC and Treasury regulations:

(1) exclude certain types of statutory reserves or portions of statutory reserves, regardless of whether they may be required by a particular statutory reserve method—for example, the statutory reserve used for tax purposes excludes life deficiency reserves, reserves attributable to deferred and uncollected premiums and unpaid premiums, and excess interest reserves.[3] Asset adequacy reserves[4] and voluntary reserves remain nondeductible for tax purposes, and

(2) require further adjustments be made to some statutory reserve amounts in the calculation of the tax reserves—for example, multiplying a statutory reserve by a factor or calculating a different tax reserve amount using an interest rate different than the one used for statutory reserves.

Tax reserves are capped by statutory reserves (including deficiency reserves) on a contract level basis except for cancellable disability income. Tax reserves for cancellable disability income are capped based on the year of incurral in aggregate for the line of business.

7. Must tax reserves continue to be determined on an individual contract basis?

A. Yes. In addition, if the reserve methodology requires or permits the calculation of all or part of the reserve on an aggregate basis, any allocation of such aggregate reserve for tax-deductible reserves must be required, permitted, or consistent with the NAIC-prescribed method.

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[3] Excess interest reserves are reserves that result from the guarantee of interest in excess of the prevailing state assumed rate that is to be paid or credited after the end of the current tax year. The prevailing state assumed rate means, with respect to any contract, the highest assumed interest rate permitted to be used in computing life insurance reserves for that contract under the insurance laws of at least 26 states. For purposes of the preceding sentence, the effect of nonforfeiture laws of a state on interest rates for reserves shall not be taken into account. The prevailing state assumed interest rate with respect to any contract is determined as of the beginning of the calendar year in which the contract was issued.

[4] Regulation §1.807-1(a) defines asset adequacy reserves as "(i) Any reserve that is established as an additional reserve based upon an analysis of the adequacy of reserves that would otherwise be established in accordance with the requirements set forth in the NAIC Valuation Manual, such as the CRVM or CARVM as applicable, or (ii) Any similar reserve.

In determining whether a reserve is a life insurance reserve, the label placed on such reserve is not determinative, provided, however, any reserve or portion of a reserve that would have been established pursuant to an asset adequacy analysis required by the NAIC's Valuation Manual as it existed on December 22, 2017, the date of enactment of Public Law 115-97, is an asset adequacy reserve."

8. How are tax reserves for non-variable IRC § 807(c)(1) Life Insurance Reserves calculated?

   A. For non-variable life insurance, non-variable annuities with life contingencies and noncancellable and guaranteed renewable accident and health insurance,[5] the tax reserve is equal to 92.81% of the reserve computed using an NAIC-prescribed method applicable to the contract on the valuation date after adjusting for removal of life deficiency reserves, reserves attributable to deferred and uncollected premiums and unpaid premiums, and reserves attributable to excess interest guaranteed beyond year-end. The result of this calculation is then subject to the net surrender value floor and statutory cap as prescribed and required in IRC § 807.

      This is an example of this calculation. Assume the statutory reserve is computed using an NAIC-prescribed method applicable to the contract on the valuation date. If the statutory reserve method is not an NAIC-prescribed method, then the first step in calculating the tax reserve is the recomputation of the statutory reserve using an NAIC-prescribed method.

Statutory Data

Statutory Mean Reserve*	1,500
Statutory Deficiency Reserve	200
Due/Deferred Premium Asset	75
Net Surrender Value	1,250

*Statutory mean reserve excludes deficiency reserve and asset adequacy reserve

Tax Calculations

Adjusted statutory reserve = 1,500 – 75	1,425
Apply 92.81%	1,323
Cash Value Floor	1,250
Statutory cap = 1,500 + 200 – 75	1,625
Tax reserve	1,323

9. How are tax reserves for variable IRC § 807(c)(1) Life Insurance Reserves calculated?

   A. Reserves for variable life insurance and variable annuity contracts with life contingencies follow the general reserve rules described in the introduction with

[5] When the term "noncancellable accident and health" policy is used in the context of tax reserves, it includes both noncancellable and guaranteed renewable health insurance contracts as these are defined for tax purposes.

some modifications to reflect the variable nature of these contracts.

The tax reserve for a variable contract is the sum of (1) and (2) where:

(1) is the greater of the total contract net surrender value and the contract reserve separately accounted for under IRC § 817, and

(2) is 92.81% times the excess, if any, of the total contract reserve calculated using an NAIC-prescribed method applicable to the contract on the valuation date over the value in (1).

