INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-108643-16

Director
Director of Field Operations, Compliance Practice Area (West)

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

State 1 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Amount A =
Amount B =
Amount C =
Amount D =

ISSUE:

Whether the federally prescribed reserves for Taxpayer's reinsured risks under long-term care insurance contracts as of the close of Year 5 and thereafter should be computed under section 807(d) of the Internal Revenue Code[1] using the morbidity assumptions Taxpayer used at the times the contracts were issued or the morbidity assumptions Taxpayer used for statutory reserves as of the close of Year 5 and thereafter.

CONCLUSION:

The federally prescribed reserves for Taxpayer's reinsured risks under long-term care insurance contracts as of the close of Year 5 and thereafter should be computed under section 807(d) using the morbidity assumptions Taxpayer used for statutory reserves as of the close of Year 5 and thereafter.

FACTS:

Taxpayer is a life insurance company under Part I of Subchapter L of the Internal Revenue Code. Taxpayer is a member of a consolidated group that files its federal income tax return based on a calendar tax year.

Taxpayer files its National Association of Insurance Commissioners' ("NAIC") annual statement with State 1's Department of Insurance ("DOI"). The NAIC annual statement is maintained on a statutory accounting basis and conforms with Statutory Accounting Principles ("SAP"). The NAIC Accounting Practice and Procedural Manual ("APPM"), which includes the SAPs, was adopted as a component of the prescribed or permitted practice of the DOI. State 1 insurers are subject to the APPM.

Taxpayer enters into reinsurance and retrocession agreements under which it assumes risks of long-term care insurance policies. Taxpayer is required to compute and report reserves for these reinsurance and retrocession agreements to comply with state regulatory requirements. Under these requirements, there are three types of reserves for long-term care insurance policies: the unearned premium reserve, the active lives reserve, and the disabled lives or claim reserve.

The issue in this case involves the computation of the active lives reserve for a block of long-term care insurance policies issued in Year 1 and subsequent years ("Block of Policies"). Taxpayer acquired the risks in the Block of Policies through multiple retrocession agreements covering policies written by several direct writers. The retrocession agreements provide for reinsurance of guaranteed renewable (non-

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as of Year 5 and Year 6.

cancellable) individual long-term care insurance policies on an indemnity coinsurance basis.[2]

The NAIC's Health Insurance Reserve Model Regulation ("Model Regulation") provides the reserve method as well as the basis (mortality, morbidity,[3] interest, and termination[4] assumptions) with which the active lives reserves for long-term care insurance must be computed.[5] Model Regulation, Section 4.B. (referring to the active lives reserves as contract reserves). Pursuant to Section 4.B.(2)(b)(ii) of the Model Regulation, the required minimum reserve for long-term care insurance policies issued after 1991 is the reserve calculated on the one-year full preliminary term method. A one-year full preliminary term method generally requires the reserve to be computed with an assumption that effectively treats the first year of coverage as term insurance with a first year terminal reserve of zero and a valuation net single premium determined as of the beginning of the second policy year.

In calculating the active lives reserves, section 4.B.(1)(a) of the Model Regulation requires the use of minimum morbidity assumptions. Appendix A of the Model Regulation provides tabular morbidity standards for some types of contracts, but not for guaranteed renewable (non-cancellable) individual long-term care insurance policies, such as the Block of Policies.

Section 4.B.(1)(a) of the Model Regulation provides that for policies for which there are no standard morbidity tables a reserve shall be computed based on tables established for reserve purposes by a qualified actuary. Section 4.B.(1)(a) of the Model Regulation requires that the morbidity tables contain a pattern of incurred claims cost that reflects the underlying morbidity and not be constructed for the primary purpose of minimizing reserves. In determining the morbidity tables, section 4.B.(1)(a)(i) of the Model Regulation requires the actuary to use assumptions that represent the best estimate of anticipated future experience but not to incorporate any expectation of future morbidity improvement. Section 4.C. of the Model Regulation provides that a reserve may be computed using alternative assumptions if such alternative assumptions produce a result at least as high as that required under minimum standards.

[2] Long-term care policies are generally written on a guaranteed renewable basis. Section 816(e) provides that guaranteed renewable health insurance contracts are treated in the same manner as non-cancellable life and health insurance contracts.
[3] Morbidity is the probability and expected cost of claims that may be filed for care under the contract and that are used to determine the amount of the reserve.
[4] Termination or lapse rate is the rate that contracts are voluntarily terminated.
[5] While State 1 has not directly adopted the Model Regulation, the provisions of the Model Regulation are incorporated in the Appendix of the APPM. State 1 insurers are subject to the APPM.

