New Regulations Provide Guidance on Computation and Reporting of Reserves

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Editor's note: As this article was going to press, the Internal Revenue Service and Treasury released a Treasury decision that includes final regulations[1] based on the proposed regulations discussed in this article. Departures from the proposed regulations are noted after the discussion of each section of the regulations.

Together with the final regulations, the IRS also issued Rev. Rul. 2020-19, providing updated guidance on changes in basis of computing life insurance reserves under section 807(f) of the Internal Revenue Code. The situations set forth in the ruling are summarized here and will be the subject of a more detailed article in a future issue of TAXING TIMES.

On April 2, 2020, the Internal Revenue Service ("IRS") and Treasury Department published proposed regulations in the Federal Register[2] to provide guidance on the computation of life insurance reserves and changes in basis of computing certain reserves of insurance companies. These proposed regulations implement amendments to the Internal Revenue Code ("Code") made by the Tax Cuts and Jobs Act ("TCJA") in 2017.[3] The project has appeared on the Treasury/IRS Priority Guidance Plan since the TCJA was enacted.

This article summarizes the proposed regulations and provides an overview of comment letters on the regulations. Four organizations submitted a total of five comment letters: American Council of Life Insurers ("ACLI"); American Academy of Actuaries ("AAA"); EY, LLP; and ScribnerHall.[4]

EXPLANATION OF PROVISIONS

The preamble to the proposed regulations provides background and an explanation of the regulations' provisions. In particular, the preamble divides the explanation of the provisions of the proposed regulations into seven categories:

A. Computation of life insurance reserves
B. Reporting of reserves
C. Change in basis of computing reserves
D. Definition of life insurance reserves
E. Electronic filing of annual statements
F. Proposed removal or revision of regulations with no future application
G. Proposed conforming changes to regulations

A. COMPUTATION OF LIFE INSURANCE RESERVES—PROP. REG. § 1.807-1

Section 807(d) sets forth the rules for computing tax deductible life insurance reserves. The TCJA made significant revisions to section 807(d) to accommodate National Association of Insurance Commissioners ("NAIC")-prescribed principle-based reserve ("PBR") methodologies, and to provide for a tax reserve

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method that is simpler, more transparent and easier to compute than under prior law.[5] Although no definition of asset adequacy reserves ("AAR") is included in the Code itself, both the TCJA Conference Report and the Blue Book observe that before and after the TCJA, AAR are not included in deductible reserves. Consistent with the discussion in both reports, the proposed regulations memorialize this rule and provide guidance on the definition of AAR. In its entirety, § 1.807-1(a) of the proposed regulations provides as follows:

> (a) *No asset adequacy reserve*. The life insurance reserve determined under section 807(d)(1) does not include any asset adequacy reserve. An asset adequacy reserve includes any reserve that is established as an additional reserve based upon an analysis of the adequacy of reserves that would otherwise be established or any reserve that is not held with respect to a particular contract. In determining whether a reserve is a life insurance reserve, the label placed on such reserve is not determinative, provided, however, any reserve or portion of a reserve that would have been established pursuant to an asset adequacy analysis required by the National Association of Insurance Commissioner's Valuation Manual 30 [("VM-30")] as it existed on December 22, 2017, the date of enactment of Public Law 115-97, is an asset adequacy reserve.

This section of the proposed regulations would replace existing § 1.807-1, which provided guidance on mortality and morbidity tables to be used under pre-TCJA section 807(d)(2).[6] It would apply to taxable years beginning on or after the date final regulations are published.

The ACLI comments suggest that the regulation would provide clearer guidance if it began by addressing how life insurance reserves are determined before stating that such reserves exclude AAR. For example, the regulation could lead with a section that lays out how life insurance reserves are determined under section 807(d) as a general matter, before prescribing a rule for AAR. Additionally, the ACLI comments suggest that the regulations could clarify (1) that reserves determined using the Commissioners' Reserve Valuation Method ("CRVM") do not include an AAR component even if they are determined using a principle-based method;[7] (2) that an AAR is "in addition to" other reserves required by the Valuation Manual, including CRVM and Commissioners' Annuity Reserve Valuation Method ("CARVM") reserves, which constitute the tax reserve method for applicable contracts under section 807(d)(3) and therefore are deductible; and (3) that additional reserves determined under VM-30 would be included in AAR (as already provided in the proposed regulations). Assuming the IRS and Treasury agree with these comments, it would also be more natural for the regulation to define what AAR "is," rather than what it "includes."

The ACLI comments also suggest that the reference to "a particular contract" should be eliminated because the fact that a reserve is not allocated to a specific contract is not determinative to a reserve being classified as a nondeductible AAR. For example, incurred but not reported ("IBNR") reserves for future unaccrued claims under individual disability contracts, or long-term care contracts, are deductible and are not AAR solely because they are not associated with specific contracts.

