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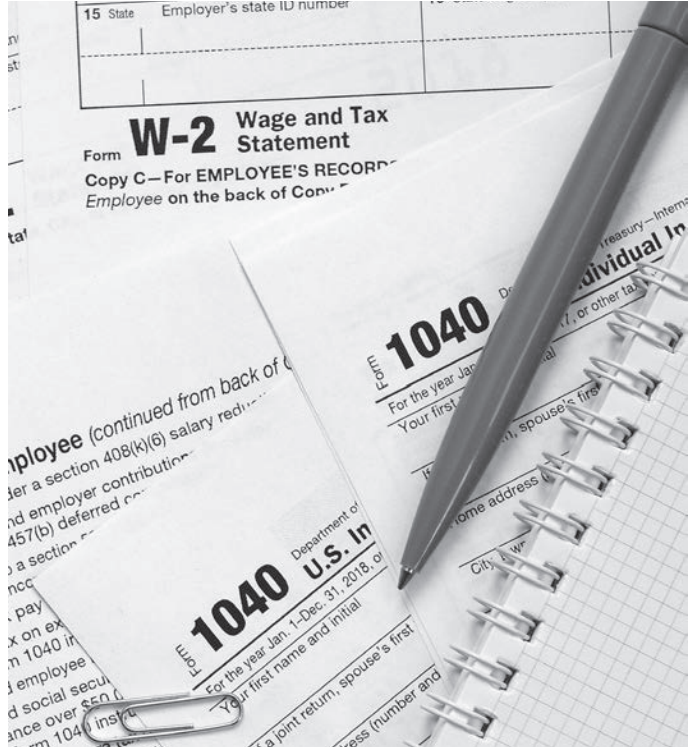
Chairperson's Corner TAX REFORM!

By Housseine Essaheb

Tax reform, or no tax reform? That has been the question raised by tax professionals over the past couple of years. On Dec. 22, 2017, President Trump signed the Tax Cuts and Jobs Act into law, unleashing a new era of tax changes that have significant implications for corporations as well as individuals. Besides having a personal and professional impact, the tax changes also affect the insurance industry.

In response, the Taxation Section set out to educate the Society of Actuaries (SOA) membership on the changes brought on by the tax reform. By the time this newsletter is published, we will have sponsored (or co-sponsored) three webinars on the topic. We are also dedicating this issue of *TAXING TIMES* to focus on several changes from the tax reform.

To foster better collaboration and ensure consistent messaging, we've reached out to other sections to see what items relating to tax reform they would like to hear more about and their plans for covering changes brought out by tax reform. Working with our colleagues from the Smaller Insurance Company Section, we are co-sponsoring a tax webinar on the impact of tax reform to small companies. Additionally, we are continuing to look for opportunities to partner with other sections.



All of this would not have been possible without the volunteers in our section and the SOA staff. Their valuable contributions helped our Tax Reform Webcast on March 9 set a record for the highest attendance—more than 5,000 participants. Bravo! ■

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Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers

By James W. Kress, Surjya Mitra and Mark S. Smith

On Dec. 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (P.L. 115-97) (“TCJA,” or “Act”),¹ following a flurry of legislative activity at a pace seldom seen on Capitol Hill. Ways and Means Committee Chairman Kevin Brady (R-Texas) released his original Mark of the TCJA on Nov. 3, launching a high stakes, seven-week scramble with significant financial and business consequences to life insurance companies. This issue of *TAXING TIMES* is devoted to a discussion of several of the major provisions that are particularly important to life insurers, with an emphasis on domestic provisions. Later issues will address international provisions, reinsurance and other matters. This article sets the stage for that discussion by providing historical context and an overview of major themes of the Act.

“TAX REFORM”: IT HAPPENS

Like death and taxes, “reform” of the Internal Revenue Code every few decades is a certainty.

1959 Act

Before the Life Insurance Company Tax Act of 1959, P.L. 86-69 (“the 1959 Act”), life insurance companies were taxed at the same rates as other corporations, but only on their net investment income.² After this legislation, life insurers instead were taxed on all their income, but under a complicated three-phase system, remnants of which still may be seen in the Internal Revenue Code and regulations. Specifically, Phase I generally taxed a profitable life insurer’s net investment income. Phase II generally taxed half of a company’s underwriting income minus certain special deductions on a current basis; and Phase III taxed the special deductions and the deferred portion of a company’s underwriting income when the company made future distributions from what was known as a policyholders’ surplus account.³ For purposes of computing gain from operations, tax-deductible life insurance reserves generally were equal to statutory reserves,

but could actually be increased above statutory reserves if a special “section 818(c) election” was made.

Older members of the insurance tax community still invoke concepts under “the 1959 Act” and with good reason. Even though Congress later dismantled the framework of the 1959 Act, many of the concepts and, in particular, definitions under the Act still survive. Even today, the definitions of insurance company, life insurance company, and life insurance reserves have their roots in 1959 Act authorities. Moreover, the current-law limitations on consolidated returns that include both life and nonlife members were originally enacted to protect the three-phase system of taxation under the 1959 Act.

1984 Act

Twenty-five years after the 1959 Act, Congress again amended many provisions of the Internal Revenue Code, with a particular focus on the taxation of life insurers. The changes were motivated by an unusually large increase in interest rates between 1959 and 1984, and by a need to simplify the 1959 Act’s complex three-phase system of taxation.

Under the Deficit Reduction Act of 1984, P.L. 98-369 (“the 1984 Act”), life insurance companies were taxed under a single-phase system, like most other corporate taxpayers. The familiar regime under section 807 for computing tax reserves was established, including computation of a Federally-Prescribed Reserve, the use of a reserve methodology determined based on when a contract was issued, reliance on prevailing interest rate and mortality tables, and application of a statutory reserves cap and net surrender value floor. The separate accounting and diversification requirements for assets supporting variable contracts were imposed.

To the disappointment of the industry, limitations that applied to consolidated returns filed by mixed life/nonlife groups were retained, even though the three-phase system that gave rise to those limitations was eliminated. Over time, new IRS guidance addressed many issues under the provisions of the 1984 Act, and authorities under the 1959 Act remained relevant as to those provisions that carried over.⁴ As a younger generation of tax professionals came up through the ranks, they spoke of the 1984 Act with the same familiarity that their elders exhibited with respect to the 1959 Act.

Nontax insurance developments in the years that followed the 1984 Act put pressure on some of the rules in Subchapter L. In particular, the adoption of Life principle-based reserving (PBR) put significant pressure on the rules for determining deductible life insurance reserves.⁵ Although the IRS and industry engaged constructively in ways to make those rules work appropriately,



tax policymakers were aware of the stresses that PBR placed on the system.

The Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act represents a wholesale rewrite of many of the most important features of the Internal Revenue Code. The federal corporate income tax rate dropped significantly. The paradigm for taxing U.S. corporations on their worldwide activity, and foreign corporations on U.S. activity, was radically altered. Most importantly for life insurers, provisions that are the most impactful—reserves, deferred acquisition cost (DAC) and proration—were rewritten. In order to make sense of these changes, it is important to understand the process that led up to the Act.

LEGISLATIVE PROCESS

Momentum for the most recent tax code changes had been building for many years, driven in large part by consensus that the United States had become an increasingly noncompetitive jurisdiction in which to do business. For example, at 38.9 percent, the average U.S. combined federal and state statutory corporate tax rate was 14 percentage points above the average of other countries that are members of the Organisation for Economic Co-operation and Development (OECD). Some believed that this rate differential favored foreign-parented companies which, in turn, encouraged some U.S. companies to “invert,” or redomesticate offshore. For property and casualty insurers, some policymakers believed that the rate differential encouraged the use of reinsurance as a means of eroding the U.S. tax base. Rep. Richard Neal (D-Mass.) and the Obama Administration both proposed legislation to address this issue by limiting tax benefits for property and casualty reinsurance transactions with an offshore affiliate.⁶ The taxation of insurance companies, specifically, was not otherwise in play, though would become important as the TCJA progressed.

Camp Bill

In 2014, then-House Ways and Means Committee Chairman Dave Camp (R-Mich.) introduced a bill known as the Tax Reform Act of 2014, or H.R. 1.⁷ Several months before its introduction, a draft text of the bill was made available in the form of a “Discussion Draft,” which was the subject of an entire issue of *TAXING TIMES*.⁸ Many provisions of the bill would have had a significant effect on life insurers, and Chairman Camp talked with *TAXING TIMES* about the bill shortly after he left Congress.⁹

Broadly, the Camp Bill included a number of features that also are in the TCJA, and was intended to accomplish many of the same goals, such as lowering tax rates and strengthening the economy. Like the TCJA, the Camp Bill would have eliminated the corporate alternative minimum tax (AMT) and would have made a number of changes to conform the taxation of insurance companies to the general rules that apply to other corporate taxpayers. The Camp Bill also would have dramatically changed the provisions that apply to life insurance companies, such as DAC, proration and, in particular, life insurance reserves. The Camp Bill’s changes to the computation of life insurance reserves would have required the use of an uneconomic discount rate to determine tax reserves. This aspect led to a number of meetings with staff on Capitol Hill to discuss with staff on the business of life insurance generally, the capitalization of DAC as compared to actual capitalizable commission expenses, the problems with the economic assumptions underlying the Camp proration proposals, the importance and measurement of reserves, the choice of discount rates, and the emergence of new reserve methodologies. The provisions included in the TCJA on proration and reserves differ dramatically from those that were included in the Camp Bill.

Unlike the TCJA, the Camp Bill was projected to be revenue-neutral.

House Republican Blueprint: “A Better Way”

Early in 2016, House Speaker Paul D. Ryan (R-Wis.) announced the creation of a new Tax Reform Task Force to develop an Internal Revenue Code that would “create jobs, grow the economy, and raise wages by reducing rates, removing special interest carve outs, and [make] our broken tax code simpler and fairer.” In June, the Task Force published its 35-page report, “A Better Way: Our Vision for a Confident America.”¹⁰ The report became known as the House Republican Blueprint.

The broad themes that had been building for Tax Reform—lower rates, simplification (or at least improved consistency) and international competitiveness—formed the foundation of the Blueprint. A controversial Border Adjustment Tax would have exempted exports of products, services and intangibles from tax, and would have taxed products, services and intangibles imported into the United States regardless of where they were produced. Global American companies thus would have been taxed on a territorial basis.

The House Republican Blueprint also would have eliminated any deduction for net interest expense to help equalize the tax treatment of different kinds of financing. Only one sentence addressed how this would apply to financial service companies:

The Committee on Ways and Means will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models.¹¹

Other than this sentence, there were no specific references to the taxation of insurance companies under the Blueprint.

Efforts to Repeal Obamacare Raise the Stakes

Soon after President Trump’s inauguration, Republicans in both the House and Senate engaged in a dedicated effort to dismantle the Affordable Care Act (“ACA”),¹² introducing several proposals to first “repeal and replace” and then to simply repeal the ACA. Beginning in March and continuing throughout much of 2017, Congress considered numerous bills, including the American Health Care Act (“AHCA”),¹³ a subsequent revision titled the Better Care Reconciliation Act (“BCRA”),¹⁴ the Obamacare Repeal Reconciliation Act (“ORRA”),¹⁵ and eventually the Graham Cassidy amendment to the AHCA.¹⁶ Each of these legislative efforts included significant changes to the tax and fee structure applicable to health insurers and health care consumers.

During the fall of 2017, it became clear that efforts to unwind the ACA would not succeed. Mindful of the importance of

achieving some measure of legislative success, Congressional leaders set their sights on federal income tax reform, another centerpiece of their agenda and the president’s campaign.

The House Chairman’s Mark

On Nov. 3, 2017, House Ways and Means Committee Chairman Kevin Brady (R-Texas) released draft statutory language of the Tax Cuts and Jobs Act in the form of a Chairman’s Amendment in the Nature of a Substitute to H.R. 1—the Chairman’s Mark—reflecting his thinking and that of the majority members of the Committee. Directionally, the Chairman’s Mark was consistent with the broad themes that had long been in play—dramatically lower the corporate income tax rate, repeal the corporate AMT, and make dramatic changes to the taxation of U.S. corporations doing business abroad and foreign multinational groups doing business in the United States. Because there had been no public hearings or other opportunities to respond to specific proposals, many provisions were made public for the first time in the Chairman’s Mark.

The pace at which the TCJA went from Chairman Brady’s Mark on Nov. 3 to an enacted law on Dec. 22 was nearly unprecedented for a bill of this magnitude.

Insurance companies were singled out with an entire subtitle in the Chairman’s Mark. Although some of the provisions in the subtitle were in the category of simplification, along the lines of the Camp Bill, other provisions were without precedent and would have resulted in a dramatic increase in taxable income for life insurers. Tax-deductible life insurance reserves were proposed to equal 76.5 percent of statutory reserves, with no cash surrender value floor.¹⁷ The life insurance company proration provision would fix the company’s share of net investment income—that is, the percentage of the otherwise-allowable tax benefit a company would receive for stock and tax-exempt bonds it owns—at 40 percent.¹⁸ The DAC capitalization percentages would increase from 1.75 percent, 2.05 percent and 7.7 percent under prior law to either 4 percent or 11 percent according to whether the contracts were group or individual contracts.¹⁹ This would have represented a 528 percent increase in the rate applied to individual annuity contracts and appeared unrelated to actual, economic acquisition costs that companies incur.

At \$23 billion,²⁰ the revenue estimates for these three provisions were widely believed to vastly understate the actual tax cost to

companies. The Nov. 3 release of the Chairman's Mark thus marked the beginning of a frantic seven-week period of work for both the industry and Hill staff to better understand the economics of the business of life insurance, the mechanics of various proposals, and appropriate estimates of the revenue that each would raise.

The House Bill

Within a week of the release of the original Chairman's Mark, a Manager's Amendment replaced the three most controversial life insurance provisions—reserves, DAC and proration—with a single provision that would retain prior law but impose an 8 percent surtax on Life Insurance Company Taxable Income (LICTI).²¹ An accompanying explanation explicitly referred to the surtax as a “placeholder,” while work on the issues continued.²² The placeholder remained in the version of H.R. 1 that passed the House on Nov. 16.

The Senate Bill

Aware of the continued work in the House on the life insurance provisions, the Senate Finance Committee included its own placeholder for Chairman Brady's proposals on life insurance reserves, DAC and proration. Rather than impose a surtax on LICTI, the Senate Finance Committee's original markup would have retained current law for reserves and proration, and modified the rules for DAC. Specifically, the Senate Finance Committee would have nearly doubled the capitalization rates and would have increased the amortization period fivefold, from 120 months to 600 months.²³ This proposal was referred to by some as “super-DAC,” and was scored to raise approximately the same amount of revenue as the original provisions in Chairman Brady's Mark and the surtax in the bill that passed the House.

The version of the bill that passed the full Senate²⁴ on Dec. 2 included an amendment by Sen. Tim Scott (R-S.C.), which largely became the basis for the TCJA life insurance provisions as passed. Under Sen. Scott's amendment, tax reserves were generally computed by applying a haircut to statutory reserves, DAC rates were increased, and the amortization period lengthened, but not as dramatically as under the Senate's “super-DAC” proposal, and a life insurer's company's share for purposes of proration was set at 70 percent.

Consensus Emerges in Conference

The life insurance provisions were not the only differences between the House and Senate bills, nor even the largest in terms of revenue. For example, the House bill would have repealed the corporate AMT, whereas the Senate bill would have made more modest changes to prior law. The House bill provided a special tax rate for personal service corporations, whereas the Senate



bill did not. The House bill would have addressed erosion of the U.S. tax base by imposing an excise tax on certain deductible payments to foreign affiliates, whereas the Senate bill would have imposed a base erosion minimum tax amount equal to the excess of 10 percent of modified taxable income over the regular tax liability for the year.

The mechanism for resolving differences between a bill passed by the House and a bill passed by the Senate is called a “conference,” in which a committee comprising members of both houses reaches a comprehensive compromise on which the two Houses then vote. In the case of the TCJA, the conference committee report was released on Dec. 15, and the House and Senate both passed the amended package on Dec. 20. The president signed the bill into law on Friday, Dec. 22. With just nine days left in the calendar year, a new scramble began to determine what steps companies should take in anticipation of the new law before Dec. 31, and what disclosures would be necessary in calendar year 2017 annual statement filings and financial statements.

The pace at which the TCJA went from Chairman Brady's Mark on Nov. 3 to an enacted law on Dec. 22 was nearly unprecedented for a bill of this magnitude. As with other tax acts, legislative history will play an important role in discerning the intent of the various provisions. In addition, the staff of the Joint Committee on Taxation will likely produce its own explanation of the provisions. That explanation is commonly referred to as “the Blue Book.” Although generally not considered authoritative as legislative history, it will be another data point in future years as companies do their best to make sense of the intent of various provisions.

BROAD IMPACT ON LIFE INSURERS

The nonpartisan Joint Committee on Taxation staff projected that, across all taxpayers, the Act would reduce federal revenues by \$1.456 trillion over the 2018–2027 federal budget window. Some taxpayers will be winners due to a dramatic cut in corporate income tax rates and the repeal of the unpopular AMT. Other taxpayers will be losers on a net basis due to other provisions. For example, U.S.-parented groups may benefit overall from lower rates and a more territorial model for taxing corporate earnings, whereas new provisions aimed at base erosion could impose significant costs on some foreign-parented multinational groups and potentially cause them to restructure their operations. Modifications of the AMT, lower tax rates and a higher standard deduction will provide welcome relief to some individuals, whereas many individuals in high-tax states will see their tax bills increase due to a dramatic limitation of itemized deductions for state and local taxes.

For insurers, the impact is particularly acute. Like the original House Chairman’s Mark, the TCJA singles out insurance companies in a unique way.

Provisions That Apply to Insurance Companies

Life insurance reserves. Under the Act, the tax-deductible life insurance reserve for a contract is generally equal to the greater of the contract’s net surrender value or 92.81 percent of the statutory reserve with regard to the contract, determined based on valuation date methods. For variable contracts, only general account reserves in excess of the greater of the contract’s net surrender value or separate account reserves with regard to the contract are multiplied by the 92.81 percent factor. A statutory reserves cap applies, as under prior law. The change is projected to raise \$15.2 billion over the 10-year budget window, in large part from an eight-year transition rule relating to reserves on existing business, discussed later in this article. However, the industry generally supported it because it is simpler than current law and should avoid much of the uncertainty that arose under prior law as a result of the adoption of PBR methodologies. The changes to life insurance reserves are discussed at page 14 of this issue of *TAXING TIMES* (“Changes to the Computation of Tax Reserves Under P.L. 115-97”).

The TCJA also made changes to unpaid loss reserves, such as reserves for cancellable accident and health insurance contracts. Much like proposals in the Camp Bill, those changes will incorporate a significantly higher discount rate based on a 60-month corporate bond yield curve and longer loss payment patterns. The effect of these changes will be more important for longer-tail than for shorter-tail lines of business. The changes to unpaid

loss reserves are discussed at page 22 of this issue of *TAXING TIMES* (“Discounted Unpaid Losses: A Rate or a Curve?”).