Section 4.D. of the Model Regulation provides that insurers must annually review the prospective contract liabilities to determine the continuing adequacy and reasonableness of the tabular reserve while giving consideration to future gross premiums. Thus, to comply with the Model Regulation, Taxpayer must annually review the liabilities for the Block of Policies.

Taxpayer provides long-term care policy administration to all of the companies it reinsures under an administrative agreement that runs for the life of the last policyholder. Administrative duties include policy design, pricing, and the filing of both the policy forms and actuarial memorandum with the state regulator under a letter of authorization from the direct writer allowing Taxpayer to file on its behalf. The pricing is done using Taxpayer's best estimate of assumptions, including the mortality rate, the morbidity rate, and the lapse rate. Taxpayer also utilizes the the mortality rate, the morbidity rate, and the lapse rate to calculate the direct writing company's statutory reserves and reports such reserves to the company.

There have never been commissioners' standard morbidity tables prescribed by the NAIC that were permitted to be used in computing reserves for the Block of Policies under the insurance laws of 26 states. For both pricing and statutory reserve purposes for the Block of Policies, Taxpayer initially used morbidity tables ("Original Morbidity Tables") that reflected assumptions based on government nursing home tables and made adjustments using the experience data of its cedants (direct writers and antecedent reinsurers) because Taxpayer did not have its own credible experience data. Pursuant to a regulatory audit by the DOI for Year 2 through Year 3, the DOI determined that Taxpayer used the incorrect mortality table for its statutory reserve methodology. Taxpayer incorrectly used "joint life mortality tables" instead of "second to die mortality tables" for the Block of Policies containing joint life second to die policies in determining statutory reserves. The lifespans under the "joint life mortality tables" were shorter than the "second to die joint mortality tables." As a result, using the incorrect shorter lifespans produced a lower reserve than would have been calculated had the longer life span from the second to die mortality tables been used. Consequently, the DOI determined that Taxpayer's statutory reserve was too low.

Effective for Year 5, the DOI required Taxpayer to change its joint life mortality assumptions, thereby causing the amount of the statutory reserve to be significantly increased. In order to minimize the amount of the required statutory reserve increase, Taxpayer requested a special accommodation from the DOI to modify other reserve assumptions as well. Specifically, Taxpayer requested that the DOI permit it to use current assumptions (as of Year 5) based on its experience for morbidity and lapse rate in computing its reserves for the Block of Policies. Although the lapse rate had been less favorable than originally anticipated (causing the total reserve to increase a bit more), Taxpayer's morbidity experience had been more favorable than originally anticipated (causing the total reserve to decrease significantly), which served to reduce the amount of the overall statutory reserve increase following the correction of the mortality assumptions. The DOI accommodated Taxpayer's request and allowed

Taxpayer to use the updated assumptions for both its lapse and morbidity assumptions. In addition, the DOI did not consider the change in the morbidity assumption to be a permitted practice that departs from the Model Regulation.[6]

When updating the morbidity assumptions, Taxpayer continued to use the morbidity assumptions based on government nursing home tables but adjusted those tables using its own experience instead of the experience of its cedants. With these updated assumptions, Taxpayer established revised morbidity tables that it used to compute statutory reserves for Year 5 ("Year 5 Morbidity Tables"). For statutory purposes, Taxpayer also changed its mortality assumptions for Year 5 and revised the lapse rate assumptions.

For federal tax purposes, Taxpayer incorporated the changes to the mortality, lapse, and morbidity assumptions in the computation of the tax reserve for the Year 6 federal income tax return. The amount of the adjustment (the difference in the amount of the reserve attributable to the revised assumptions) would have been taken into account ratably over 10 taxable years pursuant to section 807(f). Accordingly, the amount of the proposed adjustment, Amount A, would be spread out over 10 years, thereby decreasing taxable income for Year 6 through Year 7.

Subsequently, Taxpayer asserted that although it was proper to change the mortality, lapse rate, and morbidity assumptions in the computation of the reserves for statutory purposes, it was only proper to change the mortality and lapse rate assumptions (and not the morbidity assumptions) in the computation of the reserves for federal tax purposes. In other words, Taxpayer wanted to continue to use the Original Morbidity Tables for purposes of computing the reserve for tax purposes despite the fact that it used Year 5 Morbidity Tables for statutory reserve purposes.