Comments by the AAA likewise focus on the proposed regulations' definition of AAR. Like the ACLI, the AAA suggests deleting the "particular contract" element of the proposed tax definition of AAR. The AAA also recommends that the IRS change the proposed reference to VM-30 "as it existed on December 22, 2017" to reference VM-30 as of the reserve valuation date. The rationale for this recommendation is that it would be more consistent with the framework of section 807(d), which determines reserves and the tax

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reserve method as of the reserve valuation date, and that it would be more consistent with the NAIC's definition of AAR, as AAR is an actuarial concept that is not explicitly referenced in the Code.

Departures from Proposed Regulation

The final regulations adopt ACLI's recommendation to add an introductory paragraph to § 1.807-1 to describe briefly the general rules for computing tax reserves and, more importantly, to define an AAR as a reserve established as an additional reserve based on an analysis of the adequacy of reserves that otherwise would be established in accordance with the requirements of the VM, such as CRVM or CARVM, "or any similar reserve." In response to comments, the final regulations do not include the proposed requirement that reserves be held with respect to a particular contract. The final regulations do not adopt the AAA's suggestion to refer to VM-30 as of the reserve valuation date. Likewise, the final regulations do not adopt an ACLI recommendation to include an example.

B. REPORTING OF RESERVES—PROP. REG. § 1.807-3

The TCJA added section 807(e)(6) to provide that the IRS shall require reporting with respect to the opening balance and the closing balance of reserves and with respect to the method of computing reserves for purposes of determining income. To implement this provision, Prop. Reg. § 1.807-3 provides specifically that the IRS may require such reporting with respect to section 807(c) reserves. The reporting also may provide for the manner in which separate account items are reported. The preamble states that providing the information "is necessary to allow the IRS to better examine an insurance company's Federal income tax return."[8]

The reserve reporting provisions of the proposed regulations would apply to taxable years beginning on or after the date final regulations are published.

The ACLI comments on this section of the proposed regulations express the industry's concern that the ultimate reporting requirement should properly balance the burden on companies with the utility of the information provided to the government. Because the proposed regulations themselves do not provide guidance on the potential scope of the reporting requirements, it is unclear whether the requirements will be implemented in the forms and instructions process, or through a more formal process giving notice to the public and an opportunity to comment. In any event, the comments encourage further consultation with the industry before specific reserve reporting requirements are put into effect.

The ACLI comments also point out it could not be known that reporting would "allow the IRS to better examine an insurance company's Federal income tax return," without knowing what the requirements would entail. In examinations of life insurance company tax returns, the IRS routinely asks for and is provided very detailed, product-by-product tax reserve information that far exceeds the information that could be reported on the tax return itself or in its supporting schedules.

Departures from Proposed Regulation

The preamble to the final regulations states that the IRS understands the importance of obtaining the life insurance industry's input before imposing reserve reporting requirements and further states that the IRS expects to consult with the industry before doing so. Accordingly, additional reserve reporting information is not yet required to be filed on Form 1120-L.

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C. CHANGE IN BASIS OF COMPUTING RESERVES—PROP. REG § 1.807-4

Section 807(f) governs changes in basis for computing reserves of a life insurance company. The TCJA amended section 807(f) to eliminate the 10-year spread of the required adjustment for the difference between old and new basis reserves, determined as of the end of the taxable year. As amended, section 807(f) provides that the difference should be taken into account under section 481 as adjustments attributable to a change in accounting method initiated by the taxpayer and made with the consent of the IRS. Throughout 2018 and 2019, the industry and the IRS discussed implementation of this change in section 807(f), culminating with inclusion of changes in basis in Rev. Proc. 2019-43, which is the revenue procedure containing all automatic changes in accounting method.[9]

In providing the automatic change procedures, the IRS has stated that section 446(e) and § 1.446-1(e) apply to changes in basis for computing reserves as a result of the TCJA's amendments to section 807(f). In making this assertion, the IRS relied in part on language in the Conference Report[10] and in the Blue Book[11] providing that, under the amended law, income or deductions resulting from a change in method of computing life insurance company reserves is taken into account in a manner consistent with IRS procedures (generally over a one-year or four-year period) rather than over 10 years. On the other hand, section 807(f) itself makes no reference to section 446, but only to the section 481 adjustment. Before the TCJA, changes in basis for computing reserves under section 807(f) long were exempted from the consent provisions of section 446(e).

