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IRS's Proposed LRD Rules for Nonlife Reserves are Out

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Editor's note: Subsequent to Taxing Times' *editorial deadline, the IRS released Rev. Proc. 2019-06, which provided proposed discount factors under § 846 for tax years 2017 and 2018. In addition to providing the factors, Rev. Proc. 2019-06 indicated that the IRS and Treasury may publish revised discount factors following the promulgation of final regulations.* Taxing Times *will address Rev. Proc. 2019-06, revised discount factors and other developments in loss reserve discounting following the release of final regulations later in 2019.*

On Nov. 5, 2018, the Internal Revenue Service (the IRS) released REG-103163-18, proposed regulations for Modification of Discounting Rules for Insurance Companies ("the Regs"). The Regs primarily concern loss reserve discounting (LRD) for property-casualty (P&C) unpaid losses under I.R.C. section 846[1] and were promulgated in response to changes in the LRD rules under the Tax Cuts and Jobs Act (P.L. 115-97) (TCJA or "the Act").[2]

While the Regs provide insights on a variety of issues, they still leave a number of questions unanswered. This article sets forth the LRD rules as revised by the TCJA, analyzes the major changes proposed in the Regs, and highlights some remaining unknowns that remain to be addressed even as companies implement the TCJA for tax year 2018.

BACKGROUND

While unpaid losses continue to be discounted by accident year (AY) and line of business (LOB) using an applicable interest rate and loss payment patterns as inputs under the TCJA, the Act made significant changes to how those inputs would be determined.

The interest rate used to calculate LRD was historically based off a single rate, the 60-month average market yield of Treasury bonds with maturities of more than three years but not more than nine years.[3] The TCJA bases the rate on the corporate bond yield curve with maturities to be determined by Treasury.[4]

Under both old law and the TCJA, loss payment patterns for all companies are determined by the Secretary of the Treasury based on the aggregate payment experience reported by insurers on their annual statements, redetermined every fifth year (*i.e.*, in each "determination year.")[5] Insurers were historically permitted to substitute their loss payment experience for the aggregate patterns, but this election was repealed under the TCJA.[6] Short-tail lines of business are required to be discounted over a three-year period under both current and former law.[7]

Historically, loss reserves for long-tail lines of business were required to be discounted up to 15 years.[8] However, supplemental IRS guidance allowed taxpayers to limit their discount to the 10 accident years disclosed in the Annual Statement, applying a "composite" discount factor for that tenth year.[9] Under the TCJA, taxpayers are required to average the payment patterns for years seven to nine and then apply that average payout pattern for years 10 to 24, as applicable.[10]

While non-proportional reinsurance and international lines of business are presented in a similar fashion to other long-tail LOBs in the annual statement, they were carved out of the definition of long-tail lines in the Code.[11] Ultimately, they were discounted similar to other long-tail lines under relevant regulations.[12] As the Code section governing international and non-proportional reinsurance lines was repealed under the TCJA, these LOBs would seemingly be discounted as short-tail lines on a go-forward basis.[13]

Companies are also required to discount salvage and subrogation (S&S) receivable based on either unique S&S discount factors published by the IRS or the loss reserve payment patterns determined under I.R.C. section 846.[14] Historically, the IRS has published separate S&S factors rather than relying on loss payment patterns.[15]

CHANGES PROPOSED UNDER THE REGS

The Regs contain four primary components:

- Changes to the applicable rate of interest to be used in the LRD calculation under I.R.C. section 846(c)(2);
- Changes to the computation of loss payment patterns in the LRD calculation under I.R.C. section 846(d);
- Repeal of the composite method originally permitted under Notice 88-100 as an acceptable method for long-tail lines of business; and
- Elimination of distinct discount factors for S&S under I.R.C. section 832.