If Taxpayer were to use the Year 5 Morbidity Tables for statutory purposes and the Original Morbidity Tables for tax purposes, the Year 5 reserves for each policy in the Block of Policies would be larger for tax purposes than for statutory purposes. In addition, the amount of the tax reserve for some of the Block of Policies would have been capped by the statutory reserve for those polices, as provided by section 807(d)(1). If the Taxpayer were to use the Year 5 Morbidity Tables for tax purposes for Year 5, the amount of the section 807(f) adjustment would be Amount B (an additional Amount C in excess of the Amount A). Amount B represents the increase resulting from the tax reserve being subject to a statutory cap limit of Amount D.

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[6] The DOI notes that the change in the morbidity assumption is not a permitted practice provided the tables and calculations still satisfy the general requirements of the prescribed accounting practice. In addition, the DOI notes that it is "generally true that an insurer would be expected to notify the [DOI] of a significant change in claim assumptions and, if such change reduces calculated reserves, would seek prior approval from the [DOI]."

In determining the amount of the reserves for the Block of Policies for tax purposes, Taxpayer used the appropriate interest rate based on the year the Block of Policies were issued. The reserve method prescribed by the NAIC for each of the Block of Policies when it was issued was the one-year preliminary term method, as required by section 807(d)(3)(A)(iv)(I). Taxpayer correctly used the one-year preliminary term method in the calculation of the active lives reserves for both statutory and tax purposes. In addition, Taxpayer computed the amount of the reserves for each policy in accordance with the statutory cap limitations in section 807(d)(1).

LAW:

Section 805(a)(2) allows an insurance company to take a deduction for increases in certain life insurance reserves. More specifically, section 807(b) provides that if, for any taxable year, the closing balance of “the items described in subsection (c)” (which includes life insurance reserves) exceeds the opening balance, the excess is taken into account as a deduction under section 805(a)(2). By contrast, if the opening balance exceeds the closing balance, the excess is included in gross income under section 803(a)(2).

The method of determining life insurance reserves for use in computing an insurance company’s taxable income is prescribed in section 807(d). For this purpose, the reserve for a contract is generally equal to the greater of (a) the net surrender value of such contract or (b) the amount of the reserve determined under section 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 reserves (reduced by any deferred and uncollected premiums taken into account in determining the statutory reserves). Section 807(d)(1)(flush language); <u>see</u> <u>also</u> section 811(c).

Section 807(d)(2) provides that the reserve for any contract must be determined using (i) the tax reserve method applicable to that type of contract, (ii) the greater of the applicable federal interest rate or the prevailing state assumed interest rate, and (iii) the prevailing commissioner’s standard tables for morbidity or mortality adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract which are not otherwise taken into account.

Section 807(d)(3)(A)(iv)(I) provides that the tax reserve method for purposes of section 807(d) for other contracts that are not life insurance contracts, annuity contracts, and noncancellable accident and health contracts (other than a qualified long-term care insurance contract, as defined in section 7702B(b)) is the reserve method prescribed by the NAIC which covers such contract (as of date of issuance).

Section 807(d)(5)(A) provides that the term “prevailing commissioners’ standard tables” means, with respect to any contract, the most recent commissioners’ standard tables prescribed by the NAIC which were 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. Section 807(d)(5)(B) provides that if the prevailing commissioners' standard tables are changed, the issuer may use the prior prevailing commissioners' standard tables for the next three years. If there are no commissioners' standard tables applicable to a contract when the contract is issued, section 807(d)(5)(C) provides that the mortality and morbidity tables used for purposes of section 807(d)(2)(C) shall be determined under the regulations prescribed by the Secretary. When the Secretary by regulation changes the table applicable to a type of contract, the new table shall be treated (for purposes of section 807(d)(5)(B) and for purposes of determining the issue dates of the contracts for which it shall be used) as if it were a new prevailing commissioner's standard table adopted by the 26th state as of a date specified by the Secretary, but no earlier than the date the regulation is issued.