Requirement to Follow Administrative Procedures. One industry concern is that references to section 446(e) and § 1.446-1(e) could cause confusion on the role of section 811(a), which provides the rules for accounting methods of a life insurance company. Notwithstanding this concern, Prop. Reg. § 1.807-4(a) states that: "Except as provided in § 1.446-1(e), a change in basis of computing an item referred to in section 807(c) is a change in method of accounting for purposes of § 1.446-1(e)." The preamble explains this provision by stating that "[s]ection 811(a) does not affect the application of section 446(e), which generally requires a taxpayer to secure the consent of the Secretary before changing the method of computing the taxpayer's income."[12]

The proposed regulations require that a company changing its basis for computing reserves file Form 3115 under the automatic change procedures obtain consent to make the change. A nonlife insurance company that changes its basis of computing life insurance reserves also must obtain consent.

ACLI comments acknowledge that taxpayers can benefit from the administrative procedures (e.g., audit protection, four-year spread for positive adjustment) and that the automatic method change procedures themselves (i.e., filing of Form 3115) are not particularly burdensome. While not objecting to complying with those procedures, the ACLI comments again request clarification that neither the TCJA amendments to section 807(f) nor the proposed regulations override the fact that the more specific life insurance company reserve accounting method provisions of sections 811(a) and 807(d) govern how the determination of tax reserves is clearly reflected in life insurance company taxable income. Comments by ScribnerHall on behalf of nonlife insurers explicitly disagree with the conclusion that a change in basis of computing reserves is a change in accounting method for purposes of section 446(e) and § 1.446-1(e).

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Departures from Proposed Regulation
The preamble to the final regulations states: "Except in extraordinary circumstances, section 446(b) does not affect the requirement that a life insurance company compute its reserves for Federal income tax purposes as required by Subchapter L."

Section 481 Adjustment. The proposed regulations address the mechanics of the section 481 adjustment that results from a change in basis. With respect to contracts issued before the taxable year of change, the difference between the amount of the section 807(c) reserve at the close of the taxable year of change as computed on the new basis and the amount of that reserve at the close of the taxable year of change computed on the old basis is taken into account under section 481 as an adjustment attributable to a change in method of accounting.

If a company that was taxed as an insurance company for the year of change completely loses its tax status as an insurance company, then the balance of any section 481(a) adjustment(s) attributable to a change in basis of computing section 807(c) reserves is accelerated into taxable income in the last year the company is taxed as an insurance company. However, the section 481(a) adjustments for reserve basis changes are not accelerated merely because the company changes status from a life insurance company to a nonlife insurance company or vice versa.

Departures from Proposed Regulation
There were no comments on this provision, and the final regulations make no changes.

Effect on Determining Increase or Decrease in Reserves. If there is a change in basis of computing reserves, then for purposes of determining the section 807(a) and section 807(b) decrease or increase in reserves, the closing balance for the year of change with respect to contracts issued before the year of change is determined on the old basis and the opening balance for the next taxable year for such contracts is computed on the new basis.[13] The proposed regulations provide similar rules for nonlife insurance companies for purposes of section 832(b)(4).

Departures from Proposed Regulation
There were no comments on this provision, and the final regulations make no changes.

Examples. The proposed regulations include four basic examples illustrating the principles of Prop. Reg. § 1.807-4:

- Example 1 involves correction of consistent use in prior taxable years of an erroneous mortality table. The change to the appropriate mortality table is treated as a change in basis for which consent must be obtained pursuant to the IRS's prescribed administrative procedures.
- Example 2 involves a new method of CARVM prescribed by the NAIC for certain variable annuity contracts, applicable to all such contracts issued on or before the effective date. For contracts issued prior to the taxable year in which the change occurs, this also is a change in basis for which consent must be obtained.
- Example 3 illustrates the mechanics of making the section 481 adjustment required for a change in basis. That is, for contracts issued before the year of change, the old basis of reserving is used at the end of the year of change and the new basis is used at the beginning of the following year. The difference is taken into account under section 481 and the IRS's prescribed administrative procedures. For contracts issued during the year of change, the new basis of reserving is used at the end of the year of change.
- Example 4 is the same as Example 3, except the taxpayer is a nonlife insurance company rather than a life insurance company. The result is the same.

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Departures from Proposed Regulation
The ACLI comments suggested clarifications to examples 1 and 2, and also requested further substantive guidance on how the standard for what constitutes a change in basis of computing reserves applies to frequently encountered fact patterns involving life insurance reserves, such as under PBR. The ACLI comment letter included an appendix suggesting nine examples that would be helpful.

The final regulations delete examples 1 and 2 of § 1.807-4(d), in favor of a more comprehensive revenue ruling to address changes in basis.

