August 23, 2016

via electronic mail to IIR@irs.gov

Internal Revenue Service
Large Business and International Division
Washington, DC 20224

Re: Submission under Rev. Proc. 2016-19, 2016-13 I.R.B. 497

Dear Sirs/Madams:

The undersigned request guidance under the Industry Issue Resolution Program (IIR) described in Rev. Proc. 2016-19 on deferred variable annuity reserves and life insurance reserves issues of importance to life insurance companies. The undersigned represent a group of 11 companies that are among the largest life insurance companies in the United States. We understand that the American Council of Life Insurers (ACLI) will submit a letter supporting this IIR request and will express its willingness to participate in the IIR process. Each of the 11 companies in the group is an active member of the ACLI and each is committed to working with the ACLI during the IIR process to ensure that any proposed resolutions have industry-wide support.

If this request is accepted by the Internal Revenue Service (Service), the group of companies is committed to devoting the resources necessary to achieve a resolution of the issues. The group seeks guidance in whatever form the Service determines to be most appropriate for each of the issues.

Background

Reserves for Deferred Variable Annuities with Guaranteed Minimum Benefits (GMxBs)

Among the types of products sold by life insurance companies are deferred variable annuities that provide benefits that vary according to the investment experience of assets that are owned by the company but held in a segregated asset account (also called a separate account). During the accumulation phase of the contract, the contract holder's premiums are allocated to one or more subaccounts of a separate account as directed by the contract holder under the terms of the deferred variable annuity. The benefits available under a variable annuity generally are based on the account value of the contract, which in turn is based on the market value of the separate account assets allocable to the contract. However, certain deferred variable annuities have guaranteed minimum benefits of various types, which are referred to collectively as GMxBs. The GMxBs subject the company to the risk that it will be required to pay amounts in excess of the account value of the contract out of its General Account. The hedging of GMxB liabilities was the subject of a prior IIR that resulted in the issuance of LB&I Directive No. 04-

0514-0050 (July 17, 2014), which provides guidance for accounting for the tax hedges that relate to GMxBs.

The first issue in this IIR request pertains to the reserves for GMxBs, which for statutory accounting purposes are determined in accordance with Actuarial Guideline XLIII (AG 43), which became a requirement for life insurance companies' reserve valuation purposes as of December 31, 2009. (AG 43 is printed in *Accounting Practices and Procedures Manual*, Volume II, at C-161 (NAIC 2015).) AG 43 is an interpretation of the National Association of Insurance Commissioners (NAIC) Life Actuarial task force of the Commissioners' Annuity Reserve Valuation Method (CAVRM) applicable to variable annuities. CARVM generally is defined in the NAIC Standard Valuation Law (SVL) as interpreted by Model Regulations and actuarial guidelines such as AG 43. In general, the SVL defines CARVM as the excess of the greatest present value of future guaranteed benefits provided for at the end of each contract year over the present value of any valuation considerations. (SVL section 5a is printed in *Model Laws, Regulations and Guidelines*, Volume VI, at 820-19 (NAIC 2015)). AG 43 effectively has been incorporated in Part 21 of the Valuation Manual that the NAIC adopted on December 2, 2012, for incorporation in the SVL. VM-21 is CARVM for deferred variable annuities effective for all contracts issued on or after January 1, 2017. For the sake of convenience, this letter refers hereinafter to AG 43, as it applies to contracts issued before January 1, 2017, and is the same as VM-21.

For deferred variable annuities with GMxBs, AG 43 interprets the CARVM greatest present value requirement using two components, known as the Standard Scenario Amount (SSA) and the Conditional Tail Expectation Amount (CTE Amount). The SSA is the sum of the Standard Scenario Reserves (SSR) calculated on a seriatim basis for each contract. The AG 43 reserve, known as the Aggregate Reserve, is defined as the SSA plus the excess, if any, of the CTE Amount over the SSA. Stated differently, in the event the CTE Amount exceeds the SSA, the insurance company is required to report additional reserves equal to the excess of the CTE Amount over the SSA in order to ensure that it has set aside an amount which satisfies CARVM's greatest present value test.