Section 1.807-1(a) of the Income Tax Regulations provides that if there are no prevailing commissioners' standard tables applicable to an insurance contract when the contract is issued, then the mortality and morbidity tables set forth under the regulation are used to compute the reserves under section 807(d)(2). Section 1.807-1(a), row 12, specifies that for noncancellable accident and health insurance (active lives reserves) issued after 1983, the insurer must use the tables used for NAIC annual statement reserves.

Section 807(f) provides that if the basis for determining any item referred to in section 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 the contracts issued before the taxable year, is taken into account ratably over 10 taxable years (either as an increase or decrease in taxable income), beginning with the year following the year of change.

ANALYSIS:

I. The Tax Reserves for the Block of Policies Must Be Computed using the Year 5 Morbidity Tables that Were Used on the NAIC Annual Statement.

Section 807 provides specific rules for computing life insurance reserves, including the use of the prevailing commissioners' standard tables for morbidity or mortality adjusted as appropriate to reflect the risks (such as substandard risks) incurred under each contract that are not otherwise taken into account. Section 807(d)(2)(C). The term "prevailing commissioners' standard tables" means, with respect to any contract, the most recent commissioners' standard tables prescribed by the NAIC that were 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. Section 807(d)(5)(A).

If there are no commissioners' standard tables applicable to a contract when it is issued, the mortality and morbidity tables to be used for purposes of calculating the life

insurance reserves must be determined under regulations prescribed by the Secretary. Section 807(d)(5)(C). Section 1.807-1(a) sets forth the mortality and morbidity tables to be used to compute reserves if there are no commissioners' standard tables applicable to an insurance contract when the contract is issued.

For long-term care insurance products, there has never been a prevailing commissioners' standard table for morbidity, so no such table existed when the Block of Policies were issued. Accordingly, section 807(d)(5)(A), requiring the use the prevailing commissioner's standard table when the contract was issued, does not apply. Instead, section 807(d)(5)(C) applies. Section 807(d)(5)(C) provides that if there are no commissioners' standard table applicable when a contract is issued, the morbidity table is determined under regulations prescribed by the Secretary. Section 1.807-1(a) specifies the tables that taxpayer must use to compute reserves for different types of contracts. The Block of Policies are "noncancellable accident and health insurance (active lives reserves)," as described in section 1.807-1(a), row 12; and therefore, Taxpayer must use the "[t]ables used for NAIC annual statement reserves."

The tables that are to be used for the NAIC annual statement reserves are prescribed by the Model Regulation. The Model Regulation specifies morbidity standards in its Appendix A for some types of contracts but does not specify a particular morbidity table for the Block of Policies. The Model Regulations state that if no morbidity standards are specified in its Appendix A (as is the case here), then the morbidity tables used must be established by a qualified actuary based on assumptions that represent the best estimate of anticipated future experience. Model Regulation, section 4.B(1)(a). Neither the Service nor the Taxpayer argues that the Year 5 Morbidity Tables were not established by a qualified actuary. Thus, we assume the morbidity tables were established by a qualified actuary. In addition, the Year 5 Morbidity Tables were acceptable to the DOI and otherwise met the requirements of Section 4.B(1) of the Model Regulation. Accordingly, the Year 5 Morbidity Tables must be used to compute the reserve for tax purposes.

II. Taxpayer's Position

Taxpayer makes several arguments that we have determined are not persuasive. These arguments are discussed below.

A. Taxpayer Argues that Section 807(d)(5)(C) and Section 1.807-1(a) Require Continued Use of the Tables Used when the Polices Were Issued.

Taxpayer's position is that the "prevailing commissioners' standard tables" are defined in section 807(d)(5) exclusively by reference to tables that existed "when the contract was issued." Taxpayer contends that although section 1.807-1(a) by its terms is not limited to tables used for annual statement reserves in the year of contract issuance, when read in conjunction with the statute, the regulation is limited by a temporal

requirement that the specified table can only refer to tables used for annual statement reserves in the year the contract is issued. Taxpayer argues that because section 807(d)(5)(A) defines the term "prevailing commissioners' standard tables," and that definition is determined as of the time the contract was issued, the tables used pursuant to section 807(d)(5)(C) cannot change after the contract is issued.