DAC. As under prior law, acquisition costs with regard to life insurance and annuity contracts are capitalized and amortized, based on a proxy percentage multiplied by net premiums received. The current-law capitalization percentages are increased by 20 percent, and the amortization period extended from 10 years to 15 years. No recomputation of existing unamortized DAC balances is required. Instead, the new capitalization percentages and amortization period apply to net premiums received in 2018 and after. As a result, companies will be able to price newly issued products and reinsurance transactions taking this change into account as appropriate. However, in-force contracts priced under the old DAC rules also will be subject to the higher rates and longer amortization period to the extent of post-2017 premiums. At \$7.2 billion, this change is the second-largest life insurance-specific revenue raiser in the Act. The changes to DAC are discussed at page 24 of this issue of *TAXING TIMES* (“Capitalization of Certain Policy Acquisition Expenses—Changes under the Tax Cuts and Jobs Act”).

Proration. For decades, prior law has required a life insurer to “prorate” net investment income between a company’s share and policyholders’ share in order to limit the benefits of tax-preferred income (such as dividends eligible for the Dividends Received Deduction, or DRD) on assets it owns. The computation of company’s share and policyholders’ share for a life insurance has historically been very complex. The Act replaces the prior law computation of the company’s share and policyholders’ share with fixed percentages of 70 percent and 30 percent, respectively. Like the change to life insurance reserves, this approach represents a dramatic simplification. Together with a general change of the DRD from 70 percent to 50 percent, however, this change results in an increase in the amount of dividend income that is taxed to a life insurer, albeit at a lower rate. The provision was projected to result in an increase in federal tax revenue. The impact of the provision, however, is expected to vary from company to company, and from General Account to Separate Account. The changes to life insurance proration are discussed at page 26 of this issue of *TAXING TIMES* (“Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One”).

The TCJA also made changes in proration for nonlife companies. Under prior law, the adjustment to discounted unpaid losses for 15 percent of tax-exempt interest and DRD produced an effective tax rate of 5.25% (15% times 35%) on tax-exempt income. Under the TCJA, the adjustment increases to a percentage that preserves the same effective tax rate on tax-exempt

income. Based on a corporate tax rate of 21 percent, the pro-ration percentage for nonlife companies in 2018 is 25 percent (5.25% divided by 21%).

Net operating losses. Under prior law, net operating losses of corporate taxpayers generally were carried back two years and forward 20 years, according to the taxpayer's taxable income or loss for those years. Life insurers carried losses from operations back three years and forward 15. The TCJA changed these general rules to allow losses to be carried forward indefinitely, but not back under the TCJA. Losses carryovers are allowed to offset only 80 percent of the taxpayer's income for a particular year. The loss rules for life insurers are conformed to the loss rules for other corporations, such that there is no longer an independent set of rules for losses from operations of a life insurer. Non-life insurance companies, however, may still carry losses back two years and forward 20 years, and use those losses without regard to the new 80 percent of taxable income limitation. The application of different rules for losses of nonlife companies and other corporate taxpayers raises complex issues for those companies that file consolidated returns for groups that include both nonlife insurance companies and noninsurance companies. The issues will be even more difficult for consolidated return filers whose groups include life insurance companies, nonlife insurance companies, and noninsurance companies under the life-nonlife consolidated return regulations.

Other insurance provisions. A number of other provisions that are specific to insurance companies will have lesser financial impact:

- Repeal of a deduction that applies only to small life insurance companies.
- A change to conform the treatment of changes in basis for computing life insurance reserves with the treatment of changes in accounting method of other corporations.
- Repeal of a special rule that applies to a small number of companies that maintain a "policyholders surplus account" based on pre-1984 Act law.

- Repeal of a special rule that permits nonlife companies not to discount unpaid losses if they make "special estimated tax payments."

The broad theme of these changes is to remove provisions that have become obsolete, and to conform the taxation of insurance companies to the taxation of other corporate taxpayers where possible. Several of these changes are discussed together at page 28 of this issue of *TAXING TIMES* ("Repealed: Corporate AMT and Three Insurance Tax Provisions").

Effect on life insurance products. The TCJA does not change the treatment of inside buildup on life insurance and annuity contracts. The industry has long opposed any such changes out of concern for the effects of any changes on policyholders and beneficiaries and because of the important role of the products for retirement security. Commercially, however, other changes in the TCJA could have implications for the products. For example, changes in the estate tax for individuals may dampen the market for individual life insurance contracts that are purchased for liquidity purposes as part of an estate plan; a general reduction in corporate income tax rates also may change the analysis in some cases for the purchase of life insurance by banks and other corporate taxpayers. A welcome clarification that a policyholder's tax basis is not decreased by the cost of insurance provided removes uncertainty for some life settlement transactions. However, life insurers now must consider what systems adaptations are appropriate to comply with new information reporting on life settlement transactions. Amendments to the transfer for value rule are intended to capture certain indirect transfers of a life insurance contract for value. Other changes, such as changes to the life insurance reserve rules that previously were cross-referenced in the section 7702 definition of life insurance (and now are a part of that provision) also may require further careful thought in the context of Life PBR. Consequences of the TCJA to life insurance products are discussed at page 30 of this issue of *TAXING TIMES* ("The Life Insurance Product Tax Provisions of H.R. 1").

Provisions That Apply to All Corporate Taxpayers

As discussed, the most significant broadly applicable elements of the TCJA are the reduction in corporate tax rates and a change in the paradigm for taxing offshore operations of U.S. corporations and U.S. operations of foreign-parented groups. Together, the reduction in tax rates and elimination of the corporate AMT were projected by the Joint Committee on Taxation staff to result in a decrease in federal income tax revenues from corporations of almost \$1.4 trillion over a 10-year budget window.²⁵ These changes dwarf all others and approximately equal the total amount the TCJA is projected to lose over the same period.

The TCJA does not change the treatment of inside buildup on life insurance and annuity contracts.



International

By far, the next most significant changes to multinational corporate taxpayers are changes to the taxation of multinational enterprises.

Territoriality and deemed repatriation. International taxation will transition from a system that taxed worldwide income of U.S. corporations to a territorial system. The mechanism for doing so is a 100 percent DRD for certain qualified foreign-source dividends received by U.S. corporations from foreign subsidiaries. However, existing regimes that tax a U.S. corporation on earnings of certain foreign affiliates—such as “Controlled Foreign Corporations” (CFCs) and “Passive Foreign Investment Companies” (PFICs)—are retained, with modifications.

As part of the transition to a quasi-territorial system, the TCJA generally requires a U.S. shareholder of a specified foreign corporation to include in income for 2017 its *pro rata* share of the undistributed, non-previously taxed, post-1986 foreign earnings of the corporation. The TCJA permits a deduction in an amount necessary to result in a 15.5 percent tax on foreign earnings held in cash or cash equivalents, and an 8 percent tax on foreign earnings held in illiquid assets. Foreign taxes paid with respect to such foreign earnings may be treated as partly creditable. For insurance companies, the higher cash equivalent rate generally will apply, since insurance companies typically hold liquid assets.

Base erosion. To prevent erosion of the U.S. tax base that could result from making deductible payments to foreign affiliates, the

TCJA imposes a “base erosion and anti-abuse” tax (“BEAT”) on certain “base erosion payments” paid to foreign affiliated companies. Companies subject to the tax must pay the excess of tax computed at a 10 percent rate (5 percent in 2018) on an expanded definition of taxable income over their regular tax liability. The tax would not apply to companies with “base erosion tax benefits” less than 3 percent of total deductions of the taxpayer. Both the statutory language and the conference report identify premiums paid for reinsurance as base erosion payments. Other issues arise in practice as a result of different forms of reinsurance transactions. This change is particularly important to foreign-parented groups if there are reinsurance treaties of which U.S. members are a part. As the BEAT applies to reinsurance payments paid or accrued from Jan. 1, 2018, companies continue to consider what changes to their existing reinsurance treaties are appropriate to manage their BEAT liability.

PFIC insurance exception. U.S. shareholders of certain “Passive Foreign Investment Companies,” or PFICs, are required to pay tax—or interest on tax that would be owed—on their share of offshore income earned by the PFIC. An exception applies to investment income earned in the active conduct of an insurance business, and the IRS proposed regulations interpreting this exception as recently as 2015.²⁶ The TCJA limits the active insurance exception to cases where a foreign insurance company has insurance liabilities that constitute more than 25 percent of its total assets. An alternate test is available to a company whose insurance liabilities constitute at least 10 percent of its assets,

if its reserves percentage falls below 25 percent solely due to run-off or rating-related circumstances. Because for this purpose insurance liabilities do not include unearned premiums or deficiency or contingency reserves, insurers with assets materially greater than their reserves, such as companies that insure catastrophic risks, may find it difficult to qualify for the PFIC insurance exception as amended. Some bona fide offshore insurance companies that have difficulty satisfying this test may have to consider reinsuring additional risks, such as certain types of life insurance business, to continue to qualify for the exception.

International tax issues under the TCJA, and their implications for life insurers, will be explored further in the October 2018 issue of *TAXING TIMES*.

Other Non-Insurance Changes

Repeal of the Corporate AMT. The TCJA repealed the corporate AMT. The Tax Reform Act of 1986 established the corporate AMT in order to ensure that no taxpayer with substantial economic income could avoid a tax liability through the “excessive” use of exclusions, deductions, and credits. Beginning with the 2018 tax year, taxpayers no longer will be subject to AMT and will use credits for AMT previously paid to offset their regular tax liabilities and to claim refunds for the balance not absorbed by regular tax liabilities. The TCJA requires the government to refund 50 percent of the remaining balance of AMT credits carried forward to taxpayers in each of the tax years 2018–2020, with any remaining uncredited balance fully refunded in 2021.

Limitation on interest deduction. The TCJA generally limits the deduction for business interest to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year; unused deductions can be carried forward indefinitely. Because insurance companies typically earn significant interest income as part of their insurance business, applying this limitation on a consolidated group basis²⁷ would result in most life-life and life-nonlife consolidated return groups having business interest income that exceeds their business interest expense.

Changes in the taxable year for recognizing income. The TCJA imposes a new “conformity” rule on accrual-method taxpayers that may require them to recognize some items of income no later than the tax year in which that income is taken into account as revenue in an applicable financial statement. The new rule does not apply, however, where special methods of accounting apply. Subchapter L of the Code provides special rules for the taxation of insurance companies, which may provide important exceptions to the new conformity rule. For example, under Subchapter L, the starting point for computing

taxable income is the National Association of Insurance Commissioners (NAIC) annual statement, and explicit rules allow nonaccrual of market discount of life insurance companies. In addition, the Conference Report explains that the conformity rule does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.²⁸

Other provisions. Other important changes to the taxation of corporations under the TCJA include increased expensing (rather than capitalization and depreciation) of business assets, changes in rules for business tax credits, new limitations on excessive employee remuneration, new limitations on entertainment expenses, and changes in the tax deductibility of employee fringe benefits. The impact of these other provisions is beyond the scope of what *TAXING TIMES* will cover, but may nevertheless be important to some companies.

Transition

The transition rules for the many changes made by the TCJA are varied. The most significant of the insurance provisions—changes to both life insurance and unpaid loss reserves—entail the computation of a transition reserve adjustment that is taken into account over eight years. Other significant provisions, such as changes in rates, changes in DAC and proration, and changes in the utilization of losses, are generally effective for tax years beginning after 2017. Throughout this issue of *TAXING TIMES* and the next, each article about a specific provision or change will include a discussion of the transition rules and issues that arise as they apply to life insurers.

MISSED OPPORTUNITIES

Although the changes made by the TCJA were comprehensive by any standard, they did not include at least two items that are important to life insurers and would have been appropriate as a matter of policy: updating of the rules that apply to consolidated returns that include both life and nonlife insurance companies, and correction of a mismatch in the character of income and loss recognized by insurance companies.

Life/Nonlife Consolidated Returns

Current law imposes significant limitations on the ability of a life insurer to join in a consolidated income tax return that also includes group members that are not life insurance companies. Prior to the 1984 Act, the regime for taxing life insurance companies differed significantly from the regime that applied to other corporate taxpayers. In order to protect differences between those regimes, the tax law restricted a life insurer’s ability to consolidate and share losses with nonlife affiliates.²⁹



The 1984 Act removed the primary differentiating three-phase system of life insurance company taxation, and the taxation of life insurers became largely consistent with the taxation of nonlife and non-insurance companies. Following the 1984 Act, life insurance company taxable income includes premium and investment income and allows deductions for underwriting losses and general business expenses. Regardless of this parity with other taxpayers, life insurance companies remain subject to complex rules that include a five-year waiting before joining a consolidated group and a restriction on the utilization of losses generated by affiliates.³⁰ The simplification provisions of the TCJA did not remove these restrictions.

Character of Gain/Loss on Asset Disposals

Banks and other similar financial institutions invest in bonds and other debt instruments to fund deposit liabilities and reserve obligations undertaken in the ordinary course of business. These financial institutions have long enjoyed the benefit of characterizing gains and losses on the disposal of bonds and other debt instruments as ordinary (not capital) in keeping with the ordinary nature of the obligations they support.³¹ For this reason, many such financial institutions are not burdened by limitation on the use of capital losses. This relief is not, however, afforded to insurance companies.

Much like banks and other financial institutions, insurance companies invest in bonds and other debt instruments to support policy reserves and other underwriting obligations undertaken in their ordinary course of business. Insurers utilize interest

income and maturity proceeds to fund anticipated claims. Although interest income from these securities is generally taxed as ordinary income, gains and losses on disposal are not. Insurers often dispose of bond and other investment holdings prior to maturity to pay claims arising from unforeseen events, or to better match asset and liability duration. The Internal Revenue Code characterizes losses on the disposal of these investments as capital in nature, unavailable to offset taxable income from ordinary operations. Though these capital losses may carry forward to offset future capital gains, insurers face the risk that such carryforwards will expire before recognizing sufficient capital gains, particularly in rising interest rate environments. The TCJA did not address this issue.

Technical Corrections

The text of the TCJA itself was hundreds of pages long, representing a Herculean legislative effort in a small number of weeks. Unsurprisingly, as companies, practitioners, and the IRS work through the new law, minor errors become apparent. The process for correcting those errors is known as “technical corrections.” The term technical correction is a term of art, and generally refers to a drafting mistake, or an error where the plain language of a provision is contrary to its clear intent, and correcting the error will have no effect on federal tax revenue. At some point, Congress likely will correct those errors in what is known as a technical corrections bill. Where such errors have been identified for provisions affecting life insurers, the relevant articles in this issue of *TAXING TIMES* will discuss them.

NONTAX CONSEQUENCES OF THE TCJA

The pervasive and dramatic changes enacted in the TCJA so close to calendar year-end 2017 caused significant challenges with respect to the accounting and financial statement reporting of the related effects. The breadth of the changes to the taxation of life insurance companies resulted in additional turmoil within the industry, particularly for companies with both U.S. and non-U.S. operations.

In recognition of the TCJA’s widespread impact to U.S. taxpayers and the related challenges to year-end 2017 financial reporting, the Securities and Exchange Commission (“SEC”) quickly published Staff Accounting Bulletin 118, allowing companies to report the effects of the change in tax law as those effects are reasonably determined, but no later than year-end 2018. In early February, the NAIC Statutory Accounting Principles Working Group issued INT 18-01, *Updated Tax Estimates under the Tax Cuts and Jobs Act*, which generally adopted the concepts outlined in SAB 118 and provided additional guidance with respect to reporting tax effects of the TCJA in the statutory annual statement. This guidance helped to ease the burden of year-end 2017 reporting. Significant questions remain as to the impact of future guidance from Treasury and the proper

financial statement reporting of the tax balances impacted by the base erosion provisions of the TCJA.

Given the effective date for many of the TCJA provisions, life insurers are working expeditiously to consider what changes in their business are appropriate in response to the new legislation. Insurance contracts are being reevaluated for compliance with the new provisions; systems and processes are being reconsidered; income tax accounting frameworks are being reconsidered; processes to monitor tax law and accounting changes are being strengthened; and the response of the various states are being monitored to be sure that companies and their products are in compliance and transactions are reconsidered to avoid traps for the unwary.

Many of these activities bear directly on the work of actuaries, company tax professionals, outside consultants, and tax and nontax regulators. Whatever your role, we hope you find this issue of *TAXING TIMES* helpful. ■

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ENDNOTES

- 1 More precisely, "An act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97, enacted Dec. 22, 2017.
- 2 More specifically, the Revenue Act of 1921 taxed life insurers only on net investment income. Before then life insurers were taxed on all their income.
- 3 For a more detailed description of the 1959 Act, see William B. Harman, Jr., "The Pattern of Life Insurance Company Taxation under the 1959 Act," presented at the 15th Annual Tulane Tax Institute Sept. 28, 1965 and published by the *Journal of Taxation*. The late Bill Harman was a giant in the field of insurance company taxation. He was the attorney at the Treasury Department Office of Tax Policy specializing in insurance at the time the 1959 Act was enacted, and was a founding partner of Davis & Harman, LLP.
- 4 The 1984 Act legislative history expressly directs that in the absence of contrary guidance, authorities under the 1959 Act provisions are to serve as interpretive guides to the new provisions. S. Rep. No. 98-169, 98th Cong., 2d Sess. 524 (1984).
- 5 See, e.g., Notice 2008-18, 2008-1 C.B. 363; Peter Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *TAXING TIMES*, Vol. 12, Issue 1, at 21 (March 2016).
- 6 See H.R. 6270, 114th Cong., 2d Sess. (2016); Treasury Department, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," page 21 (February 2016).
- 7 H.R. 1, 114th Cong., 2d Sess. (2014).
- 8 *TAXING TIMES*, Vol. 10, Issue 3—Supplement (October 2014).
- 9 Kristin Norberg, "The Road to Tax Reform—An Interview with Chairman Dave Camp," *TAXING TIMES*, Vol. 11, Issue 3, at 4 (October 2015).
- 10 House Republican Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).
- 11 *Id.*, page 26.
- 12 Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), together the "ACA."
- 13 American Health Care Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).
- 14 Better Care Reconciliation Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).
- 15 Obamacare Repeal Reconciliation Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).
- 16 S.Amdt. 1030 to the American Health Care Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).
- 17 Chairman's Mark, section 3703.
- 18 Chairman's Mark, section 3705.
- 19 Chairman's Mark, section 3710.
- 20 The Ways and Means Committee Majority Staff's Section-by-Section Summary of the Act, released Nov. 3, 2017, estimated that the reserves provision would raise \$14.9 billion (page 51), the DAC provision would raise \$7.0 billion (page 55), and the life insurance proration provision would raise \$1.1 billion (page 52) during the 10-year scoring window.
- 21 Life Insurance Company Taxable Income already is a defined term in the Internal Revenue Code and is the base on which income tax of life insurers is computed.
- 22 H. Rept. No. 115-409, 115th Cong., 1st Sess., page 319 (2017) ("[T]he bill includes a surtax on life insurance company taxable income that is intended to have the same overall revenue consequences as reforms that were proposed [for reserves, DAC, and proration] in the introduced version of the bill. The surtax is intended only as a placeholder and the Committee intends to develop reforms in those three areas as the bill moves through the legislative process.")
- 23 The Senate Finance Committee DAC proposal was described by the staff of Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), Nov. 9, 2017, at page 139.
- 24 *Tax Analysts* Doc. No. 2017-98547.
- 25 H.R. Conf. Rept. 115-466, 115th Cong., 1st Sess., Table, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" page 8 (2017).
- 26 Prop. Treas. Reg. section 1.1297-4.
- 27 See Notice 2018-28, 2018-16 I.R.B. 492 (April 16, 2018).
- 28 H.R. Conf. Rept. 115-466, 115th Cong., 1st Sess., page 275, footnote 872 (2017).
- 29 The rules that apply to the filing of consolidated returns by a group that includes both life and nonlife members are set forth at Treas. Reg. section 1.1502-47. Industry comments on the need for updating and simplifying the regulations are set forth in comments of the American Council of Life Insurers (ACLI), *Tax Analysts* Doc. No. 2002-18864 (July 26, 2002).
- 30 See generally Treas. Reg. section 1.1502-47.
- 31 Internal Revenue Code section 582(c).