The SSR is a deterministic reserve calculated on a seriatim basis for each contract. It includes a base reserve calculation under the method set forth in Actuarial Guideline XXXIII (AG 33). It also includes a drop-and-recovery of asset value assumption as of the valuation date in order to take into account the GMxBs for each contract. This assumption is part of an Accumulated Net Revenue (ANR) calculation for each contract. The drop is an assumed reduction in account value, followed by a subsequent recovery using specified returns less contract charges and fees. Additionally, the SSR includes an allocable hedging credit and reinsurance credit if appropriate. The SSR assumptions are designed to determine the excess of the present value of future benefits over the present value of future considerations for a single defined, deterministic "Standard Scenario." The Standard Scenario captures the future claims that would occur under the deterministic assumptions taking into account reductions of those benefits for charges for the guarantee riders, maintenance and expense charges, less future considerations.

The CTE Amount is an aggregate stochastic calculation based on many projections across different economic scenarios. It is what is known as a Principle-Based Reserve, or PBR. It is tailored to satisfy CARVM's basic requirement to determine the greatest present value of future benefits over the present value of future considerations at the valuation date. It does this by employing a method referred to as the Greatest Present Value of Accumulated Deficiencies (GPVAD) for each scenario in the stochastic projection, on a block basis. In general terms, the CTE Amount is calculated as the arithmetic average of the 30% of GPVAD that are the largest among the scenarios used in the projections.

Principle-Based Reserves for Life Insurance Contracts

The second issue relates to a new minimum valuation standard for individual life insurance policy reserves that will take effect on January 1, 2017, which incorporates a PBR standard similar in concept to the AG 43 standard for variable annuities discussed above. The new standard is prescribed in the Valuation Manual that the NAIC adopted on December 2, 2012. Part 20 of the manual (VM-20) prescribes minimum reserve valuation standards for individual life insurance policies for adoption in the SVL. The new minimum valuation standard is the Commissioners' Reserve Valuation Method (CRVM) for individual life insurance policies and will apply to policies issued on or after January 1, 2017, with an optional three-year phase-in period. The ACLI has requested guidance from the Service regarding product qualification and further guidance regarding the transition to the new standard. (*See* ACLI letters to Helen Hubbard, Associate Chief Counsel (Financial Institutions & Products), dated November 4, 2015 (product qualification), and May 18, 2016 (transition).)

The new CRVM for life insurance policies will involve three components, which are a Net Premium Reserve (NPR), a Deterministic Reserve (DR), and a Stochastic Reserve (SR) for various groups of policies. The NPR is calculated on a net premium basis for a group of policies using prescribed assumptions on a contract-by-contract basis. The NPR is a floor and is compared with the cash surrender value plus any amount needed to cover the cost of insurance to the next processing date on each policy. The DR is calculated in the aggregate for each group of policies on a gross premium basis using prescribed assumptions reflecting a single economic scenario. A gross premium method projects revenues, benefits and expenses on a present value basis. The SR is calculated on an aggregate basis for each group of policies based on projections using a GPVAD approach similar to the CTE Amount approach that applies to variable annuities with GMxBs described above. The aggregate SR is based on the arithmetic average of the 30% of GPVAD that are the largest among the scenarios used in the projections.

For determining the minimum required reserves for certain groups of policies, there are exclusion tests for both the DR and the SR that a company can elect. If the exclusion for both the DR and the SR apply, the minimum required reserve for the group of policies is the aggregate NPR. If the exclusion test for the SR applies but not the exclusion for the DR, the minimum required reserve for the group of policies is equal to the aggregate NPR plus the excess, if any, of the DR with the NPR reduced by any deferred premium asset. For a group of policies to which the exclusion tests do not apply or if the group of policies fails the SR exclusion test, the minimum required reserve is equal to the aggregate NPR plus the excess, if any, of the greater of the DR or SR over the difference between the aggregate NPR for the policies and any deferred premium held on account of the policies.