The reserve separately accounted for under IRC § 817 is the portion of the total contract reserve allocable to benefits not guaranteed by the general account but not larger than the amount reported in the statutory blank. The allocation to the separate account must be required, permitted or consistent with the NAIC-prescribed method used to determine the total contract reserve. Under both statutory and tax requirements, companies must hold in their general account the reserves supporting guaranteed benefits on a variable contract.

The "total contract reserve" includes the reserves held in the general account and the reserves held in the separate account, both calculated using an NAIC-prescribed method applicable to the contract on the valuation date after adjusting for removal of life deficiency reserves, reserves attributable to deferred and uncollected premiums and unpaid premium, and reserves attributable to excess interest guaranteed beyond yearend. The result of this calculation is then subject to the statutory cap and net surrender value floor as prescribed and required in IRC § 807.

IRC § 817 also requires an adjustment to the end-of-year reserve to remove appreciation and depreciation of the assets supporting the variable products. This adjustment is made only to the end-of-year reserve so that the change for the reporting period in the amount of the reserves held does not include the amount due to current year asset value appreciation or depreciation, as these amounts are also not part of taxable income.

This is an example of the tax reserve calculation for a variable life policy. Assume the statutory reserve is computed using an NAIC-prescribed method on the date of valuation for the policy. If the statutory reserve method is not an NAIC-prescribed method, then the first step in calculating the tax reserve is the recomputation of the statutory reserve using an NAIC-prescribed method. Assume the method for the allocation of the total reserve between the separate and general accounts is compliant with IRC § 817(c). The maximum reserve for Variable Annuities attributed to the separate account is the separate account net surrender value (NSV).

Statutory Data

	Separate Account	General Account	Total
Account Value	800	200	1,000
Net Surrender Value (NSV)	736	184	920
Statutory Reserve	752	188	940
Capital gains during tax year	60	N/A	60

Tax Reserve Calculation

Max {NSV and Separate Account Reserve} = Max {920,752}	920.00
Excess to which 92.81% is applied = 940 – 920	20.00
Apply 92.81%	18.56
Calculated tax reserves = 920 + 18.56	938.56
Stat cap	940.00
EOY tax reserve after 817(a) adjustment = 938.56 – 60	878.56
Subsequent year BOY tax reserve	938.56

10. How are tax reserves for IRC § 807(c)(2) Unearned Premiums and Unpaid Losses calculated?

A. Items included in 807(c)(2) unearned premiums and unpaid losses and their tax treatment are as follows:

(1) Unearned premiums and unpaid losses on life insurance and noncancellable and guaranteed renewable Accident & Health (A&H)—the statutory reported amounts are used as tax reserves and are not required to be discounted.
(2) Cancellable disability income unpaid losses, whether reported or unreported—tax reserves are equal to 92.81% of the statutory reserve computed using a NAIC-prescribed reserve method as of the date of valuation. As under prior law, this reserve must be based on the company's actual experience for mortality and morbidity. In addition, the statutory cap continues to be based on the year of incurral in aggregate for the line of business (rather than determined on a seriatim basis). These are the only tax reserves in 807(c)(2) that are subject to the 92.81%.
(3) Credit disability unpaid losses, whether reported or unreported—tax reserves are determined using property and casualty reserve methods, following discounting rules published by the Treasury Department.
(4) Unearned premiums on cancellable health insurance—unearned premiums continue to be reduced by 20%.

(5) Cancellable health insurance claims, whether reported or unreported, on other than cancellable disability income and credit disability coverage—tax reserves are based on the assumption that unpaid losses are paid in the middle of the year following the accident year and are discounted following rules published by the Treasury Department.

11. How are tax reserves for IRC § 807(c)(3) Amounts Discounted at Interest Only calculated?

A. These reserves are amounts (discounted at interest) necessary to satisfy the obligations under insurance and annuity contracts, but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, accident, or health contingencies. Most tax experts agree that a life annuity with a certain period should be considered to be one contract that is reserved under 807(c)(1) while the life contingency applies.

The discount rate used for the tax reserves is the highest rate or rates permitted by the NAIC as of the valuation date to discount the obligation. Thus, there may be a difference between the statutory reserve and the tax reserve. As under prior law, the tax reserve is limited by the statutory cap on a contract basis.

The 92.81% factor does not apply to 807(c)(3) reserves.