Taxpayer misreads the statute. The requirement to use "prevailing commissioners' standard tables" to determine the tax reserve for a contract only applies when there is a prevailing commissioners' standard table for that contract. "Prevailing commissioners' standard tables" are the most recent commissioners' standard tables prescribed by the NAIC and permitted to be used under the insurance laws of 26 states when the contract was issued. Section 807(d)(5)(A). There were no standard tables for the Block of Policies when they were issued (let alone a standard table that was permitted to be used by 26 states). Accordingly, section 807(d)(5)(C) is applicable because "there [were] no commissioners' standard tables applicable to any contract when it [was] issued." As discussed above, section 807(d)(5)(C) refers to the Treasury regulation, which requires the use of the morbidity tables used for the NAIC annual statement reserves. The Year 5 Morbidity Table is that table. Accordingly, Taxpayer is required to use the Year 5 Morbidity Tables when computing its tax reserves for Year 5 and Year 6.[7]

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[7] A treatise on life insurance reserves for tax purposes agrees that in situations like the one at issue, the updated tables used for statutory purposes should be used to compute reserves for tax purposes instead of the tables that were used when the contracts were issued. (The below quotation references mortality tables instead of morbidity tables, but the analysis is the same.)

> The regulation [1.807-1] does not have the limiting language that says the reserve is the annual statement reserve in effect at the time the contact was issued. Moreover, the Code requirement to use the mortality table in effect when the contract was issued is limited to the prevailing table. The language in the Code does not restrict the use of a different table when there is no prevailing table. Permitting the use of a new table when the statutory annual statement table is the table used to compute tax reserves is consistent with the result reached in American Financial Group v. United States, [678 F.3d 422 (6th Cir. 2012)] in which the court held that when a statutory interest rate and statutory reserve method are used in computing tax reserves (where the NAIC has issued no guidance or there is no prevailing view of the states), if a company changes its annual statement reserve method or interest rate, then tax reserves must be computed using the new statutory method or interest rate.

Edward L. Robbins & Richard N. Bush, Tax Basis Assets and Liabilities of U.S. Life

B. Taxpayer Argues that the Original Morbidity Tables are Prevailing Tables.

Taxpayer argues that the NAIC has prescribed tables for long-term care insurance reserves in the Model Regulation, that these tables are "prevailing tables" for purposes of section 807(d)(5)(A), and that therefore, such tables that existed when the contracts were issued must be used to compute reserves for tax purposes.

Taxpayer misinterprets the definition of "prevailing commissioners' standard tables" in section 807(d)(5)(A). For there to be a "prevailing commissioners' standard table" with respect to a contract, there must have been a commissioners' standard table prescribed by the NAIC and permitted to be used by at least 26 states with respect to that contract. There were no standard tables when the Block of Policies were issued.

Instead of prescribing standard tables for long-term care contracts, the Model Regulation requires the actuary to establish his own table (within certain parameters). Model Regulation, 4.B.(1)(a) ("Contracts for which tabular standards are not specified in Appendix A shall be valued using tables established for reserve purposes by a qualified actuary."). These are not "commissioners' standard tables," the existence of which is a prerequisite for section 807(d)(5)(A)'s required use of commissioners' standard tables that existed when a contract was issued.[8] Because there were no commissioners' standard tables when the Block of Policies were issued, there can be no "prevailing commissioners' standard tables" for the Block of Policies.

C. Taxpayer Argues that Requiring the Use of Year 5 Morbidity Tables is Inconsistent with Notice 2010-29.

Taxpayer argues that the Service's position in this case is inconsistent with previously published guidance, such as Notice 2010-29, 2010-1 C.B. 547. Notice 2010-29 provides interim guidance on issues that arise under sections 807 and 816 as a result of the adoption of Actuarial Guideline 43, (a new Commissioner's Annuity Reserve Valuation Method ("CARVM") effective December 31, 2009). As relevant to Taxpayer's argument, Notice 2010-29 provides that Actuarial Guideline 43 cannot be applied to determine the tax reserve for contracts issued prior to its effective date. This is consistent with section 807(d)(3) which specifically requires that the tax reserve method to be used is CARVM "which is in effect on the date of the issuance of the contract." See 807(d)(3)(B)(ii). Thus, Notice 2010-29 merely reiterates section 807(d)(3)(B)(ii)'s requirement that the method used to compute the reserve must be that which was in effect when the contract was issued.

Insurers (2014) at 137.

[8] For sake of comparison, a standard table that is prescribed by the NAIC would be "The 1964 Commissioners Disability Table" that must be used for disability income benefits due to accident or sickness for contracts issued after January 1, 1965.

