Session 139: Company Tax Hot Topics

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Session 139: Hot Topics in Life Insurance Reserves
October 29, 2019

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Agenda

- Life Insurance Reserve Issues
  - TCJA changes
  - New guidance on changes in basis
  - New guidance on interest rate election
- Loss Reserve Discounting
- What comes next?

Hot Topics in Life Insurance Reserves

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Life Insurance Reserves

- Background
  - Amendments changes to the rules for life reserves
    - Amendments to section 807(c)
    - Amendments to section 807(d)
    - Amendments to section 807(f)
  - Accounting Methods versus Changes in Reserve Basis (historic)
- New guidance
  - Rev. Proc. 2019-10
  - Rev. Proc. 2019-34
- The big unanswered questions
  - Section 446 versus sections 811(a) and 807(f): is there an agenda?
  - Rev. Rul. 94-74 – when will IRS update existing guidance?
- CCA 201933003: New guidance, Old Law

Amendments to section 807(c)(3) Insurance contracts w/o contingencies

- Pre-TCJA
  - Highest of (when contingencies lapse)—
    - AFIR
    - PSAIR
    - Assumed by company to determine guaranteed benefit
- Post-TCJA
  - Highest rate permitted by NAIC when reserve determined
- Rev. Proc. 2019-34 will be covered in later slides

Amendments to section 807(d) Life Insurance Reserves

- Pre-TCJA
  - NAIC Tax Reserve Method (CRVM, CARVM)
  - Prescribed interest rate
  - Prescribed mortality/morbidity tables
  - Assumptions locked in on issuance
  - Federally-prescribed reserve, bounded by stat cap and NSV floor
- Post-TCJA
  - NAIC Tax Reserve Method (CRVM, CARVM)
  - Interest rate generally equals stat rate
  - No prescribed mortality/morbidity tables
  - Assumptions at valuation date (date reserve is determined)
  - Tax reserve of 92.81% of CRVM/CARVM stat reserve, bounded by stat cap and NSV floor
  - Special rules for variable contracts, non-cancellable/guaranteed renewable contracts

Amendments to section 807(d), Life Insurance Reserves, continued

- The TCJA did not change other features of section 807(d)
  - Definition of life insurance reserves
  - Application of statutory reserves cap
  - Section 811 rules, including treatment of reserves attributable to deferred and uncollected premiums
- Transition Rule
  - For the first taxable year beginning after December 31, 2017, the reserve at the end of the preceding taxable year shall be determined as if the amendments made by this section had applied to such reserve in such preceding taxable year.
  - Reserve transition adjustment is computed as of December 31, 2017, and reported ratably over 8 years.
- Rev. Proc. 2019-34 will be covered in later slides

Amendment to Section 807(f) Changes in reserve basis

- (f) ADJUSTMENT FOR CHANGE IN COMPUTING RESERVES

  (1) TREATMENT AS CHANGE IN METHOD OF ACCOUNTING.—If the basis for determining any item referred to in [section 807(c)] as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

  (A) the amount of the item at the close of the taxable year, computed on the new basis, and

  (B) the amount of the item at the close of the taxable year, computed on the old basis,

  as is attributable to contracts issued before the taxable year shall be taken into account under ~~the method provided in subparagraph (b)~~ section 481 as adjustments attributable to a change in method of accounting initiated by the taxpayer and made with the consent of the Secretary.

- Effective for tax years beginning after December 31, 2017.

Amendment to Section 807(f) Changes in reserve basis, continued

Conference Report:

Income or loss resulting from a change in method of computing life insurance company reserves is taken into account *consistent with IRS procedures*, generally ratably over a four-year period, instead of over a 10-year period. (emphasis added)

Blue Book:

Consistent with IRS procedures, a company that makes a change in method of computing life insurance reserves is required to comply with procedures for automatic method changes and is required to report and file such statements and other information as the Secretary requires under those procedures.