The Applicable Rate of Interest

One of the most prominent items of speculation following the passage of the TCJA (including in this publication)[16] was how the new applicable rate of interest would be determined using the corporate bond yield curve. The Regs continue the use of a single interest rate but considerably expand the range of maturities on the bonds that would feed into the rate to include the average of rates "with times to maturity of not more than seventeen and one-half years."[17] The choice of maturity range was unanticipated by many in industry, as it represents a near-doubling of the maturity ceiling while also extending the range beyond the majority of even the longest-tailed P&C reserves.

The preamble indicates that the decision to substitute the corporate bond yield curve for Treasury rates manifests an intent that, "the annual rate should be determined in a manner that more closely matches the investments in bonds used to fund the undiscounted losses to be incurred in the future . . . "[18] In furtherance of this goal, the IRS considered a multi-rate approach wherein the bond maturity for each payment pattern would match the spread between the year of loss and year of payment, which would best reflect the time value of money impact of bonds backstopping said reserves. However, the preamble also notes that the language of the TCJA did not demonstrate clear statutory intent to change from a single rate to a multi-rate regime. To reconcile these priorities, the IRS selected a single-rate maturity range, which "minimize[d] the differences in taxable income, in the aggregate, resulting from the use of a single discount rate versus" the income that would have been generated under the aforementioned multi-rate approach.[19]

Loss Payment Patterns

The preamble notes that the occurrence of negative loss payment patterns in certain periods "produce discount factors that vary widely from year to year or discount factors that are negative or that exceed one."[20] The IRS requested taxpayer comments on this issue in Rev. Proc. 2003-17, and commenters expressed a desire for the IRS to adopt a "smoothing" mechanism to minimize such distortions. Ultimately, the IRS declined to implement the smoothing mechanism in the ensuing determination year.[21] In an effort to address this lingering issue, the preamble to the Regs provides an example of a seven-step method to smooth payment patterns in the event that the pattern is negative in a given year. While the precise mechanics of the method are relatively complicated, the primary mechanism for smoothing is to average the negative payment pattern year with adjacent periods until a positive average is attained.

While the IRS considered a number of other methods for dealing with this issue, the preamble indicates it opted for the seven-step method as it reduces bias toward the changing of non-negative factors and it best preserves the AY seven to nine average payment pattern, which is applied in AYs 10 and onward.[22] We note this method is not memorialized in the text of the regulations; rather, a broad grant of discretion is afforded for the secretary to develop a smoothing mechanism on the basis of the example provided.[23]

The Composite Method

The original guidance providing for the composite method, Notice 88-100, indicated that formal regulatory guidance would prevent the discounting of loss years not separately disclosed in the annual statement. While that guidance was never finalized, the IRS continued allowing companies to use the composite method to discount all reserves in the 10th year and beyond with a single composite factor. The Regs would eliminate such a composite factor, providing that "a taxpayer that has unpaid losses relating to an accident year not separately reported on the NAIC annual statement must compute undiscounted losses with respect to that year using the discount factor published by the Secretary for that year."[24] The IRS likely will provide an automatic method change for companies that have been applying the composite method to switch to the newly prescribed method.

Repeal of the composite method represents a shift to a more literal interpretation of the text of the Code. The switch to a true discrete methodology is likely to generate additional administrative complexity and larger reserve haircuts for taxpayers with longer-tailed lines of business.

Salvage and Subrogation

As noted, the IRS has latitude to discount S&S recoverable based on either salvage recovery patterns or loss payment patterns. In a reversal from existing practice, the Regs propose that the IRS cease issuing separate S&S factors and instead discount S&S based on the general loss reserve discount factors. Such a change would allow companies to net their gross loss reserves and S&S before applying a single discount factor to the net reserve balance, thereby reducing compliance cost and complexity. The preamble does not indicate whether the payment and losses incurred data used to calculate payment patterns should be considered gross or net of S&S.