Rev. Rul. 2020-19 sets forth 10 fact situations—the nine included in the appendix to the ACLI comment letter plus one other (Situation 3). As noted above, the ruling will be discussed in more detail in a future issue of TAXING TIMES. The holdings in the 10 fact situations are as follows:

- **Situation 1.** A change in the consistent, impermissible application of the 92.81 percent factor prescribed by section 807(d) is a change in basis.
- **Situation 2.** An NAIC Valuation Manual change in the methodology for computing reserves on previously issued contracts is a change in basis.
- **Situation 3.** An NAIC Valuation Manual change in the methodology for computing reserves on contracts issued in the year of change is a change in basis.
- **Situation 4.** A change in Actuarial Guideline that results in a change in the methodology for computing reserves is a change in basis.
- **Situation 5.** A change in the NAIC-prescribed mortality tables is a change in basis.
- **Situation 6.** A change under VM-20 from the deterministic reserve to the sum of the policy net premium reserves due solely to the fact that the sum of the policy net premium reserves is greater is not a change in basis.
- **Situation 7.** An experience-based update in mortality rates as required by VM-20 to determine the deterministic reserve is not a change in basis.
- **Situation 8.** A 807(d)(2) to tax reserves based on the contract net surrender value resulting solely from a year-over-year change in which is greater is not a change in basis.
- **Situation 9.** An inclusion of policy cells that previously were omitted on a single return is a mathematical or posting error that is not a change in basis.
- **Situation 10.** An increase in reserves to provide solely for new benefits on existing contracts is not a change in basis.

Applicability Date*.* The rules of Prop. Reg. § 1.807-4 are proposed to apply to taxable years beginning after final regulations are published. However, a taxpayer could choose to apply the rules to earlier years.

Departures from Proposed Regulation
In the final regulations, the taxpayer option to apply the rules to earlier years applies to a taxable year beginning after Dec. 31, 2017, and on or before Oct. 13, 2020, provided the taxpayer consistently applies the rules to that year or years. For a calendar-year taxpayer, that would include 2018, 2019 and 2020.

EFFECT ON OTHER DOCUMENTS, INCLUDING REV. RUL. 94-74

The preamble to the proposed regulations states that certain revenue rulings are inconsistent with section 807(f) as amended by the TCJA and, accordingly, those rulings are proposed to be obsoleted for taxable years beginning after final regulations are published. These 14 revenue rulings are Rev. Ruls. 2002-6, 94-74, 80-117, 80-116, 78-354, 77-198, 75-308, 74-57, 70-568, 70-192, 69-444, 65-240, 65-233

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and 65-143. Also, Notice 2010-29 is proposed to be obsoleted for taxable years beginning after Dec. 31, 2017.

Of special concern is the proposed obsolescence of Rev. Rul. 94-74, which provides guidance on the standard for determining whether a change in reserve determination is a change in basis. The industry has requested that Rev. Rul. 94-74 be updated to reaffirm the long-standing standard and to address fact patterns that are more current. For example, Rev. Rul. 94-74 does not address issues that may arise or become more important under Life PBR. The ACLI comment letter presented to the IRS a number of such situations in which a change in reserves might occur, some of which should be treated as changes in basis under section 807(f) and some of which should not.

Departures from Proposed Regulation
The Treasury decision obsoletes the prior guidance as proposed by the preamble to the proposed regulations but notes that contemporaneous additional guidance is being provided in Rev. Rul. 2020-19 (already discussed above).

PROCEDURE FOR OBTAINING AUTOMATIC CONSENT

The preamble indicates that Treasury and the IRS intend to make certain revisions to section 26.04 of Rev. Proc. 2019-43, which includes the applicable procedures for automatic consent for a section 807(f) change in basis of reserves.

When Rev. Proc. 2019-10 was issued, adding section 26.04 to Rev. Proc. 2018-31 (predecessor of Rev. Proc. 2019-43), it provided for netting of multiple changes during the same taxable year for “the same type of contract (life insurance, annuity, etc.)” in determining the section 481(a) adjustment. When Rev. Proc. 2019-43 was issued as the annual update to Rev. Proc. 2018-31, the parenthetical was removed. Now, however, Treasury and the IRS have determined that the statutory language of section 807(f)(1) requires netting of the section 481(a) adjustments at the level of each item referred to in section 807(c), so that there is a single section 481(a) adjustment for each of the items referred to in section 807(c). Section 26.04 of Rev. Proc. 2019-43 will be revised accordingly. Netting was not an issue when both positive and negative section 807(f) reserve basis changes were both subject to 10-year spreads. Now, however, positive section 481(a) adjustments (reserve weakening income) generally are subject to a four-year spread, while negative section 481(a) adjustments (reserve strengthening deductions) generally are taken entirely in the year of change. Accordingly, this new rule could have the effect of converting some four-year spreads into one-year spreads, or vice versa, when reserve strengthenings and weakenings occur in the same taxable year.

