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October 24, 2000

Internal Revenue Service
National Office Technical Advice Memorandum

District Director,

Name of Taxpayer:

Taxpayer's Address:

Taxpayer's EIN:

Year(s) Involved:

Date of Conference:

Issue

Whether Taxpayer may compute the tax reserves under § 807(d)(2) of the Internal Revenue Code for certain structured settlement annuities issued in 1983 through 1987 using graded valuation interest factors, consistent with the interest rates assumed in computing the statutory reserves for the contracts, rather than the prevailing State assumed interest rates under § 807(d)(4) for single premium immediate annuities issued in each of those years?

Conclusion

Taxpayer's use of graded valuation interest factors to compute the tax reserves under § 807(d)(2) for structured settlement annuities issued in 1983 through 1987 was appropriate.

Facts

A. General background

Taxpayer is a life insurance company within the meaning of § 816 of the Internal Revenue Code and is subject to the tax imposed by § 801. Among its various life insurance products, Taxpayer issues traditional individual single premium immediate annuity contracts, such as retirement income annuities. During the years involved, Taxpayer also issued annuities in connection with structured settlement arrangements to fund the payment of damages in connection with wrongful death or injury claims. Unlike traditional single premium immediate annuities, such as those issued as retirement annuities, the level of guaranteed benefits under a structured settlement annuity often varies substantially over the payout period based on changes in the injured party's specific situation and income needs. Moreover, the injured party and/or dependents receiving benefit payments under a structured settlement annuity are often younger than the normal retirement age, so that the payout period of a structured settlement annuity may exceed the term in which the insurer can invest the premium in fixed income investments. In light of these variations in the payment pattern and potentially long payout periods associated with its structured settlement annuities, Taxpayer developed a special method of applying valuation interest rates when computing its statutory reserves for these annuities for State insurance regulatory purposes.

B. Statutory reserves

In July 1982, Taxpayer's domiciliary state adopted the 1980 amendments to the Standard Valuation Law (SVL), which introduced a system of dynamic valuation interest rates for purposes of computing minimum statutory reserves for different types of life insurance and annuity contracts. The dynamic interest rate system was designed to allow an insurance company to use assumed interest rates in computing its reserve liabilities which roughly correspond to the insurer's anticipated investment earnings rates based on (i) the year in which the premiums were received and (ii) the contract's "guarantee duration," or period of deferral between the issue date of the contract and the date when the guaranteed contract benefits are assumed to be paid. The maximum interest rate allowed in valuing the future benefits provided by an insurance or annuity contract under the 1980 amendments generally decreases as the guarantee duration associated with that contract benefit increases. The use of lower valuation interest assumptions reflects the reinvestment risk associated with long-term guarantees. For traditional single premium immediate annuities, however, the 1980 amendments did not change the basic methodology for computing the minimum formula reserve, which was simply the present value of the future annuity payments (using a single valuation interest rate based on the issue date of the contract). Moreover, the valuation interest rate allowed under the 1980 amendments for a single premium immediate annuity, or SPIA rate, was generally higher than the interest rates allowed for other types of annuities.

Following its domiciliary state's adoption of the 1980 amendments to the SVL, Taxpayer began computing its statutory reserves for structured settlement annuities using graded valuation interest rates. Under this reserve method, Taxpayer computed the present value of the guaranteed annuity benefits using different valuation interest rates (grading from higher to lower) for different benefit durations under the same contract. For contracts issued through year-end 1982, Taxpayer computed its statutory reserves using an assumed interest rate of 12.5 percent for payments during the first 20 years, 6 percent for payments during the next 10 years, and 5 percent for payments thereafter. Because the SPIA rate for 1982 issues was 13.5 percent, Taxpayer's graded reserve method resulted in relatively high reserves compared to the reserves that would have been determined using a level interest assumption.

Beginning with structured settlement annuities issued in 1983, Taxpayer's graded interest method involved the use of a valuation interest rate for benefit payments during the first 20 years that was higher than the applicable SPIA rate, and progressively lower valuation interest rates for annuity payments during the next 20 years; and for payments after 40 years.[1] The interest rate used in determining the value of future annuity benefits during the first 20 years was computed mathematically so that, taken together with the lower assumed interest rates used in determining the value of the future annuity benefits in later durations, the initial policy reserve would be equal to the reserve that would have been determined if all guaranteed payments under the annuity had been valued using the applicable SPIA rate. Thus, Taxpayer's graded reserve method for contracts issued in 1983 through 1989 was designed to produce a pattern of reserve increases which minimized the initial surplus strain associated with the issuance of a structured settlement annuity, but which through the use of a lower discount rate for scheduled payments after 20 years also reflected the reinvestment risk inherent in funding guaranteed payments for later durations of
the contract.