Changes to the Computation of Tax Reserves under P.L. 115-97

By Kristin Norberg and Jeffrey Stabach

One of the more groundbreaking changes in the insurance provisions of Public Law No. 115-97¹ (the Act) was the introduction of a modified framework for computing tax-basis life insurance reserves. The previous proposal for comprehensive tax reform, in 2014,² would have maintained the general prior-law structure requiring a distinct tax reserve based on a specified method, mortality or morbidity table, and interest rates, changing only the approach for determining the interest rates. The Act took a very different approach, generally defining tax reserves as a percentage of statutory reserves with a net surrender value floor. This has the benefit of improving conformity with statutory accounting, especially as the National Association of Insurance Commissioners (NAIC) continues implementation of principle-based reserve (PBR) approaches. There are, however, several important nuances, potential pitfalls and unanswered questions, which we will explore in this article.

The Act changed not only life insurance reserves held under Internal Revenue Code (I.R.C.)³ §807(c)(1), but also reserves held under I.R.C. §807(c)(3) for insurance and annuity contracts not involving life contingencies, and discounted unpaid losses computed under I.R.C. §846 relating to property/casualty (P&C) insurance contracts and some types of accident and health (A&H) insurance. The new requirements are briefly summarized in the sidebar and discussed in more detail below.

This article will focus on reserves held under I.R.C. §§807(c)(1) and (3). A separate article in this issue of *TAXING TIMES* will address changes made to discounted unpaid losses under I.R.C. §§807(c)(2) and 805(a)(1). The Act also made significant revisions to I.R.C. §807(f) relating to treatment of changes in the basis for determining reserves; because the industry and IRS are currently engaged in discussions on the guidance that may be

A SHORTHAND GUIDE TO INSURANCE RESERVES UNDER THE ACT

Life insurance reserves (non-variable contracts)—The tax reserve is generally the greater of:

1. The contract's net surrender value, or
2. 92.81 percent of the reserve computed using the "tax reserve method," which generally is the CRVM/CARVM⁴ reserve.

Life insurance reserves (variable contracts)—The tax reserve is generally:

1. The greater of:
 - a. The entire contract's net surrender value, or
 - b. 100 percent of the portion of the CRVM/CARVM reserve that is separately accounted for under I.R.C. §817,plus
2. 92.81 percent of any excess of the entire contract's CRVM/CARVM reserve over the amount in paragraph 1.

Insurance and annuity contracts not involving life or A&H contingencies—The tax reserve is generally the greater of:

1. The contract's net surrender value, or
2. 100 percent of the discounted value of the obligations, using the highest discount rate or rates permitted by the NAIC as of the date the reserve is determined.

Other considerations

- Life insurance reserves continue to be subject to a contract-level statutory cap.
- Items that were not previously deductible (e.g., deficiency reserves, reserves attributable to deferred and uncollected premiums if the premiums are not included in taxable income, and excess interest reserves) remain nondeductible and are excluded prior to applying the percentage factor.
- CRVM/CARVM (or other NAIC method if the contract is not subject to CRVM or CARVM) is as prescribed by the NAIC and in effect as of the date the reserve is determined.

necessary for implementing the changes to I.R.C. §807(f), we have deferred that topic to a later issue of *TAXING TIMES*. Reserves held under I.R.C. §§807(c)(4), (5) and (6) were unchanged by the Act.

LIFE INSURANCE RESERVES FOR NON-VARIABLE CONTRACTS

Prior to the Act, life insurance reserves were computed using prescribed methods and assumptions that were generally determined when a contract was issued and not changed thereafter. The federally prescribed reserve was determined using the tax reserve method, the prevailing commissioners' standard mortality or morbidity tables, and the greater of the applicable federal interest rate (AFIR) or the prevailing state assumed interest rate (PSAIR). The tax reserve method was generally the commissioners' reserve valuation method (CRVM) for contracts subject to CRVM, the commissioners' annuity reserve valuation method (CARVM) for contracts subject to CARVM, and one- or two-year preliminary term methods for noncancellable A&H insurance contracts. The prevailing tables and PSAIR were determined based on the rates that at least 26 states permitted to be used for valuation. The federally prescribed reserve was subject to a net surrender value floor and a statutory reserve cap, both applied at the contract level.

This highly prescribed framework, and particularly the “locking in” of methods and assumptions at issue, had not kept pace with the direction taken by the NAIC. Through PBR initiatives including Actuarial Guideline 43 (AG 43, now incorporated in Valuation Manual section 21 (VM-21)) for variable annuities and Valuation Manual section 20 (VM-20) for individual life insurance, the NAIC had moved toward a more dynamic, economically responsive framework that better recognized company-specific and product-specific risk characteristics. Fitting the square peg of PBR into the round hole of the pre-2018 Code had been a challenge, leading to a Priority Guidance Plan project, an IRS Large Business and International Division campaign, and an ongoing industry issue resolution project.⁵ The Congressional tax-writing committees were aware of these challenges and were interested in a solution that would simplify the process of determining tax reserves.⁶

The solution Congress ultimately adopted was to use a percentage of reserves computed under CRVM, CARVM or other NAIC-prescribed reserve methods. The methods are those “in effect as of the date the reserve is determined,” significantly improving the alignment with NAIC approaches and apparently



eliminating the issues (for tax years after 2017) raised by the *American Financial* case decided in 2012.⁷ The new definition appears to contemplate changes in methodology after issue, whether the change is specifically prescribed by the NAIC or a company changes between two alternative permissible methods within CRVM/CARVM. Companies will still need to determine whether a particular change in method should be considered an I.R.C. §807(f) change in basis.

The Act did not change several tax-specific adjustments that existed prior to 2018:

- *Deferred and uncollected premiums.* Reserves attributable to deferred and uncollected premiums, when the premiums are not properly included in taxable income, cannot be deducted. See I.R.C. §§811(c)(1) and 807(d)(4).
- *Deficiency reserves.* Reserves held “because the net premium (computed on the basis of assumptions required under [I.R.C. §807(d)]) exceeds the actual premiums or other consideration charged for the benefit,” *i.e.*, deficiency reserves, cannot be deducted. See I.R.C. §807(d)(3)(C).⁸
- *Excess interest reserves.* Reserves held for contracts that guarantee interest at a rate that exceeds the PSAIR must be modified to take into account such excess interest guarantee only up to the end of the taxable year. See I.R.C. §811(d).⁹

The new law does not contain any provisions relating to the treatment of asset adequacy testing reserves, which may be required for an actuary to issue the actuarial opinion required under section 3 of the Standard Valuation Law. Accordingly, the



treatment of such reserves would appear to be unchanged from the treatment under prior law; the Committee Reports to the Act indicate that asset adequacy reserves are not deductible.¹⁰

Also, it appears that life insurance companies may still be challenged on their deductions of unpaid loss adjustment expenses that do not meet the all-events test under I.R.C. §461, as Congress indicated in the Committee Reports to the Tax Reform Act of 1986.¹¹ The current Congress did not identify any changes to this intention in the 2017 Act or its legislative history.

Permitted or Prescribed Practices

States sometimes permit or require reserve methodologies that differ from the NAIC-prescribed methods. For example, New York generally requires the use of “continuous” CARVM for deferred annuities, requiring consideration of available values at any time within a contract year and not just “at the end of each respective contract year” as stated in the Standard Valuation Law.¹² The IRS determined in a 1994 technical advice memorandum¹³ that CARVM as defined in the Standard Valuation Law was based only on end-of-year values; continuous CARVM was not the NAIC-prescribed method, so it could not be used under the then-current Code. It is foreseeable that the IRS would apply similar reasoning with regard to a state-specific variation under the new law; *i.e.*, it is the method prescribed by the NAIC that is relevant for tax reserves, not state-specific deviations from that method. This will, in turn, likely lead to further scrutiny around what it means to be prescribed by the NAIC.

Similarly, not all states have yet enacted the 2009 version of the Standard Valuation Law that enables use of the Valuation Manual, so VM-20 is not available for valuation of individual life insurance contracts in those states. If a state has not enacted

the enabling legislation by 2020 (when the three-year transition to VM-20 expires), it is possible that a company that computes reserves under such state’s laws for contracts issued after 2019 that are otherwise in the scope of VM-20 could be required to recompute its reserves for such contracts using VM-20, before applying the 92.81 percent factor under new I.R.C. §807(d)(1)(A)(ii).

Also, U.S. taxpaying companies not subject to NAIC reporting (*e.g.*, non-NAIC captives in certain U.S. jurisdictions, or non-U.S. insurance companies electing under I.R.C. §953(d) to be treated as U.S. taxpayers) may be required to recompute reserves using the NAIC-prescribed methods prior to applying the 92.81 percent factor.

Assumptions

Mortality, morbidity and interest rate assumptions are no longer explicitly prescribed in the law; only the method is prescribed. The removal of a specific prescription for assumptions suggests that, so long as assumptions selected for statutory reserve purposes are consistent with CRVM/CARVM and actuarial standards, they should carry over for tax purposes. In any event, companies may find it beneficial to develop documentation in support of their interpretations. If the intent of Congress was to simplify reserve computations by basing them on statutory reserves, the simplest way to do this would be to use the statutory reserves as determined for the annual statement, so long as they are consistent with CRVM/CARVM and the tax-specific exclusions mentioned above have been applied.

It appears the IRS may hold this view, based on Rev. Rul. 2018-13¹⁴ released April 26, 2018. In Schedule A of the ruling, which would normally provide the PSAIRs for life insurance contracts

issued in 2018, the rates are marked “N/A” with a footnote that reads, in part (emphasis added):

Section 807(d), as amended, *requires use of the rate used for statutory reserving*, as life insurance reserves for taxable years beginning after December 31, 2017, are determined, in part, based on the reserve computed as required by the National Association of Insurance Commissioners (NAIC) at the time the reserve is determined.

Where an interest or mortality assumption is specifically prescribed within the NAIC’s definition of the method,¹⁵ taxpayers may need to consider whether their tax reserve computation can be based on a reported statutory reserve developed using a more conservative assumption.

To the extent a company changes reserve assumptions after a contract is issued, it may need to consider whether I.R.C. §807(f) applies.

Other Aspects of Life Insurance Reserves

A few other brief remarks can be made on life insurance reserves for non-variable contracts:

- *Supplemental benefits.* The supplemental benefits listed in I.R.C. §807(e)(2)(C) (whether qualified or not) are now subject to the 92.81 percent factor, rather than held equal to the statutory reserve as under prior law. Similar rules apply for aggregation as under prior law; *i.e.*, a qualified supplemental benefit (QSB) is treated as a separate contract, so the net surrender value and statutory cap comparisons would be done separately for the base contract and the QSB.
- *Qualified substandard risks.* Prior I.R.C. §807(e)(5), providing rules for reserves on qualified substandard risks, was repealed. It appears that these would now be subject to the 92.81 percent factor, to the extent the reserve is determined under the method prescribed by the NAIC.
- *Modified guaranteed contracts.* I.R.C. §817A was amended to remove a cross-reference to the calculation of required interest for proration purposes,¹⁶ but it was otherwise unchanged by the Act despite the modified framework for tax reserves. As a result, I.R.C. §817A(e)(2) continues to provide authority to Treasury to prescribe regulations for determining “interest rates applicable under sections 807(c)(3) and 807(d)(2)(B) with respect to a modified guaranteed contract.”¹⁷ However, I.R.C. §807(d)(2)(B) no longer exists. In the absence of technical corrections or other authoritative clarification, it may be reasonable to apply the 92.81 percent factor to the NAIC-basis reserve for life-contingent modified guaranteed contracts with reserves held under I.R.C.

This highly prescribed framework, and particularly the “locking-in” of methods and assumptions at issue, had not kept pace with the direction taken by the NAIC.

§807(c)(1), while continuing to apply Treas. Reg. §1.817A-1 to modified guaranteed contracts for which reserves are held under I.R.C. §807(c)(3).

LIFE INSURANCE RESERVES FOR VARIABLE CONTRACTS

There is perhaps no greater example under prior law of the tax issues resulting from the implementation of PBR than when AG 43 was adopted for variable annuities. AG 43 was effective Dec. 31, 2009, but it applied by its terms to variable annuity contracts issued on or after Jan. 1, 1981. However, there has been some uncertainty with regard to the tax treatment of AG 43. The Treasury Department and the IRS issued Notice 2010-29,¹⁸ which provided a “safe harbor” for contracts issued on or after Dec. 31, 2009. This ultimately created non-parallel tax treatment for variable annuities valued under AG 43 depending on the year of issue. The fact that the safe harbor did not extend to contracts issued prior to Dec. 31, 2009, resulted in companies using a variety of approaches for calculating tax reserves for these contracts (*e.g.*, AG 33/43 hybrid approaches or AG 39). The Act would seem to simplify this non-parallel treatment for variable annuity contracts by using the method that is “applicable to the contract and in effect as of the date the reserve is determined.” It would appear that for contracts subject to AG 43 or VM-21 on a statutory basis, reserves for tax purposes should now be determined under AG 43/VM-21.

Further complicating the calculation of tax reserves under prior law was the fact that Notice 2010-29 allowed some provisions of AG 43 (*i.e.*, the Standard Scenario Amount (SSA)) to be taken into account, but excluded others (*i.e.*, the Conditional Tail Expectation (CTE) Amount) from the federally prescribed reserve under the safe harbor. Among the IRS’s stated concerns with the inclusion of the CTE Amount were: (1) the nature of an aggregate calculation rather than one on a policy-by-policy basis, (2) the fact that assumptions were based on company experience and subject to change on an annual basis, and (3) difficulty in auditing.¹⁹ Despite these concerns, it appears Congress’s intent in the Act was to include the entire NAIC-prescribed reserve method (*see* endnote 6). The CTE Amount is not a “solvency” or “contingency” reserve as the IRS suggested



in Notice 2008-18, but rather a core part of the method developed by the NAIC that is necessary in order to recognize the risks inherent in contracts subject to AG 43.

Treatment of General and Separate Accounts

For a contract meeting the definition of a variable contract in I.R.C. §817(d), the Act first requires a company to determine the greater of the contract’s net surrender value (both general and separate accounts) or the portion of the reserve that is separately accounted for under I.R.C. §817. The 92.81 percent factor is then applied to the excess, if any, of the CRVM/CARVM reserve (for the entire contract) over this amount.

What is “the portion of the reserve that is separately accounted for under I.R.C. §817”? I.R.C. §817(c) requires that a company separately account for items attributable to variable contracts using “the method regularly employed by such company, if such method is reasonable.” As a general rule, reserves supporting guaranteed benefits on a variable contract (such as a guaranteed minimum death benefit) must be held in the company’s general account.²⁰ There is some flexibility in the allocation method beyond that rule,²¹ but as long as a company’s allocation method for statutory reporting purposes is reasonable, it appears that “the portion of the reserve that is separately accounted for under I.R.C. §817” would generally be the amount in Exhibit 3 of the company’s separate account annual statement.

An example may be helpful to clarify the process and terminology. Assume that a company issues a variable annuity contract that has an account value of 1,000, a surrender charge of 8 percent, a Basic Reserve (as defined in AG 43) of 940, and a total CARVM reserve of 970. The contract holder has allocated 80 percent of his funds to the separate account, and the company uses a proportional approach to allocate the Basic Reserve between the general and separate accounts. Table 1 illustrates the application of I.R.C. §807(d)(1)(B) to this contract:

Table 1

	General (GA)	Separate (SA)	Total
Account Value (AV)	200	800	1,000
Net Surrender Value (NSV) (8% Surrender Charge)	184	736	920
Basic Reserve (BR) (Proportional to AV)	188	752	940
Statutory CARVM Reserve (GA = Excess over SA BR)	218	752	970
Max (NSV, SA Reserve)	Max (920, 752)		920
Excess CARVM Reserve	(970 – 920)		50
Excess * 92.81%	(50 * 0.9281)		46.41
Tax Reserve	Min (920 + 46.41, 970)		966.41

This special reserve definition for variable contracts can possibly produce different results, depending on the contract holders’ distribution of the fund value and the allocation method for the CARVM reserve. In addition, the definition of the product (*i.e.*, as variable or non-variable) may create other differences. For example, a living benefit rider attached to a fixed indexed annuity (which is not a “variable contract” under I.R.C. §817(d)) may generate a lower tax reserve than a similar rider attached to a variable annuity.

RESERVES FOR INSURANCE AND ANNUITY CONTRACTS WITHOUT LIFE CONTINGENCIES

While the interest rate assumptions are no longer explicitly prescribed in the law for calculating life insurance reserves, that is not the case for insurance and annuity contracts without life, accident or health contingencies that are subject to I.R.C. §807(c)(3). The amounts are to be held, discounted using the highest rate or rates permitted to be used by the NAIC as of the date the reserve is determined. The determination of interest rates is a departure from prior law, where the assumed discount rate was generally based on the greatest of the PSAIR, AFIR and the contract guaranteed rate, all determined at issuance of the contract (or when the obligation first did not involve life, accident or health contingencies). Unlike prior law, the Act will generally require a separate tax-specific calculation of amounts under I.R.C. §807(c)(3) only where maximum interest rates permitted by the NAIC differ from those being used in the statutory valuation of contracts (*e.g.*, when using more conservative interest rates or rates that differ based on the state of domicile).

Similar to issues mentioned previously with states yet to adopt VM-20, the treatment of I.R.C. §807(c)(3) amounts for term-certain income annuities subject to Valuation Manual section 22 (VM-22) raises additional considerations. If a company is

domiciled in a state that has not yet adopted VM-22, it is possible a company may be required to compute I.R.C. §807(c)(3) amounts for contracts issued after 2017 using the highest discount rate or rates specified under VM-22, which may differ from the rates under such state's laws.