In addition, in keeping with the equal treatment in the proposed regulations of life insurance reserves, whether held by a life insurance company or a nonlife insurance company, section 26.04 of Rev. Proc. 2019-43 also will be revised to clarify the manner in which nonlife insurance companies implement changes to the basis of computing life insurance reserves.

Departures from Proposed Regulation
The preamble to the final regulations rejects the request of one commenter to apply the automatic consent procedures to changes in method of accounting for unearned premium reserves and unpaid loss reserves of nonlife insurance companies.

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D. DEFINITION OF LIFE INSURANCE RESERVES—PROP. REG. § 1.816-1

The proposed regulations include a modification to the definition of life insurance reserves. As explained in the preamble, the TCJA modified section 807(d) to provide that the amount of life insurance reserves was determined with reference to the applicable tax reserve method—that is, CRVM in the case of a contract covered by CRVM and CARVM in the case of a contract covered by CARVM. The preamble notes that CRVM and CARVM may be PBR methods, which may be gross premium reserves and may take into account certain expenses and other factors, but that Congress understood that, for purposes of section 807(d), life insurance reserves could be determined using PBR methods.[14]

A potential issue arises, however, because the section 807(a) or (b) decrease or increase in reserves is based on section 807(c) reserves, and section 807(c)(1) specifies life insurance reserves as defined in section 816(b). The preamble states that section 816(b), which was unchanged by the TCJA, and its predecessor provision have been interpreted as describing a net premium reserve that does not take into account expenses or certain other factors. Thus, while Congress intended that the section 807(d) tax reserve method could include PBR methods, the cross-reference in section 807(c)(1) to section 816(b) could be interpreted to preclude reserves determined under PBR methods from qualifying as life insurance reserves for purposes of section 807.

To clarify, the proposed regulations provide in Prop. Reg. § 1.816-1(a) that a reserve that meets the definition of life insurance reserves in sections 816(b)(1) and (2) will not be disqualified as a life insurance reserve solely because the method used to compute the reserve takes into account other factors, provided that the method used to compute the reserve is a tax reserve method as defined in section 807(d)(3) and that such reserve is not an AAR as described in Prop. Reg. § 1.807-1(a). The preamble indicates that this definition of a life insurance reserve applies whether the reserve is held by a life insurance company or by a nonlife insurance company.

This section of the regulations is proposed to apply to taxable years beginning on or after the date final regulations are published in the Federal Register. However a taxpayer may choose to apply the rules for taxable years beginning after Dec. 31, 2017, and ending before the first taxable year that begins on or after the date final regulations are published in the Federal Register.

Departures from Proposed Regulation

In the final regulations, the taxpayer option to apply the rules to earlier years applies to a taxable year beginning after Dec. 31, 2017 and on or before Oct. 13, 2020, provided the taxpayer consistently applies the rules to that year or years. For a calendar-year taxpayer, that would include 2018, 2019, and 2020.

The comments request that the preamble to final regulations be clarified to remove any negative inference as to the use of other permissible factors in computing reserves prior to the effective date of Prop. Reg. § 1.816-1(a), since it has long been recognized even under pre-TCJA law that in some cases factors other than mortality and interest may be taken into account in better measuring a reserve liability.

The preamble to the final regulations states that the IRS and Treasury agree that certain factors other than those prescribed by section 816(b)(1) and (2) may be taken into account in determining life insurance reserves for taxable years prior to Oct. 13, 2020, if the use of such factors would make the calculation more accurate.

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E. ELECTRONIC FILING OF ANNUAL STATEMENTS

Presently, § 1.6012-2(c) requires that an insurance company file with its tax return a copy of its annual statement, but § 1.6012-2(c)(4) provides that if an insurance company files its federal income tax return electronically, it should **not** include its annual statement.[15] Instead, the annual statement must be available at all times for inspection by the IRS and retained for so long as such statement may be material in the administration of the tax laws.

The Conference Report contemplates requiring the electronic filing of annual statements to improve reporting of insurance reserves.[16] Accordingly, the proposed regulations would remove § 1.6012-2(c)(4).

This section of the regulations is proposed to apply to taxable years beginning on or after the date final regulations are published. However a taxpayer may choose to apply the rules to any original federal income tax return timely filed on or after the date final regulations are published.

The ACLI comment letter notes that (1) certain sections of the annual statement are not particularly relevant to the filing of the tax return (though they may be in examination), and (2) the IRS's prohibition on electronic filing of Form 1120-L outside of a consolidated return with a parent that is not an insurance company means that electronic filing of annual statements would still exclude 15 to 20 percent of the life insurance industry. Instead, the letter recommends either that the present rule be maintained, or that only specific portions of the applicable annual statement be attached to the electronically filed return.

