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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 ■

Daniel Stringham, J.D., LL.M., is a vice president and corporate counsel of Prudential Financial and may be reached at daniel.stringham@prudential.com.

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.