TRANSITION RULES FOR I.R.C. §807

The Act provides for certain “transition relief” to account for differences in reserves calculated under the prior-law definition vs. those calculated under the Act. The amount of reserve difference is determined as of Dec. 31, 2017 and spread equally over the following eight taxable years (*i.e.*, one-eighth of the amount in each year from 2018 through 2025). As the Act refers to the transition amount as the difference in the amount of reserves determined under the prior-law vs. new-law definitions of I.R.C. §807(d), which only defines the computation of life insurance reserves, it is unclear if I.R.C. §807(c)(3) amounts would be included in the amount spreadable under the Act's transition rules. This may have been an inadvertent oversight, but in the absence of explicit inclusion in the transition rule, the change in basis of computation of I.R.C. §807(c)(3) amounts might be viewed as a change in method of accounting requiring an adjustment under I.R.C. §481(a) pursuant to the new provisions of I.R.C. §807(f).

Once calculated, there is generally no difference in treatment whether the amount is an increase or a decrease in reserve (with the possible exception of I.R.C. §807(c)(3) amounts if viewed as a change in accounting method).²² Increases in reserves are deducted under I.R.C. §§805(a)(2) or 832(c)(4), while decreases in reserves are included in income under I.R.C. §§803(a)(2) or 832(b)(1)(C). It is interesting to note that Congress did not permit a “fresh start” as in 1984 when the federally prescribed reserve framework was first enacted, nor a grandfathering of existing contracts as in 1988 when the AFIR was introduced. The redetermination of tax reserves on in-force contracts and the so-called transition relief in the Act were necessary in order to produce Congress's desired amount of revenue from the life insurance industry to offset part of the cost of the broader tax cuts.

LIFE INSURANCE COMPANY RESERVES— HOW DID WE GET HERE?

Before closing, it is worth taking a step back to consider how we ended up at the final rules in the Act. The original H.R. 1, introduced Nov. 2, 2017, had a very different approach. It would have repealed all of prior I.R.C. §§807(c), (d) and (e), replacing them with a single method for determining “reserves for future unaccrued claims.” The tax reserve was generally defined as 76.5 percent of the annual statement reserve, with no net surrender value floor. “Reserves for future unaccrued claims” had only three components:

- Life insurance reserves.
- Unpaid losses (which were discounted under I.R.C. §846 prior to applying 76.5 percent).
- The amount (not included in the first two bullets) of “reserves solely for claims with respect to insurance risks.”

The original H.R. 1 explicitly excluded “any amount of asset adequacy reserves, contingency reserves, unearned premium reserves, or any other amount not constituting reserves for future unaccrued claims as provided in guidance by the Secretary.”²³ As in the version ultimately enacted, the rules would have applied to all in-force reserves, with an eight-year spread of the impact.

Had H.R. 1 been enacted as originally introduced, it would have been devastating to the life insurance industry. A factor of 76.5 percent without a net surrender value floor would have created reserves that were significantly lower than the aggregate level of tax reserves under prior law. Income and deductions would not have been matched at all: Unearned premiums, premiums paid in advance, and amounts applied to premium deposit funds would still have been included in income under I.R.C. §803(b), but the corresponding reserve deductions would all have been repealed. Similarly, considerations paid for insurance or annuity contracts not involving life contingencies (*i.e.*, deposit-type contracts under NAIC classifications) would have been included in gross income, but it is not clear whether the corresponding reserves would have been considered “reserves solely for claims with respect to insurance risks.” After all, the first sentence of the NAIC's definition of such contracts is: “Deposit-type contracts do not incorporate insurance risk.”²⁴ Further, with no net surrender value floor, the reserve rule in the original H.R. 1 was akin to taxing banks on 23.5 percent of their deposits (but even worse, because a significant portion would have been taxed at 100 percent, as just described).

The Joint Committee on Taxation estimated that the original insurance reserves provision would have raised \$14.9 billion of tax revenue over 10 years. The industry, led by the American Council of Life Insurers (ACLI), gathered data suggesting that the actual impact of the proposed changes would have been many times that amount. In light of this, the industry and ACLI engaged in a significant undertaking during November and December with members of Congress and their staff, tax-writing committees, and revenue estimators on these issues. The result of this effort was an approach that (1) maintained the reserve categories and net surrender value floor of prior law, (2) retained and refined Congress's original attempt to define tax reserves as a percentage of statutory reserves in order to

accommodate PBR methods, and (3) was reasonably in line with Congress’s revenue target of \$15 billion²⁵ from the provision. Although the life insurance industry was still targeted with base broadeners in a way few other industries were and will incur significant tax costs especially during the eight-year spread, the reserve provisions in the final version of the Act provide a compromise that is far better than the catastrophic alternative in the original H.R. 1. ■

Note: The views expressed are those of the authors and do not necessarily reflect those of Ernst & Young LLP or Symetra Life Insurance Company.

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ENDNOTES

- 1 “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” enacted Dec. 22, 2017.
- 2 The Tax Reform Act of 2014, released as a discussion draft on Feb. 26, 2014, and introduced by House Ways and Means Committee Chairman Dave Camp (R-Mich.) as H.R. 1 (113th Cong.) on Dec. 10, 2014.
- 3 References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended. Unless otherwise specified, this includes the amendments made by the Act.
- 4 Throughout this article, the term “CRVM/CARVM” is used as shorthand for the tax reserve method as defined in I.R.C. §807(d)(3). This includes not only CRVM and CARVM in the case of contracts covered by such methods, but also other reserve methods prescribed by the NAIC that cover a contract, and, in a case where the NAIC has not prescribed a method for a particular type of contract, a reserve method that is consistent with an NAIC-prescribed method (whichever is most appropriate). Under the Act, the relevant methods are those in effect as of the date the reserve is determined.
- 5 See the 2012–2013 and subsequent Priority Guidance Plans and the Jan. 31, 2017 announcement of the initial 13 Large Business and International campaigns (www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns, accessed May 10, 2018).
- 6 See, e.g., Ways and Means Committee Majority Tax Staff, *Tax Cuts and Jobs Act*, H.R. 1: Section-by-Section Summary (Nov. 2, 2017) at 51. This was a summary of the original version of the bill as introduced in the House; the insurance provisions in the original H.R. 1 differed significantly from those in the final Act, but the original also provided for tax reserves to be based on a percentage of the NAIC reserve. The Ways and Means summary noted with respect to PBR:

Insurance regulators have been changing how life insurance companies must calculate and maintain reserves. The current rules in the Tax Code do not provide how reserves measured in the new [manner] should be taken into account for tax purposes.

This suggests that the original H.R. 1 and the Act as ultimately enacted do provide for reserves measured in the new manner, and they do so by generally accepting the NAIC’s methods, subject to a percentage factor.
- 7 *American Financial Group v. U.S.*, 678 F.3d 422 (6th Cir., 2012), *aff’d* 726 F. Supp. 2d 802 (S.D. Ohio, 2010).
- 8 As under prior law, presumably, deficiency reserves remain part of the statutory cap. See Notice 2013-19, 2013-1 C.B. 743 (Feb. 26, 2013).
- 9 I.R.C. §811(d) previously referred to interest in excess of the greater of the PSAIR or AFIR. Due to the removal of the AFIR, the Act included a conforming amendment to I.R.C. §811(d) to refer only to interest in excess of the PSAIR, as now defined in I.R.C. §808(g). The excess interest provision was otherwise unchanged.
- 10 Tax Cuts and Jobs Act, Conference Report to Accompany H.R. 1, H.R. Rep. No. 115-466, at 478 (December 2017).
- 11 Tax Reform Act of 1986, Conference Report, H.R. Rep. No. 99-841, at II-361 (September 1986).
- 12 NAIC Model 820 (2009), section 5a.B. Compare New York requirements at 11 CRR-NY §99.4(e).
- 13 TAM 9452001 (Aug. 26, 1994).
- 14 2018-20 I.R.B. 576.
- 15 For example, the NAIC has indicated that VM-20 is the CRVM for contracts to which it applies (VM-20 section 1.A.), and VM-20 section 3.C.2. defines the interest rates that “shall” be used in determining the net premium reserve.
- 16 As discussed at page 26 of this issue of *TAXING TIMES* (“Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One”), proration of the dividends received deduction has been greatly simplified under the Act and the calculation of required interest is no longer necessary.
- 17 Treasury had exercised this authority under prior law by issuing Treas. Reg. §1.817A-1 in May 2003.
- 18 2010-1 C.B. 547 (April 12, 2010).
- 19 See Notice 2008-18, 2008-1 C.B. 363 (Feb. 4, 2008).
- 20 See NAIC Statement of Statutory Accounting Principles No. 56, *Separate Accounts* (as of March 2018), paragraph 7. See also the last sentence of I.R.C. §817(d), which requires this same approach for tax purposes: “obligations under [a guarantee on a variable contract] which exceed obligations under the contract without regard to such guarantee shall be accounted for as part of the company’s general account.”
- 21 For example, some companies may hold as a separate account reserve only the portion of the net surrender value attributable to the separate account fund options, allocating the rest of the reserve to the general account. Other companies may apply the approach mentioned in the answer to Question 3.9.a. of the AG 43/C-3 Phase II Practice Note:

One simplification for determining the portion of the Basic Reserve attributable to the variable portion of the contracts might be to split the Basic Reserve for each contract between General Account and Separate Account based on the ratio of the total fund value of the contract in each fund type (General Account or Separate Account).

See American Academy of Actuaries Variable Annuity Practice Note Work Group, *A Public Policy Practice Note: The Application of C-3 Phase II and Actuarial Guideline XLIII* (March 2011), Q3.9.a.
- 22 Under the general accounting method rules, there is a different adjustment period depending on whether the change generates additional income or deductions. A positive \$481(a) adjustment (i.e., income) is generally spread over four taxable years, while a negative \$481(a) adjustment (i.e., deduction) is generally made in full in the year of change. See, e.g., Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (Jan. 16, 2015), §7.03(1).
- 23 H.R. 1 as introduced Nov. 2, 2017, §3703(a).
- 24 NAIC Statement of Statutory Accounting Principles No. 50, *Classifications of Insurance or Managed Care Contracts* (as of March 2018), paragraph 43.
- 25 Hence the oddly specific factor of 92.81 percent, determined by the staff of the Joint Committee on Taxation in order to meet the identified revenue target.

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Discounted Unpaid Losses: A Rate or a Curve?

By Kristin Norberg

For a company taxed as a life insurance company, Internal Revenue Code (I.R.C.)¹ §846 is primarily relevant for the discounting of claim liabilities on cancellable accident and health (A&H) insurance contracts other than disability income. The claim liabilities on such contracts are known as “unpaid losses” for tax purposes, and they may be considered either accrued (part of “Death benefits, etc.” deducted under I.R.C. §805(a)(1)) or unaccrued (part of “unpaid losses” deducted under I.R.C. §§805(a)(2) and 807(c)(2)). In either case, the unpaid losses are required to be discounted based on a specified interest rate and loss payment pattern, which are defined in I.R.C. §846.

Public Law No. 115-97² (the Act) left the structure of I.R.C. §846 largely unchanged but revised the discount rate and, in some cases, the loss payment patterns. This article will briefly describe the changes and identify some areas of remaining uncertainty as we await clarifying guidance from the Internal Revenue Service (IRS). At the date of this writing, such guidance had not yet been published.

THE NEW REQUIREMENTS

With respect to unpaid losses, the Act largely followed the approach used in proposals for comprehensive tax reform in 2014, spearheaded by then-Chairman of the House Ways and Means Committee Dave Camp (R-Mich.) (the Camp bill).³ This included three primary components:

- Changing the discount rate from a rate based on U.S. government debt yields to one based on the corporate bond yield curve.
- Extending loss payment patterns, particularly for long-tailed property/casualty insurance lines such as medical malpractice and workers’ compensation.
- Repealing the election for a company to use its own historical loss payment patterns in lieu of the industry-wide patterns published by the IRS.

The latter two items generally do not affect life insurance companies. For cancellable A&H insurance other than disability

It is unclear how Congress intended the IRS to translate the corporate bond yield curve into “a rate.”

income, both before and after the Act, the loss payment pattern is replaced by an assumption that unpaid losses are paid in the middle of the year following the accident year, *i.e.*, a half-year of discounting.⁴ For cancellable disability income insurance (other than credit disability), both the loss payment patterns and the I.R.C. §846 discount rate are disregarded, and the unpaid losses follow the general principles of I.R.C. §807(d). As discussed at page 14 of this issue of *TAXING TIMES* (“Changes to the Computation of Tax Reserves under P.L. 115-97”), tax reserves for such contracts under the Act will generally be equal to 92.81 percent of the statutory reserve, excluding items such as deficiency reserves.

For life insurance companies, this leaves us with the discount rate as the key new item in I.R.C. §846. Under prior law, the discount rate was the applicable federal interest rate (AFIR), which was a 60-month average of the applicable federal mid-term rates, *i.e.*, rates on outstanding marketable obligations of the U.S. government with over three years but not over nine years remaining to maturity.⁵ Under both the Camp bill and the Act, I.R.C. §846(c)(2) was changed to use “a rate determined on the basis of the corporate bond yield curve.” The corporate bond yield curve is defined in I.R.C. §430(h), which governs actuarial assumptions permitted to be used in computations relating to single-employer pension plans, as follows:

The term “corporate bond yield curve” means, with respect to any month, a yield curve which is prescribed by the Secretary for such month and which reflects the average, for the 24-month period ending with the month preceding such month, of monthly yields on investment grade corporate bonds with varying maturities and that are in the top 3 quality levels available.⁶

The Act follows the calculation above except with a 60-month averaging period, consistent with the averaging period for the AFIR under prior law.

Open Questions

Again, as of this writing, the IRS had not yet published the discount factors to be used under new I.R.C. §846(c). Thus, the biggest open questions are how the rate (or rates) will be developed and what the rate(s) will be, especially for purposes of the eight-year spread transition provision.⁷ Unlike the applicable

federal mid-term rate, where one average rate was defined by the Code for each month for a relatively narrow range of maturities, the corporate bond yield curve is what it says: a yield curve representing a broad range of maturities. It is unclear how Congress intended the IRS to translate this into “a rate.”

For example, the corporate bond yield curve for the month of December 2017 published in Notice 2018-11 includes the following rates:⁸

Maturity (Years)	Yield (%)
0.5	1.83
1	1.98
2	2.23
5	2.71
10	3.42
20	3.93
50	4.17
100	4.25

For comparison, based on Rev. Rul. 2017-24,⁹ the applicable federal mid-term rate for the month of December 2017 was 2.11 percent, and the 60-month average applicable federal mid-term rate through December 2017 (*i.e.*, the AFIR that would have applied for accident year 2018) was 1.66 percent.¹⁰

A loss payment pattern is an assumption that claims incurred but unpaid as of the valuation date will be paid in specified proportions at particular dates in the future. Discounting generally accounts for the time value of money until such assumed payment dates. Thus, it would be economically reasonable—and would not be significantly more difficult to compute—if the Act were read as allowing the use of multiple points on the yield curve when determining the discount factors. It is unclear if the reference to “a rate” in the statute would support this reading, however. At a minimum, it seems that no maturities longer than 24 years should be considered in the determination of the rate(s), as this is the longest period the loss payment patterns for any line of business can extend under I.R.C. §846(d) as amended by the Act. It remains to be seen how the IRS will address these considerations.

One other potential question relates to language remaining in the Code for disability income insurance under what is now I.R.C. §846(e)(6). As mentioned above, cancellable disability income (other than credit disability) does not use the same discount rate and loss payment patterns as other unpaid losses. I.R.C. §846(e)(6)(A) indicates that discounted unpaid losses are to be computed for such business “by using the general rules prescribed under section 807(d) applicable to noncancellable

accident and health insurance contracts *and using a mortality or morbidity table reflecting the taxpayer’s experience*” (emphasis added).¹¹ Now that the concept of a prevailing commissioners’ standard mortality or morbidity table has been removed from I.R.C. §807(d), it is unclear whether this clause has specific meaning and overrides the general deference to the methods prescribed by the National Association of Insurance Commissioners, or whether the drafters simply overlooked a conforming amendment. Given the extremely compressed legislative time-frame, the latter seems more likely.

The industry eagerly awaits the publication of the new discount rate(s) so some of these questions can be resolved and tax provisions and estimated tax payments can be accurately prepared. ■

Note: The views expressed are the author’s and do not necessarily reflect those of Symetra Life Insurance Company.

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ENDNOTES

- References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended through the date of this writing.
- “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” enacted Dec. 22, 2017.
- The Tax Reform Act of 2014, released as a discussion draft on Feb. 26, 2014, and introduced by then-Chairman Camp as H.R. 1 (113th Cong.) on Dec. 10, 2014. Section 3510 of the Camp bill addressed discounting under I.R.C. §846.
- See current I.R.C. §846(e)(6)(B) and prior I.R.C. §846(f)(6)(B).
- See prior I.R.C. §846(c) and I.R.C. §1274(d).
- I.R.C. §430(h)(2)(D)(i).
- Similar to life insurance reserves, the existing discounted unpaid losses as of Dec. 31, 2017 must be recomputed at the beginning of 2018 using the new rules defined by the Act, and the impact of the change is spread into taxable income ratably (1/8 per year) over tax years 2018–2025. See Act §13523(e).
- 2018-11 I.R.B. 425 (January 2018). Rates are published for maturities in half-year increments from 0.5 to 100 years.
- 2017-49 I.R.B. 556 (November 2017).
- 2.11 percent is the mid-term applicable federal rate using annual compounding, from Table 1 of Rev. Rul. 2017-24. 1.66 percent is from Table 6, which is now obsolete but which provided the AFIR for 2018 that would have been used for I.R.C. §846 in the absence of the Act.
- Prior to the Act, there were two modifications to this general rule: the timing of selecting the interest rate to apply under I.R.C. §807(d) and the level of aggregation for applying the statutory cap. After the Act, there is no longer a prevailing state assumed interest rate under I.R.C. §807(d), so the first modification was removed without substantively changing anything else from prior I.R.C. §846(f)(6)(A). The author has found no indication in the legislative history that the reference to mortality or morbidity tables was kept intentionally when the interest rate reference was removed.

Capitalization of Certain Policy Acquisition Expenses—Changes under the Tax Cuts and Jobs Act

By Daniel Stringham

In an article at page 25 of the October, 2014 *TAXING TIMES* Supplement (“Section 3512: Capitalization of Certain Policy Acquisition Expenses”), we reviewed in the context of the 2014 Camp Tax Reform Discussion Draft the requirement of I.R.C. § 848 of the Internal Revenue Code of 1986, as amended (the “Code”) that issuers of certain insurance products amortize, rather than immediately deduct, so-called specified policy acquisition expenses.¹ As we highlighted in the prior article, while specified policy acquisition expenses are ultimately deducted, amortizing these expenses creates a timing mismatch that increases the taxable income of the issuing company. This tax cost to the insurance company is generally referred to in the life insurance industry as the “DAC Tax.” In this article we review the recent changes made to § 848 by the Tax Cuts and Jobs Act (the “Act”).