Departures from Proposed Regulation

The final regulations retain § 1.6012-2(c)(4) but also provide that electronic filers must file their annual statement or a portion thereof in accordance with the applicable rules in the forms or instructions. The IRS and Treasury anticipate that once the IRS has the capacity to accept the electronic filing of annual statements, the tax return forms and instructions will require electronic filing of all or portions of the annual statement. The IRS, however, expects to consult with the insurance industry before requiring such electronic filing.

F. PROPOSED REMOVAL OR REVISION OF REGULATIONS WITH NO FUTURE APPLICATION

The proposed regulations would remove seven elements of the existing regulations under Part I of Subchapter L because they provide guidance under law that has been repealed or substantially changed and will have no application after the proposed regulations are finalized. These are §§ 1.801-7, 1.801-8(e), 1.806-4, 1.809-2. 1.810-3, 1.818-2(c) and 1.818-4. In addition, the proposed regulations would remove § 1.801-5(c) because its requirement that a taxpayer file certain information when it changes the basis of computing life insurance reserves is obviated by the requirement in the proposed regulations that a taxpayer follow IRS administrative procedures for automatic changes in accounting method.

The ACLI comment letter states that a more complete and systematic revision to the regulations under Part 1 of Subchapter L is warranted, as they include much deadwood. Even the guidance with continuing application often is misnumbered because the regulations were never revised after the Deficit Reduction Act of 1984.[17]

Departures from Proposed Regulation

The preamble to the final regulations states that the removal of additional deadwood provisions is beyond the scope of this rulemaking project.

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Section 1.381(c)(22)-1. Section 381 provides rules for carryovers in certain corporate acquisitions whereby the acquiring corporation succeeds to and takes into account the items described in section 381(c) of the distributor or transferor corporation. If the acquiring corporation is an insurance company taxable under Subchapter L, section 381(c)(22) provides that regulations may prescribe those items that are required to be taken into account for purposes of Subchapter L in respect of the distributor or transferor corporations. Those items are set forth in § 1.381(c)(22)-1, originally issued in 1962. Section 1.381(c)(22)-1(b)(6) provides that if the distributor or transferor corporation has unamortized amounts relating to prior-year changes in basis under section 810(d)(1) (the predecessor of section 807(f)(1)), the acquiring corporation takes them into account as the distributor or transferor corporation would have.

The proposed regulations would remove § 1.381(c)(22)-1(b)(6) because it no longer applies. The principle, however, applies to transactions where the distributor or transferor corporation has any remaining 10-year spreads under prior section 807(f). After the TCJA's amendment of section 807(f), an acquiring corporation must take into account any remaining section 481(a) adjustment of the transferor or distributor corporation pursuant to the IRS's administrative procedures.

Departures from Proposed Regulation
There were no comments on this provision, and the final regulations make no changes.

Section 1.817A-1. Section 817A provides special rules for modified guaranteed contracts (MGCs). Prior to amendment by the TCJA, section 817A(e)(2) granted regulatory authority to determine annually the interest rates applicable under sections 807(c)(3), 807(d)(2)(B), and 812 with respect to a MGC, in a manner appropriate for MGCs. That regulatory authority was the basis for § 1.817A-1(b).

The TCJA repealed section 807(d)(2)(B) (requiring use of the greater of the applicable Federal interest rate or the prevailing State assumed interest rate) and substantially revised section 812 (relating to determination of company's share and policyholders' share). Further, the TCJA amended the flush language of section 807(c) to provide that, for purposes of section 807(c)(3), the appropriate rate of interest is the highest rate or rates permitted to be used to discount the obligations by the NAIC as of the date the reserve is determined. Prior law required the determination of a rate always to be made at the time the obligation first did not involve life, accident, or health contingencies.

After the TCJA, regulatory guidance on the applicable interest rate for MGCs would apply only to MGCs with section 807(c)(3) reserves. The ACLI comment letter suggests that § 1.817A-1 could be removed. In such case, while the change would likely apply to taxable years beginning on or after the date final regulations are published, taxpayers presumably would be allowed to choose to apply the change for taxable years beginning after Dec. 31, 2017 and ending before the first taxable year that begins on or after the date final regulations are published.

Departures from Proposed Regulation
The final regulations remove much of § 1.817A-1 but retain a provision waiving section 811(d) (regarding excess interest) during the temporary guarantee period when applied to non-equity-indexed MGCs. This waiver applies to taxable years beginning after Oct. 13, 2020. However, a taxpayer may choose to apply the rules to a taxable year beginning after Dec. 31, 2017, and on or before Oct. 13, 2020, provided the taxpayer consistently applies the rules to that year or years. For a calendar-year taxpayer, that would include 2018, 2019 and 2020.

