SOCIETY OF ACTUARIES

TAXATION SECTION

Taxing Times

VOLUME 15, ISSUE 3 • OCTOBER 2019

Tax Accounting and Deferred Taxes for Life Insurance Companies

By Kristin Norberg

Taxing Times

Volume 15, Issue 3 • October 2019

Published three times a year by the Taxation Section Council of the Society of Actuaries.

475 N. Martingale Road, Suite 600
Schaumburg, Ill 60173-2226
Phone: 847.706.3500
Fax: 847.706.3599

This newsletter is free to section members. Current issues are available on the SOA website (www.soa.org).

To join the section, SOA members and non-members can locate a membership form on the Taxation Section webpage at https://www.soa.org/sections/taxation/taxation-landing/.

Publication Schedule
Publication Month: February 2020
Articles Due: November 21, 2019

The digital edition of this newsletter can be found on the section webpage at https://www.soa.org/sections/taxation/taxation-landing/.

From the Chair
Time is Taxing …

By Tony R. Litterer

As my term as the chairperson of the Taxation Section draws to a close, I reflect on what the section has accomplished and some of the things we put in place to contribute to the growth of actuaries going forward.

During my tenure we saw significant tax reform with the passing of the Tax Cuts and Jobs Act (TCJA). Since adoption of the Act, the section has provided numerous valuable sessions and articles to help inform and educate individuals of the possible implications of the new legislation and subsequent clarifications. It is without a doubt that the passing of the TCJA was disruptive to the industry, because changes of this magnitude have not been seen for several years.

The section's friends and council members contributed to two of the Society of Actuaries' (SOA) educational requirements undergoing change. First, the new Individual Life and Annuity Module contains a wealth of life and annuity product information, and this would not be complete without mention of U.S. requirements for life insurance taxation and Canada's Exemption test. The other educational component is the new U.S. version of the Individual Life and Annuity Financial Management Exam targeted to be released in the spring of 2020. The tax material needed review because of the changes resulting from the TCJA. To support the new exam syllabus, a combination of previously published articles and two additional pieces were written to introduce and succinctly describe insurance company tax to prospective students.

Lastly, the 2019 SOA Annual Meeting & Exhibit will include information not only on U.S. policyholder taxation requirements but also about Canada's product tax requirements.

None of this would have been possible without the shared vision of the section's council, friends and members. Without their contribution and willingness to volunteer, much of this would not have been possible. One does not have to be an expert to volunteer. Sometimes, all that is needed is a willingness to collaborate with others and a small investment of time to contribute to the greater good.

As the section moves forward, the need for tax information will continue, and change is inevitable. As I was recently reminded (from an image of a coaster), there are two certainties with life, death and taxes. ■

Tony R. Litterer, FSA, MAAA, FLMI, is an actuary at Fidelity & Guaranty Life Insurance Company and may be reached at *tony.litterer@fglife.com*.

Photo courtesy of Larry Hersh, *Taxing Times* editor, and Moonlight Brewing Co.

In the Beginning … A Column Devoted to Tax Basics

Tax Accounting and Deferred Taxes for Life Insurance Companies

By Kristin Norberg

Most actuaries are familiar with the major book/tax differences that affect the taxation of a U.S. life insurance company: adjustments to insurance reserves, the "DAC tax," the dividends-received deduction and limitations on the utilization of losses, to name a few. But how do these adjustments affect a company's financial statements? What impact do taxes have on statutory surplus? And what are some key concepts every actuary should understand in order to properly model the tax-related financial impacts of decisions being analyzed? This edition of "In the Beginning … A Column Devoted to Tax Basics" will address these questions through an introductory discussion of tax accounting for insurance companies.

THE TAX PROVISION

Every quarter, most insurance company tax departments across the country prepare the provision for federal, state and foreign income taxes under U.S. Generally Accepted Accounting Principles (GAAP) defined by the Financial Accounting Standards Board (FASB) and under statutory accounting principles (SAP) defined by the National Association of Insurance Commissioners (NAIC).[1] This article will focus primarily on statutory income tax accounting.

The tax provision includes both *current tax expense/(benefit)*, which estimates the company's income taxes payable or refundable for the current period, and *deferred tax expense/(benefit)*, which reflects the future income tax consequences of events that have been recognized in the company's financial statements. Generally speaking, current taxes represent what will be on the company's tax return for the current year, while deferred taxes represent what will be on future tax returns with respect to events that have already occurred. One important distinction between GAAP tax accounting and SAP tax accounting is the geography of deferred taxes: for GAAP, both the current and deferred tax expense/(benefit) are reported as part of the total provision for income taxes in net income. For SAP, only the current tax expense/(benefit) is reported in net income; the change in deferred taxes is recorded directly to surplus.