By way of background, rather than requiring the issuing company to actually determine the amount of policy acquisition expenses attributable to each particular sale, for administrative convenience § 848 deems “specified policy acquisition expenses” to be a specified percentage of net premiums, depending upon the type of insurance product in question.² These percentages serve as a proxy for actual acquisition costs. For example, as the law existed prior to the Act, on an annual basis specified policy acquisition expenses were deemed to be 1.75 percent of net premiums from nonqualified annuity products, 2.05 percent of net premiums from group life insurance products (excluding group corporate-owned life insurance (COLI) contracts)³ and 7.7 percent of net premiums for all other specified insurance products, *e.g.*, individual life insurance contracts, COLI contracts, noncancellable accident and health insurance contracts (including long-term care contracts) and long-term care



combination contracts, such as life insurance or annuity contracts with a long-term care rider.⁴ Certain types of products, such as pension plan contracts and flight insurance, are not subject to DAC Tax.⁵ Therefore, prior to the Act, if an insurance company received net premiums of \$50 million during year 1 from individual life insurance contracts, the issuer was required to amortize \$3,850,000 (7.7 percent of \$50 million) over a 120-month period, commencing in July of year 1.⁶ An insurance company with multiple product lines would go through similar calculations for the other insurance products.

Under the Act, the percentage of net premiums subject to DAC Tax increased, as did the amortization period. Specified policy acquisition expenses on nonqualified annuity products increased from 1.75 percent to 2.09 percent of net premiums, specified policy acquisition expenses on group life insurance products increased from 2.05 percent to 2.45 percent of net premiums

and specified policy acquisition expenses on net premiums from all other specified insurance products increased from 7.7 percent to 9.20 percent of net premiums. Further, the amortization period on these products increased from 120 months to 180 months. In the example above, where the insurance company received net premiums of \$50 million during year 1 from individual life insurance contracts, the issuer would now be required to amortize \$4,600,000 (9.20 percent of \$50 million) over a 180- (rather than 120-) month period, commencing in July of year 1.⁷ Reinsurance arrangements of specified insurance contracts were subject to § 848 prior to the Act, and the changes apply to reinsurance as well.

These changes apply to taxable years beginning after Dec. 31, 2017. Additionally, the legislation provides transitional relief for previously capitalized amounts. Under the transition rule, specified policy acquisition expenses first required to be capitalized before Jan. 1, 2018, continue to follow prior law, *i.e.*, issuers continue to use the 120-month amortization period.⁸

Finally, a technical glitch in the statute has raised a question as to whether or how these new rules apply. The statute points to the appropriate paragraph of § 848(c) when increasing the nonqualified annuity rate from 1.75 percent to 2.09 percent,⁹ but the cross references are wrong for the provisions increasing the group life insurance products rate from 2.05 percent to 2.45 percent¹⁰ and the all other specified insurance products rate from 7.7 percent to 9.2 percent.¹¹ The only reasonable interpretation is that this small drafting error is of no consequence—otherwise the percentages have no meaning at all in the statute. Further, the Conference Report to the legislation shows the clear intent of Congress to simply increase the relevant amortization expense percentages on all three categories of specified insurance contracts.¹² ■

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ENDNOTES

- 1 See *TAXING TIMES* Supplement, October 2014 at page 25 and Section 848(a)(1) of the Code.
- 2 See Section 848(c) of the Code.
- 3 See Section 848(e)(2) of the Code.
- 4 See Section 848(c)(1) and (e)(6) of the Code.
- 5 See Section 848(e)(1)(B) of the Code.
- 6 The first \$5 million capitalized in a taxable year is subject to 60-month amortization. However, if capitalization for a taxable year exceeds \$10 million (determined on a controlled group basis), then 60-month amortization phases out and is eliminated completely when controlled group DAC Tax capitalization is \$15 million or more in a taxable year. For this example, it is assumed that total DAC Tax capitalization for the taxable year exceeds \$15 million.
- 7 The Act retains the 60-month amortization rule (including phase-out) for the first \$5 million of capitalized DAC Tax in a taxable year.
- 8 The transition rule specifically says that pre-2018 capitalized DAC Tax “will continue to be allowed as a deduction over the 120-month period,” and does not mention 60-month amortization. Presumably, a company amortizing pre-2018 DAC Tax over 60 months would continue that amortization in post-2017 taxable years.
- 9 Note that § 13519(a)(2) of the Act references § 848(c)(1) of the Code, which sets forth the capitalization rates for all DAC-able contracts, but not specifically to subparagraph (A) of § 848(c)(1), which sets out the rate for nonqualified annuities.
- 10 Note that § 13519(a)(3) of the Act references § 848(c)(2) rather than § 848(c)(1)(B) of the Code.
- 11 Note that § 13519(a)(4) of the Act references § 848(c)(3) rather than § 848(c)(1)(C) of the Code.
- 12 See Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466) at page 337.

Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One

By Stephen Baker

Internal Revenue Code (I.R.C.) §§243–246¹ provide that a corporation is allowed a percentage deduction for dividends received from other corporations (the DRD). In addition to the general corporate rules regarding the DRD, if the recipient of a corporate dividend is a life insurance company, I.R.C. §812(a) further allocates the benefit of the DRD between the company's share and the policyholders' share. This allocation methodology is often referred to as proration. Proration has historically involved a complex and at times contentious² formulaic process.

Beginning with the present, Section 13518 of Public Law No. 115-97³ (the Act) simplified proration. The Act amended I.R.C. §812(a), which now states that for tax years beginning after Dec. 31, 2017, the company's share of the DRD is 70 percent and the policyholders' share is 30 percent for both general and separate account dividend income.⁴

PRIOR TO TAX REFORM

Prior to the Act (and thus still applicable to tax years beginning prior to Jan. 1, 2018), proration was a mired process that greatly proliferated long spreadsheets.

The company's share was the percentage equal to the (company's share of net investment income) divided by (total net investment income).⁵ The company's share of net investment income was formulaically determined as the excess, if any, of net investment income over the sum of policy interest and the gross investment income's proportional share of policyholder dividends.⁶ All three terms in the preceding sentence required further explanation.

- Net investment income was simply 95 percent of gross investment income attributable to assets held in segregated asset accounts under variable products and 90 percent of gross investment income attributable to general account assets.⁷
- Policy interest was defined as the sum of the required interest on I.R.C. §807(c) reserves at the greater of the prevailing



state assumed interest rate (PSAIR) or applicable federal interest rate (AFIR), plus the deductible portion of:

1. excess interest.
 2. amounts credited to a deferred annuity contract before the annuity starting date.
 3. interest on amounts left on deposit with the company.
 4. amounts credited to a policyholder's fund under a pension plan contract for non-retired employees.⁸
- The gross investment income's proportional share of policyholder dividends was also a windy formula.⁹ Simply stated . . . it was the sum of the deductions for policyholder dividends, excluding the deductible portions of:
 1. excess interest.
 2. amounts credited to a deferred annuity contract before the annuity starting date.
 3. amounts credited to a policyholder's fund under a pension plan contract for non-retired employees, multiplied by a simple fraction.

This fraction was gross investment income (reduced by policy interest), divided by life insurance gross income (reduced by the increase, if any, in I.R.C. §807(c) reserves).

As noted above, proration has been controversial at times. In 2007, the Internal Revenue Service issued Revenue Ruling 2007-54¹⁰ requiring a computational method of required interest that virtually assured a zero company share with respect to variable contracts. After quick and intense industry action the Service issued Revenue Ruling 2007-61¹¹ suspending Revenue Ruling 2007-54.¹² The proper application of short-term capital gains in computing net investment income percentages has been widely discussed (but arguably not settled in writing).

AFTER TAX REFORM

Even a brief review of the prior paragraphs highlights the complexity involved in computing the DRD by life insurance companies prior to the Act. Following the Act, the company's share is now 70 percent for both the general and separate accounts. The impact of this simplification will vary by company and even between the general and separate accounts.

At least the spreadsheets are shorter. ■

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ENDNOTES

- 1 All references are to the Internal Revenue Code of 1986, as amended and the Treasury Regulations promulgated thereunder.
- 2 See below.
- 3 "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," enacted Dec. 22, 2017.
- 4 It is also of interest to note that Section 13002 of the Act modified I.R.C. §243(a) reducing the general corporate DRD percentage from 70 percent to 50 percent.
- 5 See prior law I.R.C. §812(a).
- 6 See prior law I.R.C. §812(b)(1).
- 7 See prior law I.R.C. §812(c).
- 8 See prior law I.R.C. §812(b)(2).
- 9 See prior law I.R.C. §812(b)(3).
- 10 Revenue Ruling 2007-54, 2007-38 IRB 604.
- 11 Revenue Ruling 2007-61, 2007-42 IRB 799. The less controversial portions of Revenue Ruling 2007-54 were restated in Revenue Ruling 2014-7, 2014-9 IRB 539.
- 12 See, for more detail, Gregory L. Stephenson and Stephen Baker, "Separate Account Dividends Received Deduction," *TAXING TIMES* Vol. 4, Issue 3 (September 2008) at page 21.

Repealed: Corporate AMT and Three Insurance Tax Provisions

By Jean Baxley and Catherine Moore

The so-called Tax Cuts and Jobs Act (“TCJA”)¹ fully repealed the corporate alternative minimum tax (“AMT”), which affects insurance companies as well as regular corporations. The TCJA also repealed three insurance-related Internal Revenue Code (“Code”) sections including: (i) section 806 (small life insurance company deduction); (ii) section 815 (distributions from policyholders surplus accounts); and (iii) section 847 (special estimated tax payments). A brief summary of these repealed provisions and associated transition rules follows.

Repeal of corporate AMT. The TCJA (section 12001) repealed the corporate alternative minimum tax (“AMT”) for tax years beginning after Dec. 31, 2017, *i.e.*, generally for tax year 2018 and thereafter for calendar year taxpayers. Corporations, including life and nonlife insurance companies, which had been subject to the minimum income tax are no longer required to compute a tentative minimum tax and pay an “add-on” income tax to the extent that the corporation’s tentative minimum tax exceeds its regular tax liability for the current year. At an estimated negative \$40.3 billion,² AMT repeal is the most impactful, revenue-wise, of the four provisions discussed in this article.

Taxpayers that have accumulated alternative minimum tax credits (“AMT Credits”) can receive refunds of these credits beginning in tax year 2018 in an amount equal to 50 percent of their excess AMT credits as defined in the TCJA for each year through 2020. As an example, if a taxpayer has AMT Credits of \$101 as of Dec. 31, 2017 and taxable income of \$100 for the 2018 tax year and uses \$21 of the credits to eliminate tax on the \$100 income (at the 2018 tax rate of 21 percent), this leaves \$80 of unused AMT Credits for 2018, which are considered “excess” AMT Credits under the TCJA. For 2018, 50 percent of these “excess” AMT Credits, *i.e.*, \$40, is refunded to the taxpayer—leaving \$40 in AMT Credits to be applied in 2019 through 2021.

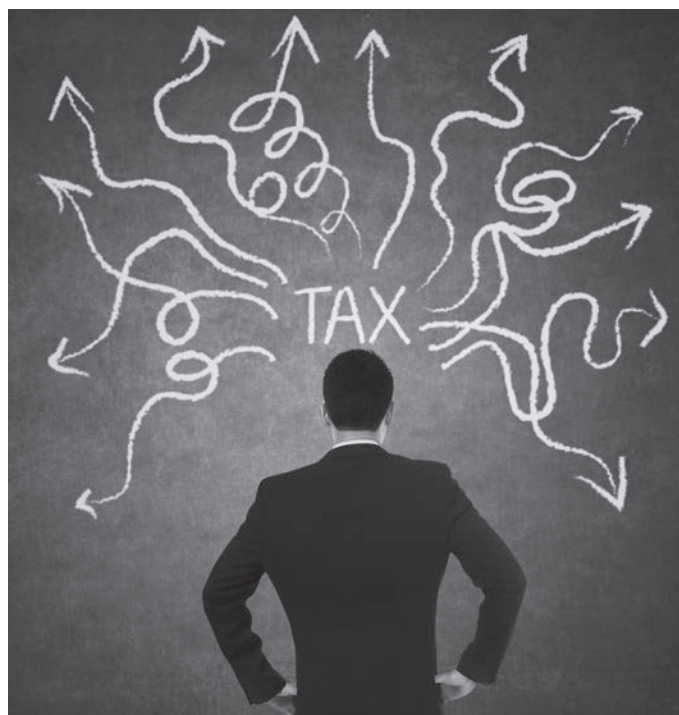
As of the 2021 tax year, any remaining AMT Credits will be refunded in full. Thus, the full amount of a taxpayer’s AMT Credits as of Dec. 31, 2017 will be allowed as refunds in taxable years from and including 2018 through 2021.

The AMT credit’s status as a refundable credit may give rise to some unexpected, or even unintended, consequences. A taxpayer’s ability to obtain a full refund of its AMT Credits, for example, may be limited in situations where there has been an ownership change such that certain limitations under section 383 apply. Additionally, there is a question whether refunds of excess AMT Credits would be subject to a “sequestration” haircut (typically between 6 and 7 percent) under federal budget rules.

INSURANCE COMPANY PROVISIONS

Repeal of small insurance company deduction. Section 806 previously provided a deduction for life insurance companies with assets of less than \$500 million after application of certain controlled group rules (“small” companies). The deduction for any taxable year was 60 percent of so much of the tentative small life insurance company’s taxable income (“LICTI”) for such year as did not exceed \$3 million, reduced by 15 percent of the excess of LICTI over \$3 million. The maximum deduction permitted was \$1.8 million. With the phase-out, any life insurance company with a tentative LICTI of \$15 million or greater was not entitled to this special deduction.

The TCJA (section 13512) repealed the small life company deduction effective for tax years beginning after Dec. 31, 2017, *i.e.*, generally for tax year 2018 and thereafter for calendar year taxpayers. No transition rule was provided. The TCJA did not reform the preferential treatment afforded to small nonlife insurance companies under section 831(b).



Many life insurance companies failed to qualify for this deduction prior to its repeal; accordingly, the revenue estimate associated with this repeal is relatively minimal, *i.e.*, \$200 million from 2018 to 2027.³

Repeal of special rule for distributions to shareholder from pre-1984 policyholders surplus account. Section 815 is a holdover from the pre-1984 Act “phased” tax system. Section 815(a) imposed a tax on any distribution determined to be from the life insurance company’s pre-1984 Act policyholders surplus account (“PSA”). Section 815(b) provided a three-tiered ordering rule for characterization of distributions from a stock life insurance company with a PSA balance: a distribution was treated first out of the shareholders surplus account (“SSA”), second out of the policyholders surplus account (“PSA”), and third out of other accounts.

Corporations ... are no longer required to compute a tentative minimum tax and pay an “add-on” income tax to the extent that the ... minimum tax exceeds its regular tax liability for the current year.

The TCJA (section 13514) repealed section 815 effective for tax years beginning after Dec. 31, 2017, *i.e.*, generally for 2018 and thereafter for calendar year taxpayers. A transition rule provides that any life insurance company with an existing PSA balance as of Dec. 31, 2017, is required to take 1/8 of this balance into taxable income for each of the eight years starting with the first tax year beginning after Dec. 31, 2017 (*i.e.*, 2018–2025 for calendar year taxpayers). For purposes of this statutory transition rule, a life insurance company’s taxable income prior to this inclusion shall not be treated as less than zero, *i.e.*, the PSA inclusion attracts income tax even if the life insurance company otherwise incurs a loss for the tax year.

Repeal of section 815 is expected to have minimal revenue impact, *i.e.*, less than \$50 million per year from and including 2018–2027.⁴ This minimal impact is due to the fact that few stock life insurance companies had a PSA balance as of 2017.

Repeal of elective deduction and related special estimated tax payment rules for property and casualty (P&C) insurance companies. Section 847 previously allowed an insurance company that was required to discount its reserves under section

846 an additional, optional deduction that did not exceed the excess of (i) the amount of undiscounted unpaid losses over (ii) the amount of the related discounted unpaid losses, to the extent the amount was not deducted in a preceding taxable year. In order to take this additional deduction, a special loss discount account had to be established and maintained for the taxpayer, and the taxpayer was required to make special estimated tax payments (“SETP”) to cover the tax benefit of this additional deduction. Any unused SETP amounts were treated as section 6655 estimated tax payments for the 16th year after the year for which the SETP was made.

The TCJA (section 13516) repealed section 847 effective for tax years beginning after Dec. 31, 2017. Under the transition rule provided in the conference report for the TCJA,⁵ a taxpayer that has an existing section 847 special loss discount account should include the balance of such account in income for the first taxable year beginning after Dec. 31, 2017, *i.e.*, generally for tax year 2018 and thereafter for calendar year taxpayers. The entire amount of existing (pre-repeal) SETPs is applied against the amount of additional tax attributable to the income inclusion from the release of the special loss discount account. Any excess estimated tax payments after the SETPs are used to offset this income inclusion are treated as regular estimated tax payments.

Repeal of section 847 is expected to have minimal revenue impact, *i.e.*, less than \$50 million per year from and including 2018–2027.⁶ ■

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ENDNOTES

- 1 Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).
- 2 Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, the “Tax Cuts and Jobs Act” (Dec. 18, 2017) (“JCT Estimate”).
- 3 JCT Estimate.
- 4 JCT Estimate.
- 5 H. R. Conf. Rep. No. 115-446, 115th Cong., 1st Sess. (Dec. 15, 2017).
- 6 JCT Estimate.

The Life Insurance Product Tax Provisions of H.R. 1

By John T. Adney, Brian G. King and Craig R. Springfield

An Introductory Note. On April 26, 2018, the day that the following article was to be sent to Society of Actuaries editorial staff for final review and formatting for publication in *TAXING TIMES*, the Treasury Department and the IRS issued Notice 2018-41, 2018-20 I.R.B. 584, regarding the reporting requirements for life settlements, which is one of the two principal subjects discussed in the article. The Notice states that Treasury and the IRS intend to propose regulations regarding these requirements, describes in general terms the expected content of these regulations, and asks for comments on the proposed rules so described. See the sidebar for a summary of the proposals described in the Notice.

The legislation enacted last December as H.R. 1, known just prior to its passage as the Tax Cuts and Jobs Act (the Act),¹ made several changes to the Internal Revenue Code affecting life insurance product (or policyholder) taxation. The first change, in the order of the Act's section numbering, altered section 7702,² the federal tax definition of "life insurance contract," to account for changes the Act made to the subchapter L rules governing the deductibility of life insurance reserves. The second change, implemented by three subsequent sections of the Act, was directed at life insurance contract sales, generally known as life settlement transactions. Enacting rules widely supported within both the life insurance industry and the life settlement industry, and endorsed (or acquiesced in) by the Treasury Department for a number of years,³ these three sections, in order of appearance, added a complex reporting regime for life settlements, reversed a revenue ruling that had reduced the tax basis of a selling life insurance policyholder, and closed a perceived loophole in an exception to the section 101(a)(2) transfer-for-value rule.