In contrast, there is no requirement that the morbidity tables used to compute the tax reserves for the Block of Policies for a given year be the same morbidity tables that were used when the Block of Policies were issued. Section 807(d)(5)(A) imposes such a requirement if there was a prevailing commissioners' standard table in existence when the contract was issued, but there was no prevailing commissioners' standard table when the Block of Policies were issued. Because there were no prevailing commissioners' standard tables for the relevant contracts, section 807(d)(5)(C) applies.

As stated above, section 807(d)(5)(C) defers to regulations, and these regulations require that the morbidity tables used for purposes of determining the tax reserve are those tables used for the NAIC annual statement. The Year 5 Morbidity Tables were used for the annual statement, so they must also be used to compute the tax reserves.

E. Taxpayer Argues that the One-Year Full Preliminary Term Method Requires the Use of Original Morbidity Tables.

Taxpayer agrees that the reserve method to be used in this case is the one-year full preliminary term method.[9] Taxpayer argues, however, that the one-year full preliminary term method requires the use of the NAIC's morbidity assumptions [that existed when the Block of Policies were issued] and that the Year 5 Morbidity Tables do not include the required morbidity assumptions. As a consequence, Taxpayer believes that use of the Year 5 Morbidity Tables is inconsistent with the one-year full term preliminary method and cannot be used to determine the reserves for tax purposes.

Taxpayer's argument ignores the fact that section 807(d) dictates what morbidity tables must be used to compute tax reserves, regardless of what morbidity tables would otherwise be used under the NAIC prescribed method. Specifically, section 807(d)(2) provides, as relevant here, that the tax reserve for a contract must be determined using (A) the tax reserve method applicable to such contract, (B) a certain interest rate, and (C) the prevailing commissioners' standard tables for mortality and morbidity. Where there are no commissioner's standard tables applicable to the contract, as is the case with the Block of Policies, then section 807(d)(5)(C) requires that the mortality and morbidity tables to be used are those prescribed in the regulations.

As discussed above, the Treasury regulations state that the morbidity tables to be used for the Block of Policies are those used for the NAIC annual statement. The morbidity tables used on the NAIC annual statement for Year 5 and Year 6 are the Year 5

[9] Section 807(d)(3)(A)(iv) provides that for a contract not described in section 807(d)(3)(A)(i), (ii), or (iii), which the policies are not, the tax reserve method applicable to the contract is the reserve method prescribed by the NAIC that covered the contract on the date of issuance. The one-year full preliminary term method was the prescribed method when the policies were issued; this is consistent with the Model Regulation. Model Regulation, section 4.B.(2)(b)(ii).

Morbidity Tables. Accordingly, the Year 5 Morbidity Tables must be used to compute the tax reserves.

F. Taxpayer Argues that the Year 5 Morbidity Tables Are Not Permitted by the NAIC Model Regulation.

Taxpayer argues that the Year 5 Morbidity Tables are not authorized by the NAIC Model Regulation. Taxpayer claims that under the Model Regulation, morbidity assumptions can never change from those established at contract issuance, in part because “best estimate” assumptions are generally understood to be no better than those submitted for original pricing.

Even if it is general practice to not update the assumptions, we do not need to address general practice, only the specific facts of this situation. These facts are unique in that Taxpayer used incorrect mortality tables for its original pricing, which must have been significantly different than the pricing that would have been if Taxpayer had used the correct mortality tables. It has not been made clear to us why in this situation Taxpayer is bound to its original pricing assumptions or the authority under which Taxpayer is prevented from updating its original pricing assumptions. Taxpayer clearly updated its assumptions for statutory purposes, and the DOI agreed to this update. Moreover, the DOI did not consider the change in the morbidity assumptions to be a permitted practice that departs from the Model Regulation. Because the Model Regulation does not preclude changes to morbidity tables to reflect current experience, Taxpayer’s revised morbidity tables are not prohibited by section 1.807-1(a).

As a variation of this argument, Taxpayer attempts to argue that Taxpayer’s Year 5 Morbidity Tables are a state variation. That is, whenever the Taxpayer must obtain DOI approval to adopt more favorable reserve assumptions (resulting in reserve weakening), such approval is a state variation that is prohibited for tax purposes. That is, the approval is a state variation from the Model Regulation.

Here, the Model Regulation and the state rule are identical and both permit such a change. There is no state variation. The obligation to seek approval from the DOI to change reserve assumptions does not make this a state variation from the Model Regulation.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.