In 1989, the National Association of Insurance Commissioners (NAIC) adopted Actuarial Guideline IX-B, which provided specific guidance for applying the dynamic interest rates of the SVL to structured settlement annuities. Actuarial Guideline IX-B reaffirmed the NAIC's requirements for an immediate annuity as set forth in Actuarial Guideline IX, but clarified the treatment of an annuity that failed to meet these requirements because it provided increasing payment schedules. More specifically, Actuarial Guideline IX-B allowed the insurer to "carve-out" for reserve computation purposes the portion of any scheduled payments under a structured settlement annuity that exceeded 115 percent of the prior year's payments by treating these amounts either as lump sum payments or as part of a new annuity, depending upon the circumstances. Actuarial Guideline IX-B also specified two methods for applying the dynamic interest rates to a structured settlement annuity (including a block of structured settlement annuities of the same year of issue) which did not satisfy the requirements to be treated as an immediate annuity. Under the first method (or so-called "carve-out method"), the portion of the future annuity benefits provided by the contract which would meet the immediate annuity test

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[1] Taxpayer computed its statutory reserves for structured settlement annuities issued in 1985 using the applicable SPIA rate from the dynamic interest rate table to determine the present value of all of the future annuity benefits regardless of duration. Although Taxpayer's reasons for deviating from the revised graded reserve valuation method adopted in 1983 were not documented, it appears that Taxpayer's actuaries reasoned that because the valuation interest assumptions that had been used in computing the statutory reserves for structured settlement annuity contracts issued in 1982 had resulted in a relatively high level of reserves, Taxpayer could use the SPIA rates in reserving for 1985 issues without impairing the overall adequacy of its statutory reserves.

may be valued using the applicable SPIA rate, whereas any deferred lump sum payments should be valued using an appropriate interest rate factor for deferred annuities based on the guarantee duration of the deferred benefit payment. Alternatively, Actuarial Guideline IX-B allows an insurance company to compute the minimum formula reserves for a structured settlement annuity using a graded valuation interest method. The graded interest method specified in Actuarial Guideline IX-B is similar to Taxpayer's graded interest rate method, except that Actuarial Guideline IX-B provides for the use of only two valuation interest rates (an initial rate for guaranteed durations during the first 20 years, and another rate for guaranteed durations after 20 years). In addition, the reserve produced by Actuarial Guideline IX-B's graded reserve method could not be less than a baseline "level interest rate reserve."

Actuarial Guideline IX-B contained a transition rule so that, if an insurance company had adopted in "good faith" a reserve computation method which had resulted in lower statutory reserves for structured settlement annuities than those required by the guideline, the insurance company was permitted to continue using that method for purposes of computing its statutory reserves for contracts issued in 1989 but had to comply with the guideline's requirements for 1990 and later issues. Actuarial Guideline IX-B also required the insurance company to conform the reserves for all structured settlement annuities with the guideline's minimum reserve requirements by no later than the 1993 year-end valuation.

Based on the above transition rule, Taxpayer computed its statutory reserves for structured settlement annuities issued in 1990 and later years in accordance with the graded interest valuation method specifically prescribed in Actuarial Guideline IX-B. Beginning with the 1992 annual statement, Taxpayer also recomputed the statutory reserves with respect to all structured settlement annuities issued prior to 1990 in accordance with the graded interest valuation method specifically prescribed in Actuarial Guideline IX-B.