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Section 1.338-11. Section 338 provides rules whereby certain acquisitions of the stock of a corporation may electively be treated as a deemed sale of the assets of "old target" to "new target." Section 1.338-11 provides guidance on the effect of a section 338 election on insurance company targets, including treatment of the deemed sale of insurance contracts as a deemed assumption reinsurance transaction.

Section 1.338-11(d)(1) generally provides that if new target subsequently increases its reserves with respect to acquired contracts, it must effectively capitalize that increase by treating the increase as additional premium in the deemed assumption reinsurance transaction. In the absence of this rule, new target could obtain a better tax result if it acquired understated reserves and subsequently increased them rather than acquiring adequately stated reserves.

Section 1.338-11(d)(2)(ii) sets forth an exception to § 1.338-11(d)(1) if new target is required by section 807(f) to spread the reserve increase over the 10 succeeding taxable years. The rationale for the exception is that the 10-year spread already removes the tax benefit that § 1.338-11(d)(1) is intended to prevent. As a result of the TCJA's repeal of the 10-year spread provisions of section 807(f), a change in basis under section 807(f) that results in an increase in reserves generally would be taken into account in one year. Accordingly, the reason for the exception in § 1.338-11(d)(2)(ii) no longer exists and would be removed by the proposed regulations.

Additionally, new § 1.338-11(d)(3)(iii) is proposed to be added so that the standard used for determining when there is an additional premium for a change in items referenced in section 807(c) is the same as that used under section 807(f). In this regard, the preamble states:

> Changes in PBRs that are contemplated by the applicable method, for example, may not constitute changes in the basis of computing reserves under section 807(f) and should not result in an amount of additional premium under § 1.338-11(d)(3).[18]

This section of the regulations is proposed to apply to taxable years beginning on or after the date final regulations are published.

Departures from Proposed Regulation
There were no comments on this provision, and the final regulations make no changes.

G. PROPOSED CONFORMING CHANGES TO REGULATIONS

Finally, the proposed regulations also include revisions to §§ 1.801-2, 1.809-5 and 1.848-1 to correct references to Code provisions or regulations that have been changed, were removed or are proposed to be removed by the proposed regulations.

Departures from Proposed Regulation
The final regulations make no changes.

TREATMENT OF NONCOMPLIANT FOREIGN-ISSUED CONTRACTS

The proposed regulations do not address the treatment of contracts that do not comply with U.S. tax rules for life insurance and annuity contracts. The preamble, however, notes that Treasury and the IRS received a request to promulgate regulations under section 807 on the treatment of foreign-issued

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contracts that do not satisfy the requirements of sections 7702, 101(f), 72(s) or 817(h). The requested guidance generally would provide that U.S. tax reserves for those contracts would be determined without regard to those provisions as long as (1) no policyholder, insured, annuitant or beneficiary with respect to the contract is a U.S. person and (2) such contract is regulated as a life insurance or annuity contract by a foreign regulator. Under the requested approach, a U.S. insurance company could establish life insurance or other tax reserves for such a contract that is reinsured by a U.S. insurance company as if the contract met the Code's technical requirements. The treatment of such contracts in the absence of regulations was the subject of two Tidbits in prior issues of *TAXING TIMES*.[19]

The preamble indicates Treasury and the IRS are evaluating this request, including whether to address it as part of this regulation project. The preamble requests comments on the issue, particularly on statutory interpretation and the implications outside of Subchapter L.

Two comment letters were submitted in response to this request, one by EY, LLP,[20] and one by ScribnerHall.[21] Both argued that in appropriate circumstances, such contracts should be treated the same as compliant, U.S.-issued contracts for purposes of determining tax-deductible reserves.

Departures from Proposed Regulation
The preamble to the final regulations states that the considerations around this topic are complex and require further study. Accordingly, the IRS and Treasury decided not to address these issues as part of this rulemaking project.

CONCLUSION

From a technical standpoint, the most impactful provision in the regulations likely is the definition of AAR. The concept of AAR is significant to valuation actuaries and an important concept in the Valuation Manual. For tax purposes, the conclusion that AAR are not deductible for federal income tax purposes is not unexpected, nor is the conclusion that a reserve established under VM-30 as it existed Dec. 22, 2017, is an AAR. The final regulations leave for another day what it means for a reserve to be "similar" to such a reserve and therefore also an AAR.

The guidance in Rev. Rul. 2020-19 is welcome, and will help life insurers understand what changes are changes in basis under section 807(f), and what changes are not changes in basis. This is particularly true for issues that arise under recent reserve methodologies, such as under PBR. It is clear the IRS and Treasury gave careful attention to industry input on these issues.

