



Annuity and Life Insurance Taxation – How Did We Get Here, and Where Are We Going?

Tim Branch, FSA, MAAA
Dave Carlson
May 21, 2013

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



The Past...

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

History of Life & Annuity Taxation



- 1909-1921: Net Income Base
- 1921-1958: "Free" Investment Income
- 1959-1981: Three-Phase System
- 1982-1984: Stopgap
- 1984 - ? : Net Income Base

3

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

History of Life & Annuity Taxation



- The Hartford's 1913 Tax Return
 - Form 1030
 - One page
 - Gross income of \$59k, gross deductions of \$88k, includes a deduction for the "increase to reserve fund" of \$62k
 - One page of instructions
- Current Form 1120L
 - 8 pages (not including supplemental schedules)
 - 26 pages of instructions

4

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



The Present...

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



Annuity & Life Insurance Company Taxation – In General

- United States Code (USC) Title 26: Internal Revenue Code, Subtitle A: Income Taxes, Chapter 1: Normal Taxes and Surtaxes, Subchapter L: Insurance Companies
 - **Part I: Life Insurance Companies (§ 801 - § 818)**
 - Part II: Other Insurance Companies (§ 831 - § 835)
 - Part III: Provisions of General Applications (§ 841 - § 848)

6

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



Annuity & Life Insurance Company Taxation – In General

- § 801 – Tax imposed on life insurance company taxable income (LICTI)
 - LICTI = life insurance gross income reduced by life insurance deductions
- § 803 – Life insurance gross income
 - In general, premiums and reserve decreases
- § 804 – Life insurance deductions
 - General deductions in § 805 and small company deductions in § 806
- § 805 – General deductions
 - Death benefits, etc.
 - Increases in reserves
 - Policyholder dividends
 - Dividends received by company
 - Operations loss deduction (§ 810)
 - Reimbursable dividends
 - Other deductions
- § 806 – Small company deductions (LICTI < \$15mm, Assets < \$500mm)

7

Copyright ©2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



Annuity & Life Insurance Company Taxation – Reserves

- § 807 – Rules for Certain Reserves
 - Reserve deduction is unique to insurance companies; life insurance reserves do not have to satisfy the “all events test”
 - Reserves taken into account
 1. Life insurance reserves (§ 816 definition)
 2. Unearned premiums/unearned losses
 3. Obligations under insurance/annuity contracts that do not involve life, accident or health contingencies
 4. Dividend accumulations
 5. Advance premiums and premium deposit funds
 6. Special contingency reserves under group insurance established for retired lives or premium stabilization
- Reserves NOT taken into account
 - Deficiency reserves
 - CTE excess under VACARVM
 - Any reserves not required by law

8

Copyright ©2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

Annuity & Life Insurance Company Taxation – Reserves



- § 807(d) – Methods for computing tax reserves
 - Three pronged approach:
 - Greater of (1) net surrender value and (2) Federally Prescribed Reserve (FPR), but not greater than (3) statutory reserves
 - Tax reserves are seriatim (contract level)
 - Tax reserve method (FPR) means:
 - CRVM for Life Insurance contracts
 - CARVM for Annuity contracts
 - Reserve method prescribed by NAIC
- IN EFFECT ON DATE OF CONTRACT ISSUANCE**
- Use greater of Applicable Federal interest rate and prevailing State assumed interest rate
 - Use prevailing commissioners' standard tables

9

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

Tax Reserves – Change in Basis



- § 807(f) – Adjustments for Changes in Reserve Basis
 - Changes in § 807(c) reserves are either “changes in basis” or “corrections of errors”
 - Changes in basis require a 10-year spread of the change based on the difference between old and new method into taxable income
 - Rev. Rul. 94-74 gives guidance between what is a “change in basis” vs. “correction of error”
 - Example 1: use of wrong mortality table in prior years
 - Example 2: use of wrong interest rates
 - Example 3: change from curtate to continuous reserves
 - Example 4: missed range of contract cells in inforce file

10

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

Separate Account Dividends Received Deduction



- “DRD” is available to all corporations and is intended to reduce the incidence of multiple layers of corporate taxation.
- Life insurance companies must “prorate” DRD between company share and policyholder share.
 - Intent is to only allow deduction to the extent of the company’s share of income.
 - Most focus is on separate accounts, as small % of equities in G/A.
- Long-running disagreement between companies and IRS about computation of company share.
 - Companies generally follow letter rulings issued by IRS between 2000-2003, which are favorable to the industry.
 - Formula can be approximated by (fees earned/net investment income)
 - Many in government would argue for a “balance sheet”-type formula (reserves/total assets), which would result in ~1%-2% company share.
 - This issue could be a significant part of any tax reform.

11

Copyright ©2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

Deferred Acquisition Costs - Tax



- IRC Sec. 848
 - Intent is to capitalize a proxy portion of acquisition costs over 10 years. Different rates for life (7.7%), annuity (1.75%) and group contracts (2.05%)
- Legislation enacted as part of 1990 Tax Act
 - Provision arose primarily due to lobbying battles between stock and mutual companies.

12

Copyright ©2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

Tax Reserves and Principles Based Reserving



- Current tax law was written in 1982-1983
 - Different products back then
 - Traditional life and health products
 - Variable business was non-existent, no ULSG, no principal guarantees
 - Computers (or “what computers?”)
 - Stochastic reserving methods not commonly used or understood
 - Formulaic reserves
- Principles Based Reserving (PBR) addresses new product designs and risks
- PBR not always “tax reserve friendly”
 - Aggregate reserves vs. seriatim tax reserves
 - How are policy-level tax reserves compared to aggregate statutory reserve?
 - Company specific assumptions

13

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.

Tax Reserves and Principles Based Reserving



- The IRS acknowledges tax issues that may arise from implementation of VACARVM with IRS Notice 2008-18
- IRS provides interim guidance for implementation of VACARVM with Notice 2010-29
 - Use of Standard Scenario for tax reserves for post-2009 issues
 - Impact of VACARVM spread over 10 years for tax, “using the method prescribed by § 807(f)(1)(B)”
 - Silent on use of CTE excess in statutory cap
- What about Life PBR (VM-20)?
 - IRS has not addressed what are tax reserves under VM-20
 - Notice 2010-29 specifically states that “No inference should be drawn from this notice regarding any federal tax issues that arise under any actuarial guideline other than AG 43 or that could arise under Life PBR.”

14

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



The Future...

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



Industry Issue Resolution Program

- Purpose of the program: IRS and industries working together to achieve a common goal on complex tax issues
 - Insurance industry requested two rulings
- Bad debt IIR
 - Issue is basically how statutory asset write-downs will be treated for tax (conformity)
 - Issued in 2012, with outcome approximating the industry position.
- Hedging IIR
 - Issue is very complex, and involves interplay between hedging gain/loss and reserve deductions.
 - Not yet issued

16

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



Tax Reform and Life Insurance

- Current budget discussions. Background of significant deficits for past four years and foreseeable future.
- The past four years of the President's Budget document have included several changes to life company taxation, including DRD, COLI and private separate account reporting.
 - Significant revenue would be raised from the life industry.
- Changes in industry
- Ways and Means v. Senate Finance Committee proposals/current actions
 - Work that industry is doing through ACLI
 - Possible outcome/timing is uncertain
 - Need for all segments of industry to work together
 - Recall lessons of DAC Tax

17

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.



Q&A

Copyright © 2013 by The Hartford. Confidential.
All rights reserved. No part of this document may be reproduced, published or posted without the permission of The Hartford.