C. <u>Tax reserves</u>

In contrast to the method used in computing its statutory reserves, Taxpayer initially computed its tax reserves under § 807(d) for structured settlement annuities issued in 1982 through 1987 using the applicable prevailing State assumed interest rates under § 807(d)(4) for single premium immediate annuities.[2]

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[2] For annuity contracts issued in 1982, the prevailing state assumed interest rate under § 807(d)(4) for individual single premium immediate annuities was based on prevailing State assumed interest rates which existed prior to the 1980 amendments to the SVL. <u>See</u> Rev. Rul. 87-26, 1987-1 C.B. 158. Under those pre-1980 valuation standards, the maximum valuation interest rate for a single premium immediate annuity was 7.5 percent, whereas the maximum valuation interest rate for other annuities was 5.5 percent. The prevailing State assumed interest rate for immediate annuities issued in 1982 was substantially lower than the graded interest rate factors used by Taxpayer in computing the statutory reserves for those contracts. Thus, the amounts taken into account by Taxpayer as the tax reserves for structured settlement annuities

For the 1989 tax year, Taxpayer changed its method of computing tax reserves under § 807(d)(2) for structured settlement annuities issued in 1983 through 1987 to adopt the same assumed interest rates as had been used in determining the statutory reserves for the related contracts. Thus, for structured settlement annuities issued in 1983 through 1987 (other than 1985 issues), Taxpayer computed the tax reserves under § 807(d)(2) using graded reserve interest factors. No change was made to the amount of Taxpayer's tax reserves with respect to structured settlement annuities issued in 1985 because the statutory reserves for those contracts had been computed using the applicable SPIA rate from the dynamic interest rate table. Pursuant to § 807(f), Taxpayer deducted the net increase in year-end 1989 tax reserves for structured settlement annuities issued in 1983 through 1987 (other than 1985) ratably over ten taxable years, beginning with the 1990 taxable year.

Beginning in the 1992 tax year, Taxpayer changed its method of computing the tax reserves under § 807(d)(2) for structured settlement annuities issued in 1982 through 1987 (including contracts issued in 1985) to parallel the change made in computing the statutory reserves for those contracts based on Actuarial Guideline IX-B. The use of the graded interest rate factors specified by Actuarial Guideline IX-B in computing the statutory reserves for structured settlement annuities issued in 1982 resulted in a net decrease in the allowable tax reserves under § 807(d)(2) (due to a reduction in the ceiling under § 807(d)(1) with respect to the amount of statutory reserves). Conversely, the use of the graded reserve factors specified by Actuarial Guideline IX-B in computing the tax reserves for structured settlement annuities issued in 1985 resulted in a significant reserve increase, since the tax reserves with respect to those contracts had previously been computed using the higher SPIA rate. Pursuant to § 807(f), Taxpayer deducted the net increase in year-end 1992 tax reserves for structured settlement annuities issued in 1982 through 1987 which resulted from the adoption of the graded reserve interest factors specified by Actuarial Guideline IX-B over 10 taxable years, beginning with the 1993 taxable year.

The District Director has questioned whether Taxpayer's use of a graded reserve method in computing its tax reserves with respect to structured settlement annuities issued in 1982 through 1987 is proper under the reserve computation rules of § 807(d)(2). The District Director contends that since § 807(d)(2) requires the reserves for a life insurance or annuity contract issued prior to 1988 to be computed using the prevailing State assumed interest rate, Taxpayer's use of multiple interest rates in computing the tax reserves for structured settlement annuities issued in 1982 through 1987 was incorrect. Taxpayer's position is that the use of graded interest rates in computing the tax reserves for structured settlement annuities issued in 1982 through 1987 was a permissible method of applying CARVM to structured settlement annuities prior to the NAIC's adoption of specific recommendations concerning these contracts in Actuarial Guideline IX-B. Taxpayer also contends that since there were no specific recommendations from the NAIC or a majority of the States regarding how to apply the prevailing State assumed interest rates to structured settlement annuities prior the adoption of Actuarial Guideline IX-B,

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issued in 1982 was limited by § 807(d)(1) to the statutory reserves for the contracts.

Taxpayer was required was the rules of § 807(d) to compute the tax reserves for those contracts consistent with the valuation interest assumptions employed in computing the statutory reserves.

Applicable law and rationale

Section 805(a)(2) authorizes a deduction with respect to the net increase in certain reserves required under § 807(b) to be taken into account. Under § 807(c)(1), the reserves to which this treatment applies include "life insurance reserves as defined in § 816(b)."

Section 807(d)(1) provides that, other than for purposes of § 816 (relating to qualification as a life insurance company), the amount of the life insurance reserve with respect to any contract is the greater of (i) the net surrender value of the contract, or (ii) the reserve determined under § 807(d)(2). In no event may the reserve for any contract exceed the amount taken into account with respect to that contract as of that time in determining the statutory reserve (reduced by any deferred and uncollected premiums taken into account in determining the statutory reserves). See § 807(d)(1) (flush language).