This article will describe these provisions in detail and, where appropriate, comment on the significance of the changes made. It may be noted that these provisions were not in H.R. 1 as originally passed by the House of Representatives. Rather, they were added by an amendment to that bill as it was being considered by the Senate, and the amendment was accepted by the Conference Committee.⁴



SECTION 7702

As discussed elsewhere in this issue of *TAXING TIMES*, section 13517 of the Act rewrote the deductible life insurance reserve amount described in section 807(d). In doing so, it jettisoned much of the mechanism for calculating such amount that was brought into the Code by the Deficit Reduction Act of 1984. In its place, the Act brought in new rules that base the deduction (in part) on a percentage-based "haircut" of the reserve determined under the tax reserve method applicable to the contract. Among the items discarded from section 807(d) was the definition of the "prevailing commissioners' standard tables" in section 807(d) (5), which has no place in determining the deductible amount of life insurance reserves after 2017. Pursuant to that definition, the "prevailing commissioners' standard tables" associated with a life insurance (or other type of) contract generally were "the most recent commissioners' standard tables prescribed by the

IRS Notice 2018-41 states that proposed regulations to implement the information reporting requirements for life settlements under new Internal Revenue Code section 6050Y will:

- Clarify which parties are subject to the reporting requirements, including parties to a viatical settlement, and identify the extent to which the requirements apply to sales or acquisitions effected by transferors and transferees outside the U.S. and to sellers and issuers that are foreign persons for purposes of reporting by life insurers.
- Define “acquirer”—the purchaser of the life insurance policy interest—potentially to encompass any person, including a life settlement or viatical settlement provider or financing entity, that takes title or possession for state law purposes or acquires a beneficial interest in the life insurance contract, and potentially to refine what it means for the acquisition to be done “indirectly.”
- Clarify that a reportable payment may include payments to persons other than the seller, such as brokers and, potentially, life settlement providers acting as intermediaries, and that the amount of the payment to be reported to the seller is the seller’s net proceeds, *i.e.*, the gross proceeds minus any selling expenses (such as brokers’ fees and commissions).
- Limit the reporting obligations imposed on life insurance companies to the company that is responsible for administering the contract being sold, so that the obligations would not apply to an indemnity reinsurer not responsible for contract administration.
- Require the contract issuer to report the amount that would have been received by the policyholder upon surrender of the contract, to determine the amount of the seller’s gain that is ordinary income.
- Define “seller” for purposes of the life insurer’s reporting obligations to include any person who transfers an interest in a life insurance contract to an acquirer in a reportable policy sale or to a foreign person.
- Limit the contract issuer’s obligation to report the “investment in the contract” with respect to a seller other than the original policyholder to the information that is known to the issuer, and, similarly, limit the “estimate of the investment in the contract” that is required to be reported by the payor of a death benefit to include only the amount of premiums paid by the buyer under the contract, less the aggregate amount received by the buyer under the contract.
- With respect to the life insurer’s reporting obligations, define “notice” of a transfer of a life insurance contract to a foreign person as any notice received by the contract issuer, including information provided for nontax purposes such as change of address notices or information relating to loans, premiums, or death benefits with respect to the contract, and in this connection, require every person (*e.g.*, life insurer) making payments of reportable death benefits to undertake the reporting obligations regardless of whether such person received a statement from the acquirer in the reportable policy sale.
- Require an acquirer to furnish the written statements required to be sent to the contract issuer by the later of 20 days after the reportable policy sale or five days after the end of any applicable state law rescission period, but in no event later than Jan. 15 of the year following the calendar year in which the reportable policy sale occurs. The deadlines for other required reporting will be the same as the deadlines for filing Form 1099-R, *i.e.*, Jan. 31 for written statements to sellers, Feb. 28 for paper information returns to the IRS, and March 31 for electronic information returns to the IRS.
- Not require reporting under new section 6050Y until final regulations are issued, and for reportable policy sales and payments of reportable death benefits occurring after Dec. 31, 2017 and before the issuance of final regulations, allow additional time after the date final regulations are published to file the returns and furnish the written statements required.

In addition, the Notice stated that amendments would be proposed to the section 101 regulations to reflect new section 101(a)(3) (the definition of reportable policy sale).

National Association of Insurance Commissioners which 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.”

While the Act eliminated the “prevailing commissioners’ standard tables” term from section 807(d), it recognized that the term had played a prominent role in section 7702—and by

cross-reference, in the “modified endowment contract” definition in section 7702A as well—since the amendment of section 7702 and the enactment of section 7702A by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).⁵ Under these two statutes, and specifically by virtue of the “reasonable mortality” rule of section 7702(c)(3)(B)(i), the applicable computations of the net single premiums that limit the permissible cash values of life insurance contracts and the guideline premiums and 7-pay

premiums that constrain the premiums that may be paid for the contracts generally were required to use mortality assumptions not more conservative than those in the prevailing standard tables defined in section 807(d)(5).

To preclude a vacuum potentially created by the demise of the prevailing standard tables definition in section 807(d), section 13517(a)(4) of the Act (1) revised the section 7702(c)(3)(B)(i) reasonable mortality rule and (2) imported the definition into a new paragraph 10 of section 7702(f).

Revised reasonable mortality rule. As changed, the reasonable mortality rule now requires the premium computations to be based on:

- (i) 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 as defined in subsection (f)(10) [of section 7702]

Significantly, prior to this change, the reasonable mortality rule had read differently. Below is the wording of the former rule with deletions made by the Act shown by strike-outs and the Act's additions shown in italics:

- (i) reasonable mortality charges which meet the requirements ~~(if any)~~ prescribed in regulations *to be promulgated by the Secretary* and which ~~(except as provided in regulations)~~ *or that* do not exceed the mortality charges specified in the prevailing commissioners' standard tables ~~(as defined in section 807(d)(5)) as of the time the contract is issued~~ *subsection (f)(10).*

As originally enacted, section 7702(c)(3)(B)(i) expressly gave the Treasury Department regulatory authority (a) to prescribe requirements that mortality charges would need to meet, in addition to not exceeding the charges specified in the prevailing standard tables, in order to be considered reasonable mortality charges, and (b) to expand the scope of reasonable mortality charges to encompass charges exceeding those of the prevailing standard tables. With the wording additions noted above, and more specifically the replacement of "and which" with "or that," the revised rule removes the prior express authority of the Treasury Department to limit the mortality assumptions used in the premium computations to amounts less than those in the prevailing standard tables. That authority, contemplated for use in regulations proposed in July of 1991, ultimately was never exercised, particularly in light of objections that any such requirement would have made the section 7702 compliance of whole life insurance difficult if not impossible. The elimination

of that authority quells a concern that more or less haunted the life insurance industry for nearly three decades.

The revised rule leaves in place the Treasury's express authority to define the circumstances in which mortality assumptions that exceed those in the prevailing standard tables are "reasonable" and thus may be used in the section 7702 and 7702A premium computations. These circumstances would occur, for example, under contracts insuring lives that are rated as substandard risks, and they could also arise under contracts issued in guaranteed-issue or simplified-issue cases. Substandard-risk and guaranteed-issue (common for group) contracts typically experience worse mortality than those that are fully underwritten, and efforts to streamline the underwriting and issuance of contracts in the individual market through the use of simplified underwriting techniques could result in some deterioration of mortality experience. In such cases, where mortality experience for these types of contracts exceeds the mortality in the prevailing tables, there is justification for Treasury guidance permitting the use of higher mortality assumptions in establishing compliance with sections 7702 and 7702A. Such guidance also would be appropriate in view of the historic role of the interim rule for mortality charges of TAMRA section 5011(c)(2), which remains in effect in the absence of regulations. The exercise of the Treasury's authority also could be called upon, as has been the case in the past, to align the requirements of the reasonable mortality rule with the advent of new tables in circumstances where the three-year transition rule of new section 7702(f)(10) (discussed below) is inadequate to do so.

Changes to section 7702(c)(3)(B)(i) and 7702(f)(10) ... "apply to taxable years beginning after December 31, 2017."

New section 7702(f)(10). While the wording of the reasonable mortality rule itself no longer references the use of the prevailing standard tables in effect "as of the time the contract is issued," the latter wording still applies to determine the tables to be used in the section 7702 and 7702A premium computations. This is brought about by the wording imported into new section 7702(f)(10) from former section 807(d)(5)(A), which recites that the prevailing standard tables are "the most recent commissioners' standard tables prescribed by the National Association of Insurance Commissioners which 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." Section 7702(f)(10) then goes on to incorporate into the new section

7702-based definition of prevailing standard tables the three-year transition rule that previously appeared in section 807(d)(5)(B). The latter rule had enabled the former reserve deduction limit to be computed using a pre-existing mortality table for three years after a new table had met the requirements to be considered “prevailing.” To preserve this rule for the section 7702 and 7702A premium computations, the second sentence of new section 7702(f)(10) reads:

If the prevailing commissioners’ standard tables as of the beginning of any calendar year (hereinafter in this paragraph referred to as the “year of change”) are different from the prevailing commissioners’ standard tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners’ standard tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the 3-year period beginning on the first day of the year of change.

While section 13517(a)(4) of the Act thus rescued and brought over to section 7702 the basic definition needed to allow a portion of the reasonable mortality rule to operate, it apparently chose not to resuscitate the “lowest reserves” rule of former section 807(d)(5)(E). That provision, one of the odder mandates of the Code, required insurers to take an extra step in computing the limit on deductible reserves where more than one mortality table (or options under a table) met the prevailing standard tables definition. In such a case, insurers were instructed by section 807(d)(5)(E) to use the table (and option) that “generally yields the lowest reserves. . . .” The additional requirement set forth in section 807(d)(5)(E), coupled with the prior instruction in section 7702 to use the prevailing standard tables in the premium computations, caused some speculation about whether the version of the prevailing standard tables that yielded the lowest reserves needed to be used for satisfying the reasonable mortality requirements of section 7702(c)(3)(B)(i). The Code is not a frequent user of terms like “generally,” leaving one to suspect that the section 807(d)(5)(E) rule had more to do with revenue-raising than with principle. It also simply could have reflected congressional uncertainty, and perhaps lack of comfort, regarding future mortality tables that might arise. The Act may wisely have chosen to consign this rule to the realm of archaeology.

In choosing to retain the concept of “prevailing commissioners’ standard tables” in the operation of the reasonable mortality rule, the Act seemingly took notice of the continuing use of such tables in the net premium reserve component of the annual statement “reported reserve” computed in accordance with chapter 20 of the new NAIC Valuation Manual, *i.e.*, VM-20. Under VM-20, life insurance companies are generally required to calculate

a net premium reserve for all life insurance contracts as part of the process for determining the reported reserve. Therefore, as long as the net premium reserve remains as a component of the calculation of the reported reserve for a life insurance contract under VM-20, and as long as the prevailing standard tables as defined in new section 7702(f)(10) are used in computing that component, the reasonable mortality rule should continue to function as it has over the past three decades.

Effective date. The changes to section 7702(c)(3)(B)(i) and 7702(f)(10) just described “apply to taxable years beginning after December 31, 2017.”⁶ Hence, these changes are now in effect. There could be questions about how this rule interacts with the original effective date of TAMRA’s reasonable mortality rule. Interestingly, the changes made to section 7702 modify the tax law governing the definition of “life insurance contract” and “modified endowment contract” without one iota of guidance or even comment in the congressional committee reports, *i.e.*, the Act’s legislative history. Much of what is known about sections 7702 and 7702A derives from the legislative history of past enactments, and so it is curious that the congressional tax-writing committees chose to be silent on this subject, even though the legislative history of the Act commented at length on the tax reserve changes wrought by section 13517⁷ and did likewise for the life settlement-related changes next discussed.

LIFE SETTLEMENTS

From its inception, the federal income tax law has provided an exclusion from gross income for amounts paid under a life insurance contract by reason of the death of the insured.⁸ Almost as long, this exclusion has been limited by a provision known as the transfer-for-value rule. Under this rule, found in section 101(a)(2), if a life insurance contract is sold (or otherwise transferred for valuable consideration) by its owner, the excludable amount of the death benefit generally is limited to the sale price plus premiums and other amounts subsequently paid by the purchaser, thereby subjecting to tax the amount of the death benefit in excess of the transferee’s basis in the contract.⁹ On the other hand, the statute contains several exceptions to this rule, under one of which the death benefit remains income tax-free where the transferee’s tax basis in the contract is determined in whole or in part by reference to the transferor’s basis.¹⁰ Thus, where a contract is transferred by gift and the donor’s basis carries over to the donee, this exception usually allows the gift to avoid the transfer-for-value rule, even in a part-gift and part-sale transfer.

In many instances, the federal income tax rules rely on widespread tax reporting regimes to enable their enforcement by requiring those who make potentially taxable payments to report those payments to both the payee and the IRS. To



achieve this result for life settlements, life insurance companies need to be aware of the characteristics of the underlying change in ownership, *i.e.*, to know whether the transaction involves a sale or, more specifically, whether one of the exceptions to the transfer-for-value rules in section 101(a)(2) applies. While life insurance companies generally have not been enthused about having contracts they've issued sold to third parties and have not been averse to reporting death benefits in such cases as taxable pursuant to the transfer-for-value rule, they often lack information necessary to such reporting. At best, there has been limited reporting by life insurance companies when the death benefits of those contracts are paid to the third-party purchasers (or their assignees). Further, companies should not report a death benefit as taxable when one of the exceptions to the transfer-for-value rules applies (as where a contract is transferred by gift), and reporting a specific taxable amount when the section 101(a)(2) exceptions do not apply requires knowledge of tax basis that professional purchasers of contracts usually do not share with insurance companies.

In an effort to preclude avoidance of section 101(a)(2)'s transfer-for-value rule, section 13520 of the Act imposes tax reporting

requirements where an existing life insurance contract is purchased in what new section 6050Y denominates a "reportable policy sale," and also imposes reporting requirements on the payor (*i.e.*, the life insurance company) where "reportable death benefits" are paid. In addition, as part and parcel of this effort (as discussed further below), section 13521 of the Act sets forth rules for determining the basis of a life insurance (or annuity) contract, and section 13522 of the Act narrows the exceptions in the transfer-for-value rules so that they do not apply where an interest in a life insurance contract is transferred in a reportable policy sale. Each of these sections of the Act is explored further in the discussion that follows.

Reporting requirements—acquisition of a life insurance contract—the buyer's turn. To facilitate the information flow among purchasers, life insurance companies and the IRS for life settlement transactions, the Act imposes a new reporting regime at the time of a reportable policy sale. The reporting requirement under new section 6050Y applies to "every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year."¹¹ Hence, the new reporting requirement captures within its net every life

settlement company (or individual) that obtains, in a transfer for value, any interest in a life insurance contract where “the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer’s interest in the life insurance contract),” which is the definition of a reportable policy sale that appears in new section 101(a)(3)(B) as added by the Act.¹² The reportable acquisition, moreover, may be direct or indirect; the latter is described in the statute as including the acquisition of an interest in a partnership, trust or other entity that holds an interest in the life insurance contract.¹³ And this reporting requirement does not cease with the initial sale of the contract, since it is not uncommon for contracts sold in life settlements to have subsequent purchasers (as reflected in Revenue Ruling 2009-14).¹⁴ Subsequent acquirers of interests in contracts also are subject to the required reporting.

Pursuant to the new reporting requirement, the buyer is to file an information return with the IRS reporting certain information about the life insurance contract purchase, and also is to provide an information statement to the seller of the contract and to the life insurance company that issued it containing (almost) the same information. On the information return filed with the IRS¹⁵ and the information statement to the seller,¹⁶ the buyer reports:

- The buyer’s name, address and taxpayer identification number (TIN).
- The name, address and TIN of each recipient of a “payment” in the reportable policy sale, with this payment being defined as the amount of cash and the fair market value of any consideration transferred in the sale.¹⁷
- The date of the sale.
- The name of the “issuer” and policy number of the contract acquired.
- The amount of each payment.

Where a contract is owned by multiple parties, so that each of them is a “seller,” the information statement presumably must be provided to each of them. The same details are to be provided in the information statement to the contract’s issuer, with the exception that the amount(s) of the purchase payment(s) need not be reported to the issuer.¹⁸

In this connection, it is noteworthy that section 6050Y uses, in a number of places, the term “issuer” rather than “insurance company.” The reason for this terminology is that the statute employs a special definition for this purpose: The issuer is “any life insurance company that bears the risk with respect to

a life insurance contract on the date any return or statement is required to be made under this section.”¹⁹ Hence, while the issuer in a specific case may be the insurer that originally issued the contract, it is possible, such as where an intervening assumption reinsurance transaction changes the obligor on the contract to a new carrier, that the assuming insurer is the party that is to receive the information statement just described or to file the returns and information statements discussed below.

At this point, one may stop to ask a few questions. First, why does the statute exclude the purchase payment’s amount from the information required to be shared with the life insurer? Without this information, the insurer lacks the necessary information for determining the taxable amount of the death benefit, limiting its ability to tax report income and withhold on the proceeds. The answer is that the legislation embodies a compromise, a well-orchestrated dance of sorts, between the life insurance industry and the life settlement industry. The professional buyers of contracts, while willing to disclose the amounts of the purchase payments to the IRS (which by law generally may not disclose the information), were not willing to disclose them to the insurers. This arrangement, together with the insurer’s information-reporting requirements described next, should provide the IRS with the data needed to enforce compliance with the transfer-for-value rule, assuming the agency’s information collection system is up to the task of matching the information provided by the buyer and the insurer, and further assuming that the buyer in question actually must file the return. The latter assumption prompts the next question: What if the buyer is an offshore entity, existing beyond the taxing jurisdiction of the United States? Many purchasers of interests in previously issued life insurance contracts are foreign parties. As discussed below, this may require withholding on the taxable portion of death benefits paid. However, if the insurance company does not know the amount of the purchase price, withholding may need to be based upon the full death benefit. Both new section 6050Y and its legislative history²⁰ take notice of the possibility of foreign contract owners, turning to the contract issuer for help in ensuring the sufficiency of information reporting as described below. The IRS may also rely on FATCA-required reporting to produce the needed data in such a circumstance (more on this later). And perhaps a further question is in order: Might contract acquisitions in transfers-not-for-value, such as gifts, also be caught within the new reporting net? Looking solely at the definition of a reportable policy sale in new section 101(a)(3), the answer arguably is yes, but the reporting requirements themselves as spelled out in section 6050Y(a) suggest otherwise. Those requirements, as noted above, include disclosure of the amount of a payment for a contract and the “date of the sale,” thereby positioning the reporting requirements squarely within the transfer-for-value context. The IRS presumably will agree with this view when it publishes guidance on these



requirements, as the agency’s updated Priority Guidance Plan said would be done,²¹ as well as when the agency frames the new reporting forms.