Tax Reserves for Deferred Variable Annuities and Life Insurance Contracts

The methods for determining the deductible tax reserves for deferred variable annuities and life insurance contracts are linked to the statutory methods described above, with adjustments for prescribed interest rates and mortality assumptions. Specifically, Internal Revenue Code (I.R.C.) § 807(d)(2) provides that the prescribed reserve for tax purposes for a contract is calculated using the "tax reserve method" applicable to such contract on the date of issuance with adjustments for (1) the use of the greater of the applicable Federal interest rate (AFIR) or the prevailing State assumed interest rate (PSAIR) on the date the contract was issued and (2) the prevailing commissioners standard tables for mortality on the date the contract was issued adjusted as appropriate to reflect the risks under the contract that are not otherwise taken into account. This tax reserve is known as the Federally-prescribed reserve. I.R.C. § 807(d)(3) defines the "tax reserve method" as the CARVM for annuities and the CRVM for life insurance contracts prescribed by the NAIC on the date the contract was issued. I.R.C. § 807(d)(1) provides that the amount of the tax reserve is the greater of the net surrender value of the contract or the Federally-prescribed reserve, but that in no case can the tax reserve be greater than the reserves for the contract reported as statutory reserves. The statutory reserves for this purpose are defined in I.R.C. § 807(d)(6) as the aggregate amount set forth in the company's annual statement. Stated differently, the net surrender amount is the floor and the statutory reserves are the cap on the Federally-prescribed reserve for tax reserve deduction purposes.

As described above, the NAIC's CARVM and CRVM are the tax reserve methods that form the basis of the Federally-prescribed reserve calculations under I.R.C. § 807(d)(3) for deferred variable annuity and life insurance contracts, respectively. The group is requesting consideration in this IIR of how the CARVM for deferred variable annuities under AG 43 (and VM-21) and CRVM for life insurance contracts under VM-20 should be addressed under I.R.C. § 807(d) for purposes of determining the Federally-prescribed reserve. With regard to deferred variable annuities subject to AG 43, the Service determined in Notice 2010-29, 2010-15 I.R.B. 547, on an interim basis that the SSA is the tax reserve method for purposes of determining the Federally-prescribed reserve for contracts that were issued on or after December 31, 2009, which was the effective date of AG 43. The Notice further determined on an interim basis that the AG 43 CTE Amount would not be included in the Federally-prescribed reserve determination and reserved for later the question of whether the CTE Amount would be included in the statutory cap. The Notice did not provide an explanation for the exclusion of the CTE Amount from the Federally-prescribed reserve, although the Service raised several issues with respect to PBR in an earlier notice, Notice 2008-18, 2008-1 C.B. 363.

Subsequent actuarial developments and case-law may require a reconsideration of how the components of the required reserve under AG 43, including the PBR component (*i.e.*, the CTE Amount), should be considered in the determination of the Federally-prescribed reserve for variable annuities. The actuarial developments include experience demonstrating that the SSA component in many cases is an inadequate reserve that does not comply with CARVM on a stand-alone basis. Case-law developments include the decision in *American Financial Group v. United States*, 678 F.3d 422 (6th Cir. 2012), which relies on the NAIC's interpretation of CARVM in actuarial guidelines as the basis for the Federally-prescribed reserve.

Regarding the implementation of the PBR standard in VM-20 for life insurance contract reserves, there is no existing guidance on how the standard is to be considered in the determination of the Federally-prescribed reserve, although the issue of PBR for life insurance reserves purposes is on the current 2016-2017 Priority Guidance Plan. Like AG 43 for variable annuities, the method described in VM-20 for life insurance contracts is complex and involves the application of actuarial principles and assumptions to voluminous factual data. The group believes that it would be valuable to the Service to have input from the industry in an IIR process regarding how the standard is expected to work in operation and have industry views regarding how it might be considered in the determination of the Federally-prescribed reserve.