Section 807(d)(2) provides that the reserve for any contract must be determined using (i) the tax reserve method applicable to such contract (ii) the prevailing State assumed interest rate (or, for contracts issued in 1988 and later years, the higher of this rate or the applicable Federal interest rate), and (iii) the prevailing commissioners' standard tables for morbidity and mortality adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

Sections 807(d)(3)(A)(ii) and 807(d)(3)(B)(ii) provide in the case of an annuity contract covered by CARVM , the prescribed tax reserve method is the CARVM in effect when the contract is issued.

Section 807(d)(4)(B) defines the prevailing State assumed interest rate as the highest assumed interest rate permitted to be used in computing life insurance reserves for insurance or annuity contracts under the laws at least 26 states as of the beginning of the calendar year in which the contract was issued.

Section 807(f) provides that if the basis for determining any item referred to in § 807(c) as of the close of any taxable year differs from the basis for determining that item as of the close of the preceding taxable year, then so much of the difference between (i) the amount of the item at the close of the taxable year, computed on the new basis, and (ii) the amount of the item at the close of the taxable year, computed on the old basis, as is attributable to contracts issued before the taxable year, is taken into account ratably over 10 taxable years (either as an increase or decrease in taxable income).

Section 811(a) provides that all computations entering into the determination of life insurance company taxable income are to be made under an accrual method of accounting or, to the extent permitted by regulations, under a combination of an accrual method of accounting with any other recognized method (other than the cash receipts and disbursements method). To the extent that they are not inconsistent with Federal tax accounting rules, all such computations are made in a manner consistent with the manner required for purposes of the annual statement approved by the NAIC.

Taxpayer was required by the reserve computation rules of § 807(d)(2) to determine the tax reserves for structured settlement annuities issued in 1983 through 1987 using (i) the Federally prescribed tax reserve method applicable to those contracts, (ii) the prevailing State assumed interest rate as defined in § 807(d)(4), and (iii) and the prevailing commissioners' standard mortality table adjusted as appropriate to reflect substandard risks. Under § 807(d)(3), the Federally prescribed tax reserve method for Taxpayer's structured settlement annuities issued in 1983 through 1988 was the CARVM prescribed by the NAIC which was in effect on the issue date of those contracts.

The legislative history of § 807(d)(2) indicates that the method to be used by an insurance company in determining the amount of the tax reserves for an insurance or annuity contract is prescribed regardless of the method employed in computing the insurer's statutory reserves for the contract for State regulatory purposes. The Federally prescribed reserve methods are those recommended by the NAIC in computing the minimum required formula reserves for the particular type of contract. In applying the Federally prescribed reserve methods, an insurance company must take into account any factors specifically recommended by the NAIC. If the NAIC prescribed method is silent as to particular factors, the prevailing State interpretation of that method should be considered for purposes of determining what factors can be taken into account for tax purposes. H. Rep. No. 432, Pt. 2, 98th Cong. 2d Sess. 114 (1984); S. Prt. No. 169, Vol. 1, 98th Cong. 2d Sess. 541 (1984). The overall purpose of this calculation is to limit the amount of life insurance reserves to the "minimum reserve that most States would require," with such reserves being determined based on a computational method that minimizes "State-by-State" variations. H. Rep. No. 432, at 1414 (1984); S. Prt. No. 169, at 540 (1984).

The 1980 amendments to the SVL, which introduced the system of dynamic interest rates, were approved by 26 states in 1983. Accordingly, for annuity contracts issued in 1983 and later years, the prevailing State assumed interest rates under § 807(d)(4) are based on the system of dynamic interest rates adopted by the NAIC as part of the 1980 amendments to the SVL.
The selection of the appropriate dynamic interest rate table for a particular annuity contract is complex and depends not only on the nature or classification of the annuity, but also on various product features (such as whether the contract is valued on an issue year or change in fund basis, whether the contract provides a future interest guarantee, the nature of the policyholder's withdrawal rights, and the length of the contract's guarantee duration). Because the 1980 amendments provide a multitude of possible valuation interest rates for different categories of annuities (or combinations of product features), the classification of an annuity contract, together

with an analysis of the benefit provisions of the contract, are necessary when determining the appropriate prevailing State assumed interest rate under § 807(d)(4) to be used in applying CARVM to the contract.