Reporting requirements—seller’s basis in the life insurance contract—the insurer’s turn. On receipt of the buyer’s information statement, or on receipt of any “notice” that the contract is being transferred to a “foreign person,” the issuer is required to file an information return with the IRS²² and to send an information statement to the seller of the contract,²³ containing:

- The name, address, and TIN of the seller (including, according to the legislative history, that of the transferor to a foreign person).
- The investment in the contract within the meaning of section 72(e)(6) at the time of sale (*i.e.*, usually the sum of the premiums paid for the contract less any untaxed distributions from it).
- “The policy number” of the contract.²⁴

The legislative history proceeds to elaborate on these requirements of the new statute, apparently to prompt action from Treasury and the IRS.²⁵ First, it clarifies that the initial element above (identification of the seller) includes the transferor of the contract to a foreign person. Second, regarding such a transfer, the history observes that the “notice” of the transfer of a contract to a foreign person “is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.” And, perhaps

foreshadowing the clarification that the legislation makes in section 13521 of the Act (described below), the same history refers to the second item above—the section 72(e)(6) investment in the contract—as the “basis of the contract.” That phrasing is music to the ears of life insurers and life settlement purchasers alike, as will be discussed subsequently. The requirement of reporting the investment in the contract to the seller (and the IRS) presumably is to enable the seller’s filing of a proper tax return (*e.g.*, IRS Form 1040) and to enhance the tax collector’s ability to verify its propriety.

Effective date for the contract sale reporting requirements. The reporting requirements for “reportable policy sales” just described are effective for both contract buyers and contract issuers with respect to sales occurring after Dec. 31, 2017,²⁶ and are subject to the same penalties for failure to comply with the requirements as are other mandated information returns and statements.²⁷

Reporting requirements—reportable death benefits. When a “reportable death benefit” is paid under a life insurance contract, section 6050Y requires the payor insurance company—described in the statute as “a person who makes a payment of reportable death benefits”—to file an information return with the IRS about the payment and to provide an information statement to the payee as well. Not surprisingly, such a reportable death benefit is defined in the statute as “an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.” Pursuant to this requirement, the payor’s information return²⁸ (to the IRS) and information statement²⁹ (to the purchaser) reports:

- The name, address and TIN of the person making the death benefit payment(s) (presumably the insurer).
- The name, address and TIN of each recipient of such payment.
- The date of each such payment.³⁰
- The gross amount of such payment.
- The payor’s estimate of the buyer’s section 72(e)(6) investment in the contract.

The last item on this list also is worthy of comment. The statute’s use of the term “estimate” suggests that the payor/insurer may not know, or perhaps that it is not expected to know, the precise amount of the buyer’s investment in the contract within the meaning of section 72(e)(6). This presumably follows from the omission of any required reporting to the insurer of the purchase price the buyer paid to the seller, an amount that

should constitute the buyer's section 72(e)(6) investment in the contract at the point of sale. That an amount equal to the buyer's purchase payment is its initial investment in the contract is mandated by section 72(g), which equates that amount with the "aggregate amount of the premiums or other consideration paid" component of the investment in the contract. Of course, it is possible that the buyer would voluntarily disclose the purchase payment amount to the insurer. Alternatively, the insurer could simply report what it knows to be the case, *i.e.*, the buyer's investment in the contract (the premiums it pays to the insurer less the untaxed distributions it receives) after the sale. It would seem appropriate for the section 6050Y guidance promised by the Priority Guidance Plan to address the nature of the estimate the insurer is to report.

In any event, while the amount so reported as investment in the contract may be pertinent to determining the taxable amount of gain in the contract under section 72(e)—should the buyer decide to surrender the contract or take withdrawals from it—the section 72(e)(6) investment in the contract technically has little to do with determining the taxable amount of the death benefit under section 101(a)(2), in that the latter provision does not reference section 72(e)(6). One would think that determining the taxable portion of the death benefit is the whole point of this branch of the reporting exercise. Pursuant to section 101(a)(2) itself, the excludable amount of the death benefit is defined similarly to the section 72(g) "aggregate amount of the premiums or other consideration paid," without making any reference to section 72(g) let alone to section 72(e)(6). Given the change made by section 13521 of the Act, perhaps Congress was equating the section 72(e)(6) investment in the contract with tax basis and, in turn, with the section 101(a)(2) excludable amount. If so, it may be that the insurer's estimate of the buyer's investment serves all of these purposes. Again, the promised IRS guidance may shed some light on this.

Where a life insurance policyholder sells his or her contract to a foreign purchaser, the withholding tax rules of sections 1441-1442 and 1471 (*i.e.*, FATCA) may come into play when amounts are distributed from the contract. A death benefit paid by a U.S.-based insurance company under a life insurance contract originally issued in the United States may well give rise to U.S. source fixed, determinable, annual or periodical (FDAP) income, which is subject to the 30 percent withholding tax imposed under both of those sections. The FATCA-required withholding can be avoided, of course, with the appropriate registration of, or reporting by, an entity that is the purchasing foreign party, as well as the proper documentation provided by the recipient to the payor. Where section 1441 or 1442 is concerned, in some places a treaty may be invoked to avoid or reduce the withholding tax (based on a valid claim of benefits on a Form W-8BEN or W-8BEN-E). But the insurer must

make a judgment about whether to withhold tax and, if so, how much to withhold. Under the applicable regulations, where the tax basis of a payment of U.S. source FDAP income to a foreign person is unknown, rendering the amount of the taxable income unknown, withholding is based on the gross amount of the payment.³¹ This would seem to be incentive enough for a foreign life settlement company to disclose the amount of the purchase payment to the insurer, absent a claim of treaty-based exemption.

These reporting requirements apply to death benefits paid after Dec. 31, 2017,³² and like the requirements applicable to reportable policy sales, are subject to penalties for failure to comply with the requirements.³³

Clarification of a seller's basis in a life insurance contract. Prior to a decade ago, a policyholder's tax basis in his or her life insurance contract at the time it is sold in a life settlement transaction was widely understood to be the investment in the contract as defined in section 72(e)(6) (again, the sum of the premiums paid for the contract less any untaxed distributions from it). That changed with the publication of Revenue Ruling 2009-13,³⁴ in which the IRS ruled (in "situation 2") that where a cash value life insurance contract is sold by the original owner, the seller's basis is reduced by prior cost of insurance, a view that contrasted starkly with both the previous understanding and with the treatment of a contract surrender under section 72(e) (also discussed in the ruling). The reasoning underlying the ruling appeared to be that the reduction for cost of insurance charges was necessary to account for the insurance protection the policyholder received before the sale. The ruling cited *Century Wood Preserving Co. v. Commissioner*³⁵ and characterized the court as concluding that a taxpayer who sold a life insurance contract could not include in basis amounts that were used to provide annual insurance protection.³⁶ Situation 2 of this ruling was controversial, to say the least, and perhaps adding to the controversy, in a companion ruling, Revenue Ruling 2009-14,³⁷ the IRS held that such a reduction in basis did not apply to the buyer of the contract upon its subsequent sale of the contract. The distinction between the original sale case and subsequent sale case, as explained in the latter ruling, was that the purchaser from the original owner did not purchase the contract for protection against economic loss upon the insured's death but rather acquired and held the contract solely with a view to making a profit.

There were many problems with the IRS's position in situation 2 of Revenue Ruling 2009-13, as detailed in a prior *TAXING TIMES* article.³⁸ For example, in the case of personal property unrelated to business or investment, federal tax law generally makes no provision for adjusting the basis of the property to account for personal use or consumption. In determining gain on the sale of

such property, the property's basis equals its cost, unadjusted for personal use or consumption. The IRS position, it was pointed out, ran completely counter to this treatment. The authorities the ruling cited in support of its position, moreover, dealt with the treatment of basis in cases of losses incurred when businesses sold or surrendered life insurance contracts they had purchased, a situation distinguishable at a variety of levels. The IRS position, many said, lacked a sound basis.

Into this fray stepped section 13521 of the Act, with rousing support from both the life insurance industry and the life settlement industry, and with Treasury Department acquiescence if not endorsement. That provision rewrites section 1016(a)(1), governing adjustments to tax basis, to provide in new subparagraph (B) that "no adjustment [to basis] shall be made . . . for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract." The legislative history briefly elaborates on the meaning of this revision of the statute, saying the mortality, expense and other reasonable charges just referred to are "known as 'cost of insurance'" and observing that the addition of the new rule "reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance."³⁹

New section 101(a)(3) applies to transfers occurring after Dec. 31, 2017.

This amendment of the tax basis rules for life insurance (and annuity) contract sales is effective for transactions entered into after Aug. 25, 2009.⁴⁰ Thus, the amendment dates back to the effective date of Revenue Ruling 2009-13, supporting the view that the revisions to section 1016 merely clarify the law rather than alter it (a view also supported by the legislative history).⁴¹ One might also observe that the revised section 1016(a)(1) (B) rule clarifies the policyholder's basis in the case of taxable exchanges as well, a point not covered in the IRS's ruling. The legislation does not appear, or purport, to change what the IRS said in Revenue Ruling 2009-14.

Narrowing the transfer-for-value exceptions. As previously noted, exceptions exist to the section 101(a)(2) transfer-for-value rule. Prior to the Act, an exception applied where the transferee's basis in the contract was determined in whole or in part by reference to the transferor's basis in the contract.⁴² Hence, the death benefit remained income-tax-free in cases where the original policyholder's basis "carried over" in the transfer, such as a transfer by gift (generally including a part-gift and part-sale transaction) or in connection with a corporate reorganization.

Exceptions also applied in the case of a transfer of a contract to the individual insured under the contract, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.⁴³

These exceptions to the transfer-for-value rule, dating back to the 1940s, have generally stood the test of time, but of late, with the advent of life settlements and some practices of the promoters thereof, an abuse of the exceptions was perceived to arise. By way of example, some life settlement transactions were structured as partnerships between a buyer and a seller who was also the insured under the contract, ostensibly enabling the buyer to benefit from the exception for a transfer to a partnership in which the insured is a partner and thereby retain the income-tax-free status of the death benefit, despite the obvious transfer of the contract for value. The seller/insured/partner may be accorded a very minor interest in the partnership and thereafter may exit the partnership.

To preclude any such abuse, section 13522(a) of the Act, while leaving intact the historic exceptions in section 101(a)(2), added a new section 101(a)(3) to limit the exceptions' scope. According to the new provision, the exceptions to the transfer-for-value rule do not apply where the transfer of a life insurance contract, or any interest therein, constitutes a "reportable policy sale." This reportable policy sale, as defined in new section 101(a)(3) (B), is the same one that triggers the reporting requirements discussed earlier. Thus, some portion of the death benefit ultimately payable under such a contract—the excess of the death benefit over the buyer's purchase price plus any premiums subsequently paid (adjusted for any untaxed distributions from the contract)—will be includable in the buyer's gross income for tax purposes. New section 101(a)(3) applies to transfers occurring after Dec. 31, 2017.⁴⁴

While legislation enacted to preclude tax abuse is laudable, anyone conversant with the history of federal income tax law knows that anti-abuse legislation often throws off flack that hits innocent parties. This legislation may well have done so, in that the sweep of the new section 101(a)(3) rule could be construed, for example, to include some contract transfers in connection with corporate reorganizations. Yet it was to enable contract transfers in such cases, among others, that the section 101(a) (2) exceptions were written as they are. The authors understand that further work is being done to refine the anti-abuse rule so that it can operate without detracting from the tax treatment of legitimate life insurance contract transfers. This could also be a fit subject for the promised administrative guidance.

CONCLUSION

On balance, the changes the Act made to the Internal Revenue Code in the realm of life insurance product (or policyholder) taxation appear to be beneficial. Section 7702 was altered to

preserve the role played by the prevailing commissioners' standard tables in determining "reasonable" mortality charges while deleting the express authorization of regulations that might require the use of lesser charges in the section 7702 and 7702A computations. Life settlement transactions, in the past somewhat shrouded in darkness, were brought into the light by means of a web of reporting requirements, and the basis of selling policyholders was clarified to align with the tax treatment of non-business property sales generally. And the transfer-for-value rules were modified in an effort to preclude abuse. As with all tax legislation, these changes prompt questions and concerns, most if not all of which may be susceptible to resolution through IRS guidance. ■

The views expressed are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or any member firm of the global EY organization or of Davis & Harman LLP.

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ENDNOTES

- 1 P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017).
- 2 Unless otherwise noted, references to "section" are to provisions of the Internal Revenue Code of 1986, as amended through the date of this writing (the "Code").
- 3 This portion of the legislation passed the Senate in 2012 as part of a highway funding bill but was ultimately deleted from the measure before its final passage. See John T. Adney, Bryan W. Keene and Joshua R. Landsman, "Life Settlements: Congress Wades Into the Fray," *TAXING TIMES*, October 2012, Vol. 8, Issue 3 (Society of Actuaries 2012).
- 4 H.R. Rep. No. 115-466 (2017) (Conference Report) at 478, 486.
- 5 P.L. 100-647, 102 Stat. 3342 (Nov. 11, 1988).
- 6 Section 13517(c)(1) of the Act.
- 7 Conference Report at 476.
- 8 Section 101(a)(1).
- 9 According to the flush language of section 101(a)(2), "other amounts" includes interest with respect to the contract that was not deductible under section 264(a)(4).
- 10 Section 101(a)(2)(A).
- 11 Section 6050Y(a)(1), as added by section 13520(a) of the Act.
- 12 Section 6050Y(d)(2). See section 13522(a) of the Act, adding new section 101(a)(3).
- 13 Section 101(a)(3)(B).
- 14 2009-21 I.R.B. 1031.
- 15 Section 6050Y(a)(1).
- 16 Section 6050Y(a)(2).
- 17 Section 6050Y(d)(1).
- 18 Section 6050Y(a)(2)(B). On the information statements, the buyer must also supply the name, address and phone number of the buyer's "information contact." Section 6050Y(a)(2)(A).
- 19 Section 6050Y(d)(3).
- 20 Conference Report at 485.
- 21 2017-2018 Priority Guidance Plan (Feb. 7, 2018) (referring to "Guidance under §§101 and 1016 and new §6050Y regarding reportable policy sales of life insurance contracts"). See the note at the outset of this article regarding IRS Notice 2018-41 and the related sidebar.
- 22 Section 6050Y(b)(1).
- 23 Section 6050Y(b)(2).
- 24 On the information statements, as was the case with the buyer, the insurer must also supply the name, address and phone number of the insurer's "information contact." Section 6050Y(b)(2)(A).
- 25 See *supra* note 20.
- 26 Section 13520(d)(1) of the Act.
- 27 Section 6724(d)(1)(B)(xxvi) and (2)(JJ) as added by section 13520(c) of the Act.
- 28 Section 6050Y(c)(1).
- 29 Section 6050Y(c)(2).
- 30 The use of the term "such" in connection with "payment" in this list is necessary here and was borrowed from the statute itself, since the reporting described in this list refers to the death benefit payment or payments, not to the term "payment" described in the statute's definitional section. The latter "payment" (see Section 6050Y(d)(1)) is the one for the purchase of the contract, limited by definition to the consideration for the reportable policy sale.
- 31 See Treas. Reg. sections 1.1441-3(d)(1) and 1.1471-2(a)(5).
- 32 Section 13520(d)(2) of the Act.
- 33 See *supra* note 27.
- 34 2009-21 I.R.B. 1029.
- 35 69 F.2d 967 (3rd Cir. 1934).
- 36 The ruling also cited *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2d Cir. 1935) and *Keystone Consolidated Publishing Co. v. Commissioner*, 26 B.T.A. 1210 (1932), as authority for its holding.
- 37 See *supra* note 14.
- 38 See *supra* note 3.
- 39 Conference Report at 486.
- 40 Section 13521(b) of the Act.
- 41 Conference Report at 483 (referring to "clarification of the tax basis of life insurance contracts").
- 42 Section 101(a)(2)(A).
- 43 Section 101(a)(2)(B).
- 44 Section 13522(c) of the Act.

ACLI Update

By Pete Bautz, Paul Graham, Mandana Parsazad and Regina Rose

ACCOUNTING ISSUES FOLLOWING TAX REFORM

Tax reform created a multitude of accounting issues for life insurance companies. With a lower corporate rate enacted on Dec. 22, 2017 and effective on Jan. 1, 2018, little time was available for companies to determine the effects of all aspects of the new tax law on 2017 financial statements.

All U.S. accounting regimes require accounting for the effect of a rate change on the date of enactment. As a result, all deferred tax assets (DTAs) and liabilities (DTLs) had to be reassessed and restated for purposes of filing Dec. 31, 2017 GAAP and statutory financial statements. In addition, the tax effects of amounts held in Accumulated Other Comprehensive Income (AOCI) were also required to be restated. All changes resulting from tax reform had effects on either continuing operations, capital and surplus, or both for insurers.

The U.S. accounting standards setters immediately recognized the need to act quickly to provide necessary guidance for companies where accounting questions arose as a result of new tax law provisions. On the day President Trump signed H.R. 1 into law (the enactment date), the SEC issued Staff Accounting Bulletin (SAB) 118, allowing registrants to record provisional amounts during a “measurement period,” similar to the measurement period used when accounting for business combinations. During the measurement period, adjustments for the effects of the law must be recorded to the extent a reasonable estimate for all or a portion of the effects of the law can be made. To the extent that all information necessary (including computations) is not available, prepared or analyzed, companies may recognize provisional amounts. Companies are to adjust their provisional amounts when they obtain, prepare or analyze additional information about facts and circumstances that existed at the enactment date that, if known, would have affected the amounts that were initially reported as provisional amounts. Disclosures are required detailing the description and effects of estimates as well as the subsequent finalization of those estimates during the measurement period.

On Dec. 21, 2017, ACLI wrote to the Financial Accounting Standards Board (FASB) to request that it consider a more

accurate reflection of the impact of the tax rate change on balances in AOCI due to the large amount of investments carried at fair value in AOCI by our member companies. ACLI requested that FASB allow companies to reclassify amounts from AOCI to retained earnings to correct the mismatch between historical tax rates recorded in AOCI and the newly enacted tax rate. ACLI subsequently met with the FASB about this issue, and in early January, the FASB held a board meeting at the request of the banking and insurance industries to consider this item. At the same board meeting, FASB considered other tax reform implementation issues, including whether SAB 118 should be adopted for private companies and not-for-profit entities, whether to discount tax liabilities for repatriation and alternative minimum tax (AMT) credits that become refundable, and how to account for the new base erosion anti-abuse tax (BEAT) and global intangible low-taxed income (GILTI) provision.