Only rarely since the Deficit Reduction Act of 1984[22] overhauled the system of life insurance company taxation has the government issued regulations under Part I of Subchapter L of the Code. The regulations provide important guidance on reserve-related issues, and deserve thorough analysis and understanding. In addition, the issues in the regulations still deserve close monitoring, as the precise mechanics of reserve reporting remain unknown and could have a significant impact on a company's tax compliance system.

The views expressed herein are solely those of the authors and are not necessarily the views of their employers or clients.

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1 85 Fed. Reg. 64386 (Oct. 13, 2020).

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2 85 Fed. Reg. 18496 (April 2, 2020).
3 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. See also Taxing Times, Vol. 14, Issue 2 (June 2018) (devoted exclusively to changes made by the TCJA).
4 See ACLI letter dated June 1, 2020, Tax Analysts Doc. No. 2020-21175 (commenting on all provisions of the proposed regulations); AAA letter dated May 28, 2020, Tax Analysts Doc. No. 2020-20901 (commenting on the definition of asset adequacy reserves); EY, LLP, letter dated May 27, 2020, Tax Analysts Doc. No. 2020-20902 (commenting on section 807 treatment of foreign-issued contracts that do not comply with sections 7702, 101(f), 72(s) or 817(h)); ScribnerHall letter dated May 29, 2020, Tax Analysts Doc. No. 2020-21753 (commenting on changes in basis for computing reserves, including references to section 446(e); ScribnerHall letter dated May 27, 2020, Tax Analysts Doc. No. 2020-20903 (commenting on section 807 treatment of foreign-issued contracts that do not comply with sections 7702, 101(f), 72(s) or 817(h)). In addition, the ACLI submitted a comment letter to the Office of Management and Budget ("OMB") on information collection aspects of the proposed regulations. That letter is at *https://www.regulations.gov/document?D=IRS-2020-0003-0008*. To the extent there were no inconsistencies, this article refers to these collectively as the "comments."
5 H.R. Rep. No. 115-466, at 331 (2017) ("Conference Report"); Staff of the Joint Committee on Taxation, 115th Cong., General Explanation of Public Law 115-97, at 235-236 (Comm. Print 20138) ("Blue Book").
6 Because section 807(d) no longer prescribes mortality and morbidity tables to use, these existing regulations no longer are relevant and are not included in Prop. Reg. § 1.807-1.
7 Congress intended this result. As the staff of the Joint Committee on Taxation explained, under NAIC-prescribed PBR methodology in effect at TCJA's enactment, PBR for any contract does not include any AAR component. Blue Book at 235-236. The Blue Book goes on to note that, therefore, no AAR-related reduction to the NAIC-prescribed PBR reserves as then in effect is necessary or required before applying the percentage reduction mandated in section 807(d) in computing tax reserves.
8 85 Fed. Reg. 18503 (April 2, 2020).
9 Section 26.04 of Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, sets forth the automatic procedures that govern a change in basis for computing reserves under section 807(f). The IRS provided guidance earlier in Rev. Proc. 2019-10, 2019-2 I.R.B. 296, which added section 26.04 to Rev. Proc. 2018-31, 2018-22 I.R.B. 637. Rev. Proc. 2018-31 was superseded by Rev. Proc. 2019-43.
10 Conference Report at 321.
11 Blue Book at 228.
12 85 Fed. Reg. 18499 (April 2, 2020).
13 Although this has long been the rule for section 807(f) and its predecessor, section 810(d), it was not explicitly incorporated, but only illustrated by example, in § 1.810-3.
14 The Blue Book describes the amendments to section 807(d) as accommodating the NAIC-prescribed PBR methodology. See Blue Book at 235.
15 Under current procedures, an insurance company can electronically file a Form 1120-L (for life insurance companies) or Form 1120-PC (for nonlife insurance companies) only if the insurance company is part of an affiliated group filing a consolidated return, the parent of which files Form 1120.
16 See Conference Report at 479; see also Blue Book at 236-237.
17 P.L. 98-369.
18 85 Fed. Reg. 18502 (April 2, 2020).
19 Winslow, Peter, Subchapter L: Can You Believe It? Reserves for Life Insurance Contracts that Flunk I.R.C. § 72(s) Can Be Deductible, Taxing Times, Vol. 12, Issue 2, at 42 (June 2016); Winslow, Peter, Subchapter L: Can You Believe It? Deductible Tax Reserves Might be Greater for Life Insurance Contracts that Flunk I.R.C. § 7702 than for Those That Do Not, Taxing Times, Vol. 11, Issue 3, at 46 (October 2015).
20 Tax Analysts Doc. No. 2020-20902.
21 Tax Analysts Doc. No. 2020-20903.
22 P.L. 98-369.

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