Change in accounting method versus change in reserve basis

- Change in accounting method with permission (Rev. Proc. 2015-13)
  - Permission generally required
  - Form 3115 – user fee
  - Computation of section 481(a) adjustment
    - BOY determination
    - 1 year or 4 years
  - Consent agreement
  - Audit protection and ruling protection
- Change in accounting method, automatic (Rev. Proc. 2018-31)
  - Satisfy conditions, permission automatically granted
  - 1 year or 4 years
  - Abbreviated Form 3115
  - Audit protection and ruling protection
- Special rules for triggering 481(a) adjustment

Change in accounting method versus change in reserve basis

- Section 807(f) (historic)
  - No permission required
  - No Form 3115 filed
  - No audit protection
  - Ability to change basis by amended return
- Rev. Proc. 2019-34 will be covered in later slides

Revenue Procedure 2019-10 addresses routine changes in basis going forward

- Addition to “Mass Automatic” revenue procedure for changes in accounting method governs section 807(f)
- Key Features
  - Abbreviated Form 3115 filing, like other automatic changes
  - 1-year or 4-year spread for section 481(a) adjustments, like other automatic changes
  - Netting for the same “type” of contract (life or annuity)
  - Audit protection, but no ruling protection

Revenue Procedure 2019-10 addresses routine changes in basis going forward

- Implementation Issues
  - Netting of adjustments for the same “type” of contract
  - Description of changes in basis- a learning curve
  - Use of estimates by taxpayers under examination
  - Changes that result from changes in administrative system
- Background section references only section 446
  - What about sections 807(f) and 811(a)?

Revenue Procedure 2019-34 gives automatic permission to comply with TCJA

- Automatic permission to change methods of accounting to comply with TCJA changes to 3 provisions:
  - Section 807(d) (Life insurance reserves) – 8 years spread, no audit protection
  - Section 807(c)(3) (Interest rate) – 1- or 4-year spread, audit protection
  - Section 848 (DAC) – no spread because implemented on a cutoff basis, audit protection
- No Form 3115 required
  - A company that complies correctly need not do anything it would not have done anyway
- One-time procedure applies only for TCJA-required changes
  - IRS took a similar approach to TCJA amendment to section 451(b)
  - Query why permission is needed to comply with an amendment to the Code
  - Would a formal 3115 be required for future amendments to the Code if no automatic procedure were published?

Revenue Procedure 2019-34 gives automatic permission to comply with TCJA

- “If you do what you were already planning to do, you don’t have to file Form 3115 that you didn’t think was required”
- How could there possibly be implementation issues, right?
  - Why no audit protection for life insurance reserves?
  - Treatment of transition adjustments as “section 481(a) adjustments”
  - Confusion about the relationship between Rev. Proc. 2019-10 and 2019-34
- Background section references only section 446
  - What about sections 807(f) and 811(a)?

Why do the revenue procedures refer to section 446 rather than sections 807 and 811(a)?

Section 446.-General Rule for Methods of Accounting

(a) General rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exception.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) Permissible methods.—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

> (1) the cash receipts and disbursements method;
>
> (2) an accrual method;
>
> (3) any other method permitted by this chapter;

* * *

(e) Requirement Respecting Change of Accounting Method.—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

Why do the revenue procedures refer to section 446 rather than sections 807 and 811(a)?

Section 811. Accounting Provisions

(a) Method of Accounting.—All computations entering into the determination of the taxes imposed by this part shall be made—

> (1) Under an accrual method of accounting, or
>
> (2) To the extent permitted under regulations . . . Under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

To the extent not inconsistent with the preceding sentence or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the NAIC.

Why do the revenue procedures refer to section 446 rather than sections 807 and 811(a)?

Section 807

(d) Determination of Reserve.

* * *

(f) Adjustment for Change in Computing Reserves.

(1) TREATMENT AS CHANGE IN METHOD OF ACCOUNTING.—If the basis for determining any item referred to in [section 807(c)] as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

(A) the amount of the item at the close of the taxable year, computed on the new basis, and

(B) the amount of the item at the close of the taxable year, computed on the old basis, as is attributable to contracts issued before the taxable year shall be taken into account under section 481 as adjustments attributable to a change in method of accounting initiated by the taxpayer and made with the consent of the Secretary.