<u>*Issues for Consideration*</u>

The following issues are proposed for consideration in the requested IIR:

1. *For deferred variable annuities subject to AG 43/VM-21* – How is the CTE Amount taken into account in tax reserves for deferred variable annuities with GMxBs?

2. *For life insurance contracts subject to VM-20* – How are the three components of the reserve, the NPR, DR and SR, considered, and what adjustments are necessary, in the determination of tax reserves for life insurance contracts?

Appropriateness of the Issues for the IIR Program and the Need for Guidance

The issues on which guidance is being requested have the characteristics that are appropriate for the IIR Program, as listed in section 3.01 of Rev. Proc. 2016-19. The issues are likely to be examined by auditing agents for most life insurance companies in future years and the deferred variable annuity issue has already been addressed in examination. Rev. Proc. 2016-19 identifies six factors common to issues that are appropriate for the IIR Program and suggests that the Service will not consider an issue unless at least two of the factors are present. All six factors are present here.

The first factor is whether the proper tax treatment of a common factual situation is uncertain. In light of actuarial and case-law developments subsequent to Notice 2010-29, whether the CTE Amount is a deductible reserve for purposes of I.R.C. § 807 and the adjustments that are required for tax purposes are uncertain issues that are resulting in controversy on examination. Additionally, there is no current guidance on how the components described in VM-20 for life insurance contracts will qualify as a deductible reserve under I.R.C. § 807. This lack of specific guidance could result in substantial burden and resources being used by both the government and taxpayers and may be resolved most efficiently on a collaborative basis through an IIR process.

The second factor is whether the uncertainty results in frequent, and often repetitive, examinations of the same issue. The AG 43 issues currently are being examined and are likely to be raised by other companies and become repetitive. The VM-20 PBR issue additionally will be widespread as it comes into use and likely will result in a substantial number of examination controversies. It is possible, if not likely, that Revenue Agents will examine similar facts or Appeals Team Case Leaders will settle based on similar facts, with potentially different conclusions absent timely guidance.

The third factor is whether the uncertainty results in the use of significant resources from both the Service and taxpayers. The deferred variable annuity and life insurance reserve issues are extraordinarily complex, involving the application of actuarial principles to voluminous data. The issues cannot be handled for taxpayers without significant input and work from company actuaries and other personnel. It is the group's impression that the number of examinations that may result in the absence of guidance could place a significant burden on the Service's examination teams and particularly on its actuaries.

The fourth factor is whether the issue affects a large number of taxpayers. The issues are prevalent in the life insurance industry and could affect every company issuing deferred variable annuities with guarantees and every company that issues life insurance contracts subject to VM-20.

The fifth factor is whether the issue requires extensive factual development and whether an understanding of industry practices and views concerning the issues would assist the Service in determining proper tax treatment. Here, understanding deferred variable annuity and life insurance reserving practices is essential in determining the proper tax treatment, and understanding industry views concerning these complex issues certainly would assist the government in determining the proper tax treatment.

The sixth factor is whether collaboration would facilitate proper resolution of the tax issues by promoting an understanding of the entities' views and business practices. The group believes that this factor is particularly important in this context because of the complex actuarial nature of the determination of the CTE Amount and the three components of the VM-20 reserve that will be required for life insurance contracts.

Finally, the issues on which guidance is being requested contain none of the characteristics listed in section 3.03 of Rev. Proc. 2016-19, which make an issue not appropriate for the IIR Program.

Supplemental Submission Request

If the issues are accepted for the IIR Program, the undersigned requests to submit additional factual information and legal analysis and present the position of the companies in person. To repeat, the companies are committed to devoting the resources necessary to work with the Service to achieve appropriate guidance in a timely fashion.

Contact Information

For any additional information, please contact Kevin Brown at (202) 346-5051, Peter Winslow at (202) 434-9164 or Samuel Mitchell at (202) 434-9162.

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Sincerely yours,

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