12. How are tax reserves for IRC § 807(c)(4) Dividend Accumulations and Other Amounts Held at Interest calculated?

A. These reserves are ordinarily equal to the statutory reserves held.

The 92.81% factor does not apply to 807(c)(4) reserves.

13. How are tax reserves for IRC § 807(c)(5) Premiums Paid in Advance and Premium Deposit Funds calculated?

A. These reserves are ordinarily equal to the statutory reserves held.

The 92.81% factor does not apply to 807(c)(5) reserves.

14. How are tax reserves for IRC § 807(c)(6) Reasonable Special Contingency Reserves under contracts of Group Term Life Insurance or Group Accident and Health Insurance which are established and maintained for the provision of insurance on retired lives, for Premium Stabilization or for a combination thereof calculated?

A. These reserves are ordinarily equal to the statutory reserves held.

The 92.81% factor does not apply to § 807(c)(6) reserves.

15. What defines a reserve basis for statutory reporting?

A. At the time a reserve is determined for statutory reporting, the reserve basis includes:
   (1) The NAIC-prescribed method, or rules required or permitted by the regulatory authority to be followed in the calculation, including any actuarial assumptions specifically prescribed in the method, or
   (2) Any other actuarial methods or assumptions used in the calculation of the reserve.

16. What defines a reserve basis for tax reporting?

A. At the time a reserve is determined for tax reporting, the reserve basis includes:

   (1) an NAIC-prescribed method applicable to the contract on the valuation date, including any actuarial assumptions specifically prescribed in the method, and other assumptions if not prescribed by the NAIC that are used in the calculation of the statutory reserve for purposes of tax reporting, or
   (2) if there is not an NAIC-prescribed method applicable to the contract on the valuation date, another appropriate actuarial method should be used (see question 4) and
   (3) any adjustments such as application of the 92.81% factor used for calculating certain tax reserves, and
   (4) the elimination of certain items (e.g., deficiency reserves or due and unpaid premiums) as prescribed in the appropriate tax rules.

17. Can a statutory or tax reserve basis for a contract be modified or be changed after issue?

A. The reserve basis is determined at the valuation date, but this basis may be modified at a later valuation date. Such a modification may be defined as a reserve basis change, provided the regulatory guidance (e.g., Valuation Manual, IRS notices, etc.) for the reserve determination considers such a modification to be a reserve basis change. This means other modifications may not be a reserve basis change.

18. Are there differences between statutory reserve basis changes and tax reserve basis changes?

A. There are differences in the definitions, the measurements, and the reporting processes.

Statutory reserve basis changes are described in the NAIC Valuation Manual. Tax reserve basis changes are described in the IRC, in guidance issued by the Department of the Treasury and the IRS, and in court interpretation, if any.

Many tax experts agree that most changes in valuation basis for statutory accounting (stat basis change, reported in Exhibit 5A) should be considered a tax basis change. Examples of exceptions are noted in the answer to question 21.

In addition, tax reserve basis changes may include items that are not considered stat reserve basis changes. See question 21 for examples and additional guidance.

There are also differences in the way reserve basis changes are measured and reported. Stat reserve basis changes are measured at the beginning of the year of change, while tax reserve basis changes are measured at the end of the taxable year of change. In other words, the stat basis change amount shown in Exhibit 5A is based on the impact of the change in reserve basis on the inforce at the beginning of the year and flows through surplus. The reserves used to calculate statutory income are on the new basis as of the beginning and end of the year of change.

The tax reserve basis change is determined as of the end of the year based on the inforce at the end of the year (excluding contracts issued in the year of change) and is taken into taxable income as required by the IRC guidance issued by the Department of the Treasury and the IRS. Tax reserves for new business issued in the year of change are on the new basis, whereas the reserves for inforce business are based on the old basis for the year of change, but on the new basis in subsequent years.

The following example illustrates these calculations:

Assume there is a change in the calculation of stat reserves for a year of change X greater than 2017, for all contracts issued in X-5 and later. Assume the stat reserve is based on NAIC-prescribed CRVM. Assume the contracts are life insurance reserves and follow IRC §807(c)(1), which uses the 92.81% factor. Assume this change is considered a basis change for both statutory and tax accounting.