Why do the revenue procedures refer to section 446 rather than sections 807 and 811(a)?

- What between section 446 and sections 811(a) and 807(f) are most important?
  - Annual statement as starting point versus Secretary determination of clear reflection of income
  - Permission needed for change versus requirement to change to follow NAIC annual statement
  - Annual statement determinations control such concepts as solvency reserves, asset adequacy reserves
- Is there an agenda in the revenue procedures, or simply an inartful summary of the underlying provisions? Further guidance under section 807 is anticipated in the IRS/Treasury Department Priority Guidance Plan

When will IRS update Rev. Rul. 94-74?

- Rev. Rul. 94-74 provided guidance on what constitutes a change in basis of computing reserves, and what does not constitute a change in basis
  - Situation 1-Change in mortality tables is a change in basis.
  - Situation 2-Change in interest rate is a change in basis.
  - Situation 3-Change from curtate to continuous is a change in basis.
  - Situation 4-Addition of previously-omitted contracts is a correction of a mathematical or posting error.
- Changes in basis may be made in earliest open year.

When will IRS update Rev. Rul. 94-74?

- What has changed?
    - Tax
        - Interest rate is no longer prescribed
        - Mortality/morbidity tables no longer prescribed
        - Changes in manner of implementing change (Amended return?)
    - Non-tax
        - Adoption of new Valuation Manual
        - Routine updates anticipated by the Manual itself?
        - When is an assumption part of a method?
    - What else could the IRS address?

CCA 201939033
Old Law, New Guidance

- Before TCJA
  - Federally Prescribed Reserve (subject to cap and floor)
    - Tax Reserve Method
    - Prevailing (26-state) mortality/morbidity tables
    - Greater of PSAIR (26-state) or AFR
  - Company could elect to redetermine AFR every 5 years, permission needed to revoke
    - Few companies made the election
    - Two companies revoked in past 5 years or so
    - Provision repealed by TCJA
    - Renewed interest due to decrease in tax rate

CCA 201939033
Old Law, New Guidance

- The CCA
  - Company elected in 2017
  - Original plus 3 amended returns
  - All contracts issued after 1987
- IRS response
  - No election on amended returns
  - Apply to only 5 years of contracts
  - No practical effect because PSAIR > AFIR anyway
- What's next on this issue?

Hot Topics in Loss Reserve Discounting

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Loss Reserve Discounting (LRD)

- Insurance companies may immediately deduct unpaid loss reserves and loss adjustment expenses for income tax purposes.
- Insurers are required to discount their loss reserves and salvage & subrogation (S&S) under IRC 846 in order to reduce the timing benefit.
    - Losses and S&S are discounted by accident year (AY) and line of business (LOB) based on Schedule P data.
    - Discount factors based off loss payment patterns and prescribed interest rate
        - Loss payment patterns are based on industrywide aggregate payment patterns.
        - Interest rate historically benchmarked off of single average Treasury bond rates
    - Short- and long-tail lines generally discounted over different periods.
- For administrative ease, the IRS calculates and publishes the factors (broken out by AY & LOB) on an annual basis.

LRD: Overview of Recent Changes

- Variety of changes to loss reserve discounting rules since passage of TCJA
  - Statutory changes (TCJA section 13523), December 2017
  - Proposed regulations (REG-103163-18), November 2018
  - Rev. Proc. 2019-06, December 2018
  - Final regulations (T.D. 9863), June 2019
  - Rev. Procs. 2019-30 and -31, July 2019

LRD and the TCJA

- Shift of Applicable Interest Rate from treasury rates to corporate bond yield curve.
- Repeal of custom payment pattern election.
- Extension of long-tail lines from 15 to 24 years.
- Repeal of carveout for international and non-proportional reinsurance LOBs
- 8-year transition rule under 13523(e)

Proposed Regulations (REG-103163-18)