UNANSWERED QUESTIONS AND NEXT STEPS

The Regs offered insights on a number of pressing issues but also left several key issues unresolved. Most noticeably, there is some ambiguity as to what inputs should be used to calculate opening discounted loss reserves for purposes of the transition calculation. The transition rule provides that opening reserves

(*i.e.*, 1/1/2018 reserves for calendar year taxpayers) "shall be determined as if the amendments made by this section had applied . . . and by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018."[25] Under one reading of the transition rules, the discount factors determined as of Dec. 31, 2018, would be applied to the opening reserves and discounted accordingly. Conversely, the rules could be interpreted to require the recalculation of prior year factors as if the TCJA had been in effect during such loss years and then applying those factors to the opening reserve balances.

Other unanswered questions include how discounted unpaid losses for international and non-proportional lines of business will be calculated and whether S&S recovery patterns will be included in revised loss reserve payment pattern calculations.

In advance of the Dec. 20, 2018, hearing on the Regs, the IRS requested public comments on the following items:

- Length of loss payment patterns to be used for discounting the international and non-proportional reinsurance lines of business;
- The methodology used to select the revised maturity window for the LRD interest rate; and
- Whether net payment data (loss payments less salvage recovered) and net losses incurred data (losses incurred less salvage recoverable) should be used to compute discount factors.

Some notable themes in the comments submitted to the IRS in response to the request for comments are as follows:

- **Interest rate.** Commenters seemed to unanimously disagree with the bond maturity range outlined in the Regs. Though many issues were raised, the most common was that the maturity range selected did not appropriately match the bonds held to backstop P&C loss reserves, resulting in an unduly high interest rate.
- **Composite method.** Commenters generally opposed repeal of the composite method, citing challenges obtaining older historical data, particularly for companies relying on "legacy technology" systems.
- **International and reinsurance LOBs.** Commenters remarked that Treasury lacked statutory authority to continue treating these LOBs as long-tail as a result of the changes made by the TCJA. At least one commenter suggested a technical correction would be required to restore prior treatment.
- **Smoothing adjustments.** Commenters generally supported the implementation of a smoothing mechanism to help produce a stable pattern of positive factors.
- **S&S discount factors.** Commenters generally supported applying the LRD factors to S&S balances as a simplifying measure.

While the Regs provided some clarity as to the IRS's current thinking and the general direction for how some open questions will likely be resolved, they also left taxpayers eagerly awaiting final guidance to provide an ultimate resolution to LRD issues. ■

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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 to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97, enacted Dec. 22, 2017.

3 *See* former I.R.C. section 846(c)(2) and former I.R.C. section 1274(d).

4 *See* current I.R.C. section 846(c)(2).

5 *See* current and former I.R.C. section 846(d).

6 *See* former I.R.C. section 846(e).

7 *See* current and former I.R.C. section 846(d)(3)(A)(i).

8 *See* former I.R.C. section 846(d)(3).

9 IRS Notice 88-100, 1988-2 C.B. 439.

10 *See* current I.R.C. section 846(d)(3)(B)(ii).

11 *See* former I.R.C. section 846(d)(3)(E).

12 *See* Treas. Reg. § 1.846-1(b)(3), and Treas. Reg. § 1.846-1(b)(4).

13 TCJA Section 13523(b).

14 Treas. Reg. § 1.832-4.

15 *See e.g.*, Rev. Proc. 2018-13, 2018-7 IRB 356.

16 Kristen Norberg, "Discounted Unpaid Losses: A Rate or a Curve?," *Taxing Times* Vol. 14, Issue 2 (June 2018) at page 26.

17 Prop. Reg. § 1.846-1.

18 Modification of Discounting Rules for Insurance Companies, 83 Fed. Reg. 55650 (proposed Nov. 7, 2018).

19 *Id*.

20 *Id*. at 55651.

21 Rev. Proc. 2008-10.

22 Modification of Discounting Rules for Insurance Companies, *supra*, at 55652.

23 Prop. Reg. § 1.846-1(d)(2).

24 Modification of Discounting Rules for Insurance Companies, *supra*, at 55652.

25 TCJA Section 13523(e).