Assumed Data for Reserves and Cash Surrender Values

EOY X-1	Old Basis	New Basis	CSV
IssYr X-5 thru X-1	1,000	900	830
IssYr X	N/A	N/A	N/A

BOY X

IssYr X-5 thru X-1	1,000	900	830
IssYr X	N/A	N/A	N/A
EOY X			
IssYr X-5 thru X-1	1,075	950	890
IssYr X	N/A	100	60

<u>Financial Reporting for Year X</u>

Statutory Accounting:

Basis Change = 900-1,000 for a reserve decrease of 100, which is reflected as an increase in surplus at the beginning of Year X.

Change in reserves, which flows through operating income for Year X
IssYr X-5 thru X-1: 950-900=50 reserve increase, which is an expense
IssYr X: 100-0=100 reserve increase, which is an expense

Tax Accounting:

Basis Change = max (950*0.9281, 890) – max (1,075*0.9281, 890)
= 890 – 997.71
= 107.71 of income, amortized over 4 years
= 26.93 of taxable gain in years X through X+3.

Change in reserves (IssYr X-5 thru X-1):
= max (1075*0.9281, 890) – max (1000*0.9281, 830)
= 997.71 – 928.10
= 69.61 of reserve increase, a deduction

Change in reserves (IssYr X):
= max (100*0.9281, 60)
= 92.81 reserve increase, a deduction

The change in tax reserves in Year X is a deduction of 135.49, which is equal to 69.61 plus 92.81 minus 26.93.

The beginning of year X+1 tax reserves are all on the new basis.

19. How are tax reserve basis changes reflected in taxable income?

A. There are three answers depending on when the basis change occurs:

1. Treatment of Tax Reserve Basis Changes Occurring in 2018 and later (Post TCJA)

   Under TCJA, changes in the calculation of tax reserves starting with tax reserve changes reported for the change year 2018 and after are to be spread following rules similar to the automatic accounting method change rules. Under the automatic accounting method change rules, a decrease in income (due to an increase in reserve resulting from a change in basis) is recognized in taxable income in the year of change. An increase in income (due to a decrease in reserve resulting from a change in basis) is spread over four tax years (that is, the year of change and the next three tax years). These rules have been addressed in Rev. Proc. 2019-10, Rev. Proc. 2019-43, Revenue Ruling 2020-19 and Regulation 1.807-4.

   Rev. Proc. 2019-10 and Rev. Proc. 2019-43 collectively provide guidance on how to treat multiple tax reserve basis changes occurring in the same tax year. Tax reserve basis changes are to be netted by § 807(c) category. This netting will result in a single tax reserve basis change amount for each § 807(c) category.

   A taxpayer that changes its basis of computing reserves is subject to the procedures that apply to obtain the automatic consent of the commissioner to change a method of accounting. Under these procedures, the taxpayer must file Form 3115. These procedures are spelled out in Rev. Proc. 2019-10. The automatic accounting method change rules for tax are reviewed, updated, and published annually by the IRS and Treasury. Actuaries should consult tax professionals for any impact on tax reserves.

2. Treatment of pre-1/1/2018 Tax Reserve Basis Changes (Pre TCJA)

   TCJA did not address the treatment of pre-2018 basis change amounts. Rev. Proc. 2019-10 clarifies that for changes that arose under section § 807(f) in a year beginning prior to January 1, 2018, a taxpayer must continue the 10-year spread under prior law by taking such amounts into account as described in section § 807(f)(1) before its amendment by the TCJA.

3. Treatment of the Difference Between Tax Reserves as of 12/31/2017 and 1/1/2018 (TCJA Impact)

   Tax reserves as of 12/31/2017 are calculated according to rules in effect prior to TCJA, while the tax reserves as of January 1, 2018, are calculated according to TCJA.

   There is a transition rule in TCJA for how to treat certain of these changes in reserves due to TCJA. This transition rule applies to the following:

- § 807(c)(1) life insurance reserves;
- § 807(c)(2) unaccrued unpaid loss reserves; and
- § 805(a)(1) accrued unpaid losses that are subject to discounting under § 846.

Specifically, the difference between:

(1) the tax-deductible amount of these reserves as of 12/31/2017 under the prior tax act and after 2017 basis changes and

(2) the tax-deductible amount of these reserves as of 1/1/2018 calculated as required under TCJA is to be included in or deducted from taxable income in equal amounts over the next eight tax years, that is, beginning in 2018, using the tax return reference to Reserve Transition Relief.