- Released November 2018
- Major changes:
  - Expand maturity window for Applicable Interest Rate from 3.5-9 years to .5-17.5 years
  - Adoption of loss payment pattern “smoothing mechanism”
  - Repeal of the “composite method” under Notice 88-100
  - Alignment of discounting rates for LRD and S&S
- Significant pushback on maturity range and repeal of composite method from commenters

Rev. Proc. 2019-06

- Released December 2018
- Provides TCJA discount factors for 2017, 2018, and forward.
- Relies on interest rate window from proposed regulations.
- Provides both composite factors and factors out 24 years for long-tail lines.
- Treats reinsurance and international LOBs as short-tail lines.
- Provides preliminary guidance should new factors be released

Final Regulations (T.D. 9863)

- Released June 2019
- Narrows maturity window to 4.5-10 years
  - No periodic redetermination of maturities
- Permanently reinstates composite method
- Adopts S&S alignment and smoothing mechanism as proposed
- International and reinsurance treated as short-tail LOBs
- Future guidance to provide for automatic method change

Rev. Proc 2019-30 and Rev. Proc. 2019-31

- Rev. Proc. 2019-31
  - Provides "Revised" discount factors updated for final regulations for 2017, 2018, and 2019.
  - Interest rate for 2017 and 2018 drops from 3.12% to 2.94%.
  - Discount factors generally increased .1-.75%.
- Rev. Proc. 2019-30
  - Adoption of TCJA discounting rules are an automatic method change under section 446(e) and related regulations.
    - Taxpayers adhering to the guidance are not required to file Form 3115.
    - Interplay with statutory transition rule.
    - Potential accelerating events (cross-reference to Rev. Proc. 2015-13).

Rev. Proc. 2019-30 (cont.)

- Taxpayer may adopt “Proposed Factors” or “Revised Factors” for 2018 return.
  - Taxpayer using Proposed Factors must calculate Remainder and Supplemental Adjustments beginning in 2019.
  - Remainder: Difference in TCJA transition adjustment between Proposed and Revised factors, spreadable over 7 years.
  - Supplemental: Difference in 2018 activity between Proposed and Revised factors, can be included in 1 year or spread over 7 at taxpayer’s discretion
- S&S not subject to 8-year spread. Can be taken under 481(a) (4/1 rule) or accelerated into income in 2018.

LRD Discussion

- 481(a) treatment vs. standalone transition rule
- Reinsurance and international issues
- Interplay of TCJA transition and ancillary method changes
- Market observations

What Comes Next?

Additional Guidance on section 807

- Section 807
  - Guidance on asset adequacy reserves
    - “What remains to be said?”
  - Guidance on reserve and separate account reporting
    - “Well, which is it?”
  - Administrative cleanup of old guidance
    - “For future generations!”

What about section 954(i)?

- Special rules apply for purposes of computing taxable income of certain offshore companies
- The rules were not amended to keep up with TCJA changes to the rules for domestic insurers
- Pending guidance, different companies are taking different approaches
- Issues require close collaboration between actuaries and tax department, future guidance may require changes

Net Operating Losses

- Guidance on net operating losses
  - TCJA amended rules for NOLs, guidance is likely on the transition
  - What is the treatment of NOLs generated pre-TCJA
  - As a result of the TCJA amendments, different rules apply to nonlife insurance companies and all other taxpayers. How will those rules apply in a consolidated return context?
  - What is the status of the Life-Nonlife consolidated return regulations, will those ever be updated?

Guidance on Life Settlement Transactions

- TCJA provisions generally supported by the industry
- Proposed regulations were published, final regulations are rumored to be "close"
- Section 6050Y
  - Form 1099-LS
  - Form 1099-SB
  - Company readiness to comply
- Section 101- Transfers for value
  - The problem of "indirect transfers"
  - Favorable proposed regulations
  - Problems with effective date- Whither the transaction that predates final regulations?

International provisions

- Although we have focused on domestic/reserve issues in this session, international corporate issues were a major focus of the TCJA
- These provisions drove significant changes in corporate behavior and transactions, and guidance continues to come out:
    - PFIC
    - BEAT
    - GILTI
    - Other

Questions?

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