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Discounted Unpaid Losses: A Rate or a Curve?

By Kristin Norberg

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

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. 115-97[2] (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 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 timeframe, 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.

Kristin Norberg, FSA, MAAA, is director of actuarial tax at Symetra Life Insurance Company and may be reached at *kristin.norberg@symetra.com*.

ENDNOTES

1 References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended through the date of this writing.

2 "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.

3 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.

4 *See* current I.R.C. §846(e)(6)(B) and prior I.R.C. §846(f)(6)(B).

5 *See* prior I.R.C. §846(c) and I.R.C. §1274(d).

6 I.R.C. §430(h)(2)(D)(i).

7 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).

8 2018-11 I.R.B. 425 (January 2018). Rates are published for maturities in half-year increments from 0.5 to 100 years.

9 2017-49 I.R.B. 556 (November 2017).

10 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.

11 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.