There is not a transition rule in TCJA for how to treat the differences between IRC Section § 807(c)(3) amounts discounted at interest-only reserves as of 12/31/2017 under the prior tax act and as of 1/1/2018 under TCJA. However, Rev. Proc. 2019-34 states this difference is not subject to the transition rule but is subject to the change in basis rules under new IRC Section § 807(f) Change in Basis Accounting. That is, a decrease in income (due to an increase in reserve resulting from a change in basis) is taken in the year of change, and an increase in income (due to a decrease in reserve resulting from a change in basis) is spread over four tax years (that is, the year of change and the next three tax years).

20. What reporting is required for tax basis changes?

A. Consistent with § 481(a) adjustment, attributable to a change in method of accounting, taxpayers are required to file Form 3115 listing tax basis changes by § 807(c) category even if the tax basis change amount is zero (see Rev. Ruling 2020-19). While approval is required, in most cases it is expected to be deemed approved.

21. What are examples of reserve basis changes?

A. There are two sets of examples.

(1) Rev Ruling 2020-19 provides guidance in the following examples of potential basis changes:

Situation	Description of Reserve Basis Changes	Change in basis for tax reporting?	Change in basis for stat reporting?

1	A correction of the application of the tax reserve formula (e.g., applying the 92.81% factor to all components of the reserve) for more than one year	Yes	N/A
2	An NAIC Valuation Manual change in the methodology for computing reserves on previously issued contracts	Yes	Yes
3*	An NAIC Valuation Manual change in the methodology for computing reserves on contracts issued in the year of the change	Yes	No
4	A change in Actuarial Guideline that results in a change in the methodology for computing reserves	Yes	Yes
5	A change in the NAIC-prescribed Commissioner's Standard Ordinary mortality tables	Yes	Yes
6	A change under VM-20 from the deterministic reserve to the sum of the policy net premium reserves due solely to the fact that the sum of the policy net premium reserves is greater	No	No
7	An experience-based update in mortality rates as required by VM-20 to determine the deterministic reserve	No	No
8	A change from tax reserves based on 92.81% of the NAIC-prescribed reserve to tax reserves based on the contract NSV resulting solely from a year-over-year change in which part of the comparison is greater	No	N/A
9	An inclusion of policy cells that were previously omitted on a single return resulting from a mathematical or posting error	No	N/A
10	An increase in reserves to provide solely for new benefits on existing contracts	No	No

*Note this is different than under prior tax law

(2) Other examples:

Example	Description of Reserve Basis Changes	Change in basis for tax reporting?***	Change in basis for stat reporting?
1**	A change in stat reporting from a domiciliary state-approved method to the NAIC-prescribed method	N/A	Yes
2**	Any change in non-NAIC-prescribed method	N/A	Yes

**Tax reporting would have already been based on the NAIC-prescribed method as a starting point.
***Whether a change in tax reserves due to a change in the stat cap results in a tax basis change is unclear; however, consistent tax treatment of these changes should be applied in company filings.

22. How are tax reserves for supplemental benefits calculated?

A. The tax law defines supplemental benefits as:

(1) Guaranteed insurability
(2) Accidental death or disability benefit
(3) Convertibility
(4) Disability waiver benefit
(5) Other benefit prescribed by regulations[6]

These benefits must be supplemental to a contract for which a reserve is being held in one of the IRC § 807(c) categories.

The calculation of the tax reserve depends on whether a supplemental benefit is a qualified supplemental benefit (QSB) or a nonqualified supplemental benefit.

A qualified supplemental benefit is defined as a supplemental benefit listed above that meets the following requirements:
(1) There is a separately identified premium or charge for such benefit, and
(2) Any net surrender value under the contract attributable to any other benefit is not available to fund such benefit.

The tax reserve for any supplemental benefit must start with the statutory reserve calculated using an NAIC-prescribed method for that benefit on the valuation date.

However, qualified and nonqualified supplemental benefits are treated differently in the tax reserve calculation process.

A qualified supplemental benefit is treated as though such benefit were under a separate contract. In other words, the calculated tax reserve for a qualified supplemental benefit is subject to the cash value floor attributable to the qualified supplemental benefit (usually none) and cannot exceed the statutory reserve held (the statutory cap) for the qualified supplemental benefit on a per contract basis.

In contrast, a nonqualified supplemental benefit is treated as part of the underlying contact. In other words, the statutory reserve using an NAIC-prescribed method, the cash value and the statutory cap for a nonqualified supplemental benefit are added to the underlying contract statutory reserve using an NAIC-prescribed method, cash value and statutory cap before applying the 92.81% and before the cash value compare and before the statutory cap compare.