In 1981, the NAIC adopted Actuarial Guideline IX for purposes of identifying those types of annuity contracts which qualified as single premium immediate annuities for purposes of the higher valuation interest rates allowed under the 1980 amendments to the SVL. Under Actuarial Guideline IX, an individual single premium annuity is treated as an immediate, as opposed to deferred, annuity for purposes of the applicable valuation and nonforfeiture requirements provided that it satisfies the following three-prong test:

> (i) The first annuity payment is due no more than 13 months after the issue date of the contract;
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> (ii) After the initial payment, succeeding payments under the annuity contract are due at regular intervals no less frequently than annually; and
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> (iii) In the case of a fixed benefit annuity, the total guaranteed payments due in any contract year do not exceed by more than 115 percent the total guaranteed payments in the immediately preceding contract year.

The explanatory material accompanying Actuarial Guideline IX notes that the higher valuation interest rates for immediate annuities in the 1980 amendments to the SVL are premised on the concept that an insurance company may lock-in higher rates of investment return in the year the premiums are received to the extent that the contract provides a regular and fixed pattern of benefit payments. Moreover, the amount of policy reserve reflecting the issuer's liability to make future payments under an immediate annuity should decrease from year to year as fewer payments remain to be made. Accordingly, Actuarial Guideline IX sought to limit the classification of immediate annuities to those contracts where there were no "gaps" between scheduled benefit payments, or where there were no substantial benefit increases that could cause the policy reserve to increase from one year to the next. See 2 Proceedings of the National Association of Insurance Commissioners, 425 (1988).

Most of Taxpayer's structured settlement annuities did not qualify as single premium immediate annuities under the requirements set forth in Actuarial Guideline IX because there were some years when the guaranteed benefits provided by the contracts exceeded 115 percent of the guaranteed payments due in the preceding year. With the adoption of the dynamic interest rate system as the prevailing State assumed interest rates under § 807(d)(4), therefore, it would have been improper for Taxpayer to compute its tax reserves for structured settlement annuities under CARVM using the higher dynamic interest rates for immediate annuities when those contracts did not qualify as immediate annuities based on the NAIC's recommendations in Actuarial Guideline IX.

Although Actuarial Guideline IX provided a three-prong test for determining whether a particular annuity contract was classified as a single premium immediate annuity for purposes of the applicable valuation requirements, the actuarial guideline did not address how to apply the dynamic interest rates to an annuity contract that failed to satisfy this test because it provided scheduled benefit increases that exceeded 115 percent of the prior year's payments. For example, it was unclear under Actuarial Guideline IX whether the portion of the payments provided by a structured settlement annuity that did not exceed the guideline's 1115 percent limitation could be valued using the SPIA rates. Actuarial Guideline IX also did not address whether a graded valuation interest rate reserve could be used in computing the minimum formula reserves for a structured settlement annuity. In 1986, the New York Insurance Department issued Regulation 126 which, among other issues, addressed the minimum reserve requirements for structured settlement annuities. Regulation 126 required the CARVM reserves for structured settlement annuities to be computed using a "carve-out procedure" similar to one of the methods eventually adopted by the NAIC in Actuarial Guideline IX-B. Unlike Actuarial Guideline IX-B, there was no provision in Regulation 126 allowing the use of graded interest rates. See "New York Regulation 126 Revisited, Record (Society of Actuaries), Vol. 14, No. 3, 1183-1228 (1988). With the exception of this New York regulation, however, it does not appear that other State insurance regulators addressed the issue of how to apply the dynamic interest rates in applying CARVM to structured settlement annuities prior to the NAIC 's 1989 adoption of specific recommendations in Actuarial Guideline IX-B.

Given these circumstances, Taxpayer's use of a graded interest rate method in computing the tax reserves with respect to structured settlement annuities issued in 1982 through 1987 (other than 1985 issues) was a permissible interpretation of CARVM prior to the adoption of Actuarial Guideline IX-B. Although Taxpayer might have applied CARVM to those contracts using a different combination of valuation interest rates, such as the "carve-out procedure" required by New York Regulation 126, Taxpayer's graded reserve method was consistent with CARVM requirements and NAIC guidelines.

Pursuant to § 6110(c), names, addresses, and taxpayer identification numbers are required to be deleted from the copy of this technical advice memorandum that will be open to public inspection. A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.