During the FASB meeting, the members decided to permit, but not require, reclassification of stranded tax effects related to the newly enacted reduction in the corporate tax rate as well as other issues created by tax reform from AOCI to retained earnings. They also considered opening a broader project in the coming year to look further at allowing backwards tracing for accounting for the release of all past and future stranded tax effects in AOCI. They determined that neither the repatriation tax liability nor the AMT credit refund receivable should be discounted. The FASB determined the BEAT should be accounted for as a period cost and GILTI could be accounted for through a policy election as deferred taxes or as a period cost. Finally, the FASB determined that private companies and not-for-profit entities should have the option to apply SAB 118. After the meeting, the FASB staff issued an exposure draft on the reclassification of certain tax effects from AOCI, on which ACLI commented, and subsequently decided to proceed with drafting a final standard. They also released guidance in the form of staff Q&As on the repatriation, AMT, GILTI and BEAT tax accounting issues. The FASB Emerging Issues Task Force (EITF) briefly considered the staff Q&As on those issues, and there was general agreement among the members that the answers presented do not represent new guidance, but interpret what is already applicable in codification. The FASB has developed a webpage within the “STANDARDS—Implementing New Standards” site to house tax reform materials.

While the ACLI was working with the FASB to secure needed guidance for GAAP companies, the industry also recognized the need for immediate guidance from the National Association of Insurance Commissioners (NAIC) on statutory accounting matters post-tax reform. The Statutory Accounting Principles Working Group (SAPWG) exposed (via e-vote) agenda item 2018-01 to consider the impact of the Tax Cuts and Jobs Act (TCJA) on *SSAP No. 101—Income Taxes*. However, the ACLI was



more immediately concerned with a few other pressing matters affecting 2017 financial statements resulting from tax reform.

The ACLI contacted the NAIC, asking them to adopt SAB 118 immediately for statutory accounting purposes. SAPWG Chair Dale Bruggeman quickly issued a letter to all state insurance commissioners on Jan. 8, addressing the impacts of tax reform on statutory financial statements. Mr. Bruggeman advised states that DTAs and DTLs (i) should be computed using the newly enacted tax rate of 21 percent for year-end 2017 financial statements, and (ii) the change in DTAs and DTLs to reflect the new tax rate should be recognized in the designated reporting line as a separate component of gains and losses in unassigned funds (surplus). He further noted that guidance for admittance calculations for the year-end 2017 statutory financial statements would not change, but companies might have to take into account the elimination of the net operating loss carryback provisions as they assessed reversals of DTAs and DTLs.

Subsequent to Mr. Bruggeman's letter to state insurance commissioners, the ACLI worked through the NAIC Interested Parties on a letter to the SAPWG and spoke with the NAIC staff to request formal, authoritative guidance on the adoption of guidance consistent with SAB 118 and clarification regarding how and when to record the effects of changes in tax rates. Subsequently, the NAIC staff issued interpretive guidance (INT 18-01) to provide a limited-time, limited-scope exception to the Type I subsequent event guidance in SSAP No. 9 and to specify the reporting lines for reporting changes related to tax rate changes. The ACLI commented on the items in the INT

though the NAIC Interested Parties and the SAPWG voted to adopt the INT with the changes suggested by the ACLI and Interested Parties.

As noted above, SAPWG exposed an agenda item to consider the impact to SSAP 101 of changes made in TCJA. On Feb. 6, SAPWG modified the exposure to include updated NAIC staff recommendations in response to FASB exposed accounting guidance and FASB staff interpretations pertaining to federal tax reform that were released by the FASB after the original exposure of agenda item 2018-01. ACLI and member companies joined with NAIC Interested Parties on a Feb. 20 comment letter that addressed the SSAP 101 proposed changes as well as the NAIC response to FASB guidance on accounting for repatriation, AMT credit refunds, BEAT and GILTI. The comment letter generally agreed with NAIC that because, as noted in the exposure draft, SSAP No. 101 already makes references to enacted tax rates and tax law loss carryback provisions, the necessary revisions to SSAP No. 101 for the tax law changes are minor and non-substantive in nature. On March 24, ACLI presented its comments and answered questions from SAPWG at its hearing on SSAP 101 during the March NAIC meeting. At that hearing, SAPWG decided to re-expose, for a 30-day period, revisions to SSAP No. 101 that largely incorporate Interested Parties' comments. However, two items—treatment of AMT credit carryovers and accounting for GILTI tax—were deferred for consideration as separate agenda items.

ACLI and NAIC Interested Parties reviewed the March 24 re-exposure and in their April 23 comment letter, reiterated the positions set forth in previous comment letters, and responded to a request for comments by SAPWG on the assessment by companies of reversal patterns of deferred tax items as a result of TCJA.

ACLI looks forward to continuing to work collaboratively with SAPWG regarding accounting changes that are needed or would be helpful as a result of the TCJA.

UPDATE ON CAPITAL/RBC ISSUES POST-TAX REFORM

The new tax law has a significant impact on risk-based capital (RBC) requirements at companies. The impact of the law on RBC results from both the drop in the federal corporate income tax rate from 35 percent to 21 percent and the reduction in the value of DTAs (also attributed to the tax rate drop as well as the elimination of net operating loss carrybacks).

The ACLI spent several months working with a group of member company actuarial, tax and accounting personnel regarding the changes required to adjust RBC ratios to reflect the newly enacted 21 percent corporate tax rate.

The 35 percent tax rate is currently hard-coded into many aspects of the RBC ratio calculations. Therefore, the NAIC must make some changes to restate RBC requirements using a 21 percent enacted tax rate. While in many cases the new tax rate will simply flow through the calculations, there are a few instances where a significant modeling effort is likely needed to accurately reflect the new tax rate. The changes are required because of the tax rate reduction interaction with the C-1 (asset default risk) and C-2 (mortality and morbidity risk) RBC factors that are modeled using tax cash flows and after-tax discount rates. For example, ACLI has determined that the move from a 35 percent to 21 percent maximum federal tax rate could reduce the C-1 bond factors recently proposed by the AAA by as much as 3.2 percent, partially offsetting the impact to RBC ratios that would occur from the corporate income tax rate drop alone. For the purposes of expediency, it appears that the NAIC will estimate these impacts by reducing certain pre-tax factors by 3 percent, with the knowledge that the more accurate impact will be incorporated in upcoming NAIC projects to update RBC factors for bonds, real estate and mortality risk.

Additionally, ACLI determined that the C-3 (interest rate disintermediation risk—non-modeled) and C-4a factors (general business risk) were not originally developed with tax cash flows, but were point estimates of post-tax factors based on judgment. Therefore, ACLI recommended that these factors themselves be reduced by the same amount as the reduction in tax offset from the new tax rate. These recommendations might reduce by about half the increase (which otherwise could be as much as 20 percent at companies) in capital requirements required by tax reform.

On Feb. 12, ACLI sent a letter to the NAIC addressing the impact of federal tax reform legislation on RBC. The letter concluded that overall, the impact of tax reform on the RBC calculation is significant, noting that there are factor changes that would increase RBC and factor changes that partially offset the increase. ACLI recommended that the impact of the increases and the offsets be implemented at the same time, and due to the complexity of some of the changes, that the target date for completion be 2019. Also, the letter noted that one particular use of RBC that will need recalibrating is the minimum 450 percent RBC ratio requirement for the small company exemption within

the principle-based reserve (PBR) requirements. ACLI recommended that the 450 percent RBC requirement be decreased to 360 percent (with the final number subject to review after other RBC changes are completed).

The impact of federal tax reform on RBC was addressed at the recent NAIC meeting, where regulators were not willing to rule out getting all items changed for 2018 filings. They did commit, however, to not implementing the changes in a piecemeal fashion. While they also acknowledged that it would be difficult to complete everything for this year's deadlines of exposure by April 30 and adoption by June 30, significant work effort has been undertaken by the NAIC to meet those deadlines, and it has become more likely than not that the changes to RBC will go into effect for 2018 RBC calculations. The RBC work through the NAIC is fast-moving and this article only represents the status as of the end of April 2018. ■

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T³: TAXING TIMES Tidbits

IRS Updates Post-Age-100 Guidance

By John T. Adney

Eight years ago, in Revenue Procedure 2010-28, 2010-34 I.R.B. 270, the Internal Revenue Service established “safe harbor” rules for calculations of net single premiums and guideline premiums under section 7702¹ and 7-pay premiums and necessary premiums under section 7702A in the case of life insurance contracts that (1) have mortality guarantees based on the 2001 Commissioners’ Standard Ordinary Mortality Tables (2001 CSO tables) and (2) may continue in force after the day on which the insured attains age 100. Last February, the Internal Revenue Service issued Revenue Procedure 2018-20, 2018-11 I.R.B. 427, extending these safe harbor rules to “life insurance contracts that have mortality guarantees based upon not only the 2001 CSO tables, but also upon the 2017 CSO tables and any other prevailing commissioners’ standard tables that extend beyond age 100.”

By way of background, in order for a contract that is a life insurance contract under applicable law to be treated as a life insurance contract for federal tax purposes, section 7702 requires that the contract’s cash surrender value must not (by the contract’s terms) exceed the net single premium for its death benefit at any time. If that is not the case, then at minimum the gross premiums paid for the contract cannot exceed the guideline premium limitation as defined in section 7702. Also, assuming the contract meets one of these rules, the premiums paid for it as of any time cannot exceed the cumulation of the 7-pay premiums as defined for the contract under section 7702A if the contract is not to be classified as a “modified endowment contract,” which would result in a more adverse tax treatment of distributions from the contract while the insured is living. And to avoid treating a benefit increase under the contract as a “material change” within the meaning of section 7702A, re-submitting the contract to the 7-pay premiums’ limit, the premiums paid cannot exceed the “necessary premium” referenced in the statute’s material



change rule. All of these calculated limits—the net single premiums, guideline premiums, 7-pay premiums and necessary premiums—have in common the “maturity date” requirement of section 7702(e)(1)(B). Pursuant to that requirement, these premiums must be computed assuming that the contract matures no earlier than when the insured attains age 95 and no later than the insured’s 100th birthday. When section 7702 was enacted (in 1984), the assumption that the contract would be at an end by the time the insured reached age 100 aligned with the assumption in the official mortality tables then in use, *i.e.*, the 1958 and 1980 CSO tables.

But along came the 2001 CSO tables in the first decade of the 21st century, with all lives no longer assumed to end by age 100. Those tables contained a limiting age, but a much higher one—age 121. As a result of this change, companies that issue life insurance contracts with maturity dates now typically use age 121 as their terminal dates (and, as was previously the case, other contracts do not specify a maturity date). These changes in contract design prompted questions regarding how contracts with age 121 maturity dates should be administered under sections 7702 and 7702A in light of the maturity date requirement of section 7702(e)(1)(B). Some wondered whether it was permissible to use a contract's actual maturity date in the statutes' calculations, even though that date exceeded the maximum deemed maturity date specified in section 7702(e)(1)(B), while others were concerned with how the tests should be applied technically assuming the maximum age of 100 controlled. How, it was asked, should a 7-pay premium be calculated in circumstances where a contract was materially changed less than 7 years before the insured reached age 100?

In 2005, the Taxation Section of the Society of Actuaries formed the 2001 CSO Maturity Age Task Force (SOA Task Force) to study the effect section 7702's requirement of a deemed maturity date not later than the insured's age 100 would have on a contract providing coverage through the end of the 2001 CSO tables. The SOA Task Force proposed methodologies, published in the May 2006 issue of *TAXING TIMES*, that would be actuarially acceptable under sections 7702 and 7702A for calculations under contracts that do not provide for actual maturity by or before age 100. Others in the life insurance industry requested such guidance from the government, and there followed the issuance of Notice 2009-47² by the Treasury Department and the IRS, setting forth safe harbor rules—denominated the “Age 100 Safe Harbor Testing Methodologies”—modeled on the SOA Task Force recommendations. The Notice also requested comments on certain tax issues that could arise where a life insurance contract continues beyond the insured's age 100. The virtues of, and problems in, this Notice were explored in an article published in *TAXING TIMES* in September 2009.³

Following considerable back and forth between life insurance industry representatives and the government, the IRS published Revenue Procedure 2010-28 in August 2010,⁴ in most key respects adopting the safe harbor rules described in Notice 2009-47. In doing so, Revenue Procedure 2010-28 specifically referenced the role of the SOA Task Force and the publication of its recommendations in *TAXING TIMES*. By its terms, the revenue procedure applied—and provided a safe harbor—only with

respect to sections 7702 and 7702A and only for contracts based on the 2001 CSO tables that may continue in force after the insured attains age 100. More specifically, Revenue Procedure 2010-28 stated that the IRS “will not challenge the qualification of a contract as a life insurance contract under section 7702, or assert that a contract is a [modified endowment contract] under section 7702A, if the contract satisfies the requirements of those provisions using all of the ‘Age 100 Safe Harbor Testing Methodologies.’” In this connection, the 2010 revenue procedure made it clear that to take advantage of its safe harbor, all calculations under sections 7702 and 7702A (other than the cash value corridor) must assume the contract's maturity by the insured's age 100, notwithstanding a later contractual maturity date; the remainder of the safe harbor methodologies were keyed to this assumption. Thus, pursuant to the revenue procedure, the date the insured attains age 100 must be used as the maturity date for calculating net single and guideline premiums as well as necessary premiums; to determine the guideline level premiums, premium payments must be assumed to be made through the day the insured attains age 99; and under section 7702A, in the case of a contract issued or materially changed within fewer than seven years of the day the insured attains age 100, the 7-pay premiums must be computed assuming level annual premium payments over the number of years between the date the contract is issued or materially changed and the date the insured attains age 100. In addition, the cumulation of the guideline level premiums and the 7-pay premiums must stop by the time the insured reaches age 100, although premiums may continue to be paid and, if so, must be tested against those “frozen” limits.

Revenue Procedure 2010-28 thus clarified many section 7702 and 7702A computational issues presented by contracts based on the 2001 CSO tables. It also provided guidance for administering the statutes' rules for contracts that undergo changes in their benefits. And while the 2010 revenue procedure provided its safe harbor only if all of its age 100 testing methodologies were followed, it made crystal clear, as the life insurance industry urged, that it was indeed a safe harbor. In the revenue procedure's own words, “[n]o adverse inference should be drawn with respect to the qualification of a contract as a life insurance contract under § 7702, or its status as not a MEC under § 7702A, merely by reason of a failure to satisfy all of the requirements” of the testing methodologies. Additional detail on Revenue Procedure 2010-28, including illustrations of the effects of its rules, may be found in an article published in *TAXING TIMES* in 2011.⁵

The issuance of Revenue Procedure 2010-28 seemingly settled the questions regarding section 7702's age 100 maturity date

requirement for a number of years, but then the 2017 CSO tables arrived when new VM-20 became effective on Jan. 1, 2017. Since the 2010 revenue procedure by its terms addressed only contracts based on the 2001 CSO tables, the prior questions theoretically became pertinent once again.

And this development brings us to Revenue Procedure 2018-20. The new revenue procedure recites the history of and rationale for the issuance of the 2010 revenue procedure, acknowledging (as did its predecessor) the role played by the SOA Task Force in formulating the Age 100 Safe Harbor Testing Methodologies. Revenue Procedure 2018-20 also sets out all of those methodologies in full, as it now (effective Feb. 23, 2018) replaces its predecessor as the official statement of the age 100 testing methodologies; it “modifies and supersedes” Revenue Procedure 2010-28. Additionally, mirroring its predecessor, the new revenue procedure repeats *verbatim* the “no inference” language quoted above.

Most importantly, as noted at the outset, Revenue Procedure 2018-20 extends all of this to the 2017 CSO tables and to all future CSO tables that provide mortality rates beyond age 100. To quote from the operative wording of the new procedure, the safe harbor provided under its predecessor is made available “to life insurance contracts that (1) have mortality guarantees based upon prevailing commissioners’ standard tables that extend beyond age 100, such as the 2001 CSO tables and the 2017 CSO tables, and (2) may continue in force after the day on which the insured individual attains age 100.” In so stating, Revenue Procedure 2018-20 cites to the meaning of “prevailing commissioners’ standard tables” as defined in section 7702(f)(10) as added by section 13517 of Public Law 115-97, becoming the first official IRS pronouncement to reference section 7702 as amended by the 2017 tax legislation.

The IRS is to be commended for issuing Revenue Procedure 2018-20, which represents a good step forward. The new revenue procedure is helpful to life insurers and others charged with assuring the section 7702 and 7702A compliance of life insurance contracts, who otherwise would be concerned with the same questions that spawned the drafting of the age 100 testing methodologies in the first place. It also represents a sound approach to tax administration by looking beyond the newest CSO tables and making the safe harbor available to all contracts based on prevailing commissioners’ standard tables that extend beyond age 100. Insofar as mortality tables are anticipated to change in the future and perhaps to do so more frequently, the approach taken by the IRS in Revenue Procedure 2018-20 provides greater certainty going forward while reducing the need for further official guidance on this topic. ■

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ENDNOTES

- 1 Unless otherwise noted, all references to “section” are to provisions of the Internal Revenue Code of 1986, as amended (the “Code”).
- 2 2009-24 I.R.B. 1083.
- 3 John T. Adney, Craig R. Springfield, Brian G. King and Alison R. Peak, “IRS Issues Proposed Safe Harbor Prescribing ‘Age 100 Methodologies,’” *TAXING TIMES*, Vol. 5, No. 3, at p. 19 (September 2009).
- 4 2010-34 I.R.B. 270.
- 5 John T. Adney, Craig R. Springfield, Brian G. King and Alison R. Peak, “Life Beyond 100: Rev. Proc. 2010-28 Finalizes the ‘Age 100 Methodologies’ Safe Harbor,” *TAXING TIMES*, Vol. 7, No. 1 (February 2011).

Synopsis of Frequently Asked Questions Paper on Tax Reserve Methods and Assumptions

By the Tax Work Group of the Life Practice Council of the American Academy of Actuaries, Barbara Gold, Chairperson

The Tax Work Group of the Life Practice Council of the American Academy of Actuaries has received questions about how changes to actuarial assumptions as part of reserving methods prescribed by the NAIC may impact the determination of deductible amounts for tax reporting. As a result, the Tax Work Group has prepared a frequently asked questions (FAQ) paper that discusses Tax Reserve Methods and Assumptions.

The FAQ paper describes various questions concerning changes in methods, factors and assumptions used in the calculation of statutory reserves, and what the impact of such changes might be on the methods, factors and assumptions used in the determination of tax-deductible reserves. The FAQ paper is focused on the Internal Revenue Code effective during 2017. The Tax

The FAQ Paper describes various questions concerning changes in methods, factors, and assumptions used in the calculation of statutory reserves.



Work Group identifies a number of open issues that do not have clear IRS guidance, and offers commentary based on tax reserve principles of general applicability.

The FAQ paper may be accessed at http://www.actuary.org/files/publications/Academy_Tax_FAQ_on_Life_Insurance_Tax_Reserve_Methods_and_Assumptions.pdf. ■

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