Example, assuming the stat reserves are calculated using an NAIC-prescribed method:

[6] As of the date of publication of this paper, there have been no other benefits prescribed by regulations.

	Stat Reserve	Cash Value	Stat Reserve after applying 92.81%
Underlying contract	100	95	92.81
Supplemental Benefit	20	0	18.57

If the supplemental benefit is qualified, the tax reserve is 95 + 18.57 = 113.57.
If the supplemental benefit is nonqualified, the tax reserve is 111.38, which is the greater of 92.81% times 120 and the cash value of the contract, which is 95.

23. How are tax reserves calculated for supplemental benefits that are not listed in the tax law?

A. Contracts can have benefits other than those listed in the tax law as supplemental benefits. For example, contracts can have the following benefits:
  (1) Long Term Care that provides benefits in excess of the underlying life insurance or annuity benefits
  (2) Other non-listed benefits such as:
     a. LTC that does not provide benefits in excess of the underlying life insurance or annuity benefits,
     b. Accelerated death benefits
     c. Disability Income benefits

The general approach of the IRC is to treat a life insurance contract as a single integrated contract. Qualified supplemental benefits (QSBs) are an exception and have been since 1984 (see question #22).

The issue is whether the tax reserve for such benefits should be treated as a separate contract or combined with the underlying contract in applying the statutory cap, the 92.81% factor and the cash value floor. In either case, under the TCJA, the starting point for all of the calculations is an NAIC-prescribed method applicable to the benefit on the valuation date.

With respect to Long Term Care benefits in excess of the underlying life insurance or annuity benefits, many tax experts agree that the tax reserve for the portion of a Long-Term Care benefit that is in excess of the underlying life insurance or annuity benefits should be treated as if the benefit were a separate contract. This opinion is based on the language in IRC Sections § 7702B and § 818(g).

The treatment of other non-listed benefits in determining tax reserves is unclear.

24. Do any of the reserve assumptions used in an NAIC-prescribed reserve method directly affect life insurance contract tax compliance and thus policyholder taxation?

A. Yes, with respect to both the mortality and interest requirements. Certain constraints must be met, and this provides compliance and assures the appropriate policyholder taxation.

Mortality

The definition of life insurance rules (IRC § 7702) and the modified endowment contract (MEC) rules (IRC § 7702A) require the computation of the guideline single premium, guideline level premium, net single premium and the 7-pay premium for a contract to be based *inter alia* on "reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables…."

"Prevailing commissioners' standard tables" are defined as "the most recent commissioners' standard tables prescribed by the NAIC that are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 States when the contract was issued."

Since at least 26 states have adopted the Valuation Manual, new commissioners' standard tables automatically become prevailing as of the first date the Valuation Manual permits them to be used.

However, the tax rules provide for a three-year transition period when there are new prevailing commissioners' standard tables. Specifically, if the prevailing commissioners' standard tables at the beginning of a calendar year are different from the prevailing commissioners' standard tables as of the beginning of the prior calendar year, a company may use the prior tables for issues during that year and for the next two years. For example, assume at the beginning of 2025, there are new prevailing commissioners' standard tables. They are not required to be used for the computations under the definition of life insurance rules (IRC § 7702) and the modified endowment contract (MEC) rules (IRC § 7702A) rules until 1/1/2028, but they may be used prior to 1/1/2028.

This quoted rule reflects the U.S. Congress's assumption that the mortality tables used for valuation purposes apply as well for purposes of state nonforfeiture laws. However, IRC § 7702(c)(3)(B)(i) authorizes the issuance of regulations permitting the use of mortality charges that are different from those specified in the prevailing commissioners' standard tables.

Interest

For policies originally issued on or after 1/1/2021, the minimum interest rate required to be used in the net single premium, guideline level premium and 7-pay premium calculations under the definition of life insurance rules (IRC §7702) and the modified endowment contract (MEC) rules (IRC §7702A) is the greater of the rate or rates guaranteed in the contract compared with the lesser of the Insurance Interest rate as defined in §7702 and 4%. The minimum interest rate required to be used in the guideline single premium calculation under the definition of life insurance rules (IRC §7702) is the greater of the rate or rates guaranteed in the contract compared with the lesser of the Insurance Interest Rate plus 2%, and 6%. Changes in the maximum valuation rate for life insurance contracts with durations of more than 20 years as defined in the SVL may trigger changes in the Insurance Interest Rate