A simple example will illustrate the basics of current and deferred taxes. Assume that an individual life insurance contract has an annual premium of 100 due on Dec. 15, 2019, but by year-end the premium has not yet been received. Under SAP, the insurance company's statutory annual statement for 2019 will reflect the 100 of premium income anyway because it has been "earned." Because the 100 of uncollected premium has been recognized in the financial statements, tax accounting principles require that we consider the current and deferred tax consequences of that premium.

Tables 1 and 2 illustrate these consequences, looking at the uncollected premium in isolation.[2] Because the individual policyholder has not paid the premium yet, it is not includible in taxable income, so the tax provision would subtract 100 from pre-tax book income in order to get to current taxable income, and there would be no current tax expense in 2019 (Table 1). However, in 2019 the company would recognize a deferred tax expense of 21 (100 of premium multiplied by the current enacted tax rate of 21 percent). This is because, in 2020, either the premium will actually be received and will become taxable income at that time (Table 2A), or the premium will not be received and will be reversed out of statutory earned premiums (Table 2B). Either way, the timing difference from the earlier recognition of the premium in statutory income will "reverse" in 2020 when the statutory uncollected premium asset is either settled or written off.

Notice that in all three tables, the line "Tax: Uncollected premium adjustment" involves 21 of tax expense on one side, and (21) of tax benefit on the other. In this case, the tax adjustment line reflects deferred tax expense and current tax benefit in 2019 when the earned premium is reported in statutory income, followed by current tax expense and deferred tax benefit in 2020. This is a typical pattern for timing or temporary differences, and it is commonly referred to as a *current/deferred flip*. Ultimately, the cumulative total tax expense is equal to 21 percent of whatever premium is actually received; the current/deferred flip is merely accounting that in many cases may have no material economic impact, although it can create significant differences in statutory surplus, as we will explore later.

Table 1
As of 12/31/2019: Premium is Due Dec. 15 but Uncollected

	Current		Deferred (in Surplus)	
	Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory earned premium	100	21		
Tax: Uncollected premium adjustment	(100)	(21)	100	21
Tax expense/ (benefit) in 2019		**0**		**21**

Table 2A
As of 12/31/2020: If Premium Due is Collected in January

	Current		Deferred (in Surplus)	
	Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory earned premium	0	0		
Tax: Uncollected premium adjustment	100	21	(100)	(21)
Tax expense/ (benefit) in 2020		**21**		**(21)**
Cumulative tax expense/(benefit)		**21**		**0**

Table 2B
As of 12/31/2020: If Premium Due is Never Received

	Current		Deferred (in Surplus)	
	Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory earned premium	(100)	(21)		
Tax: Uncollected premium adjustment	100	21	(100)	(21)
Tax expense/ (benefit) in 2020		**0**		**(21)**
Cumulative tax expense/(benefit)		**0**		**0**

CURRENT TAXES AND PERMANENT AND TEMPORARY DIFFERENCES

Let's step back from the uncollected premium example for a more general view of the tax provision, beginning with the current side. The following series of formulas summarizes how a current tax provision operates.

Pre-tax book income

+/– Permanent differences

+/– Temporary differences

Taxable income before net operating loss (NOL) carryforward

– NOL carryforward

Taxable income

× Applicable tax rate

Current tax provision before credits and adjustments

– Applicable tax credits

+/– Other discrete adjustments

Provision for current tax expense/(benefit)

Permanent differences are items that are included in book income but never included in taxable income, or vice versa. For example, certain meals, entertainment expenses, fines and penalties that a company incurs are disallowed as a tax deduction; the company must "add back" those expenses to pre-tax book income in order to determine taxable income. Also, certain investment income items have favorable permanent differences: municipal bonds and corporate stocks produce interest income and dividend income, respectively, but these amounts can be partially excluded from taxable income through tax-exempt interest adjustments and the dividends-received deduction.

Temporary differences are items that may be included in book income in one year and taxable income in a later year, or vice versa. As we saw in the uncollected premium example, these differences are only timing and do not affect the ultimate amount of taxable income over the life of the item. However, particularly after the 2017 tax law commonly known as the Tax Cuts and Jobs Act (TCJA),[3] some of a life insurance company's timing differences can be very large and of long duration, creating significant costs due to the time value of money. Further, as we will see, the requirements of statutory deferred tax accounting mean that a company may have an immediate surplus hit due to a temporary difference. Despite the fact that a company expects to realize an offsetting tax benefit in the future when the temporary difference reverses, it may have to reflect most of the tax expense in its surplus position today and only recognize the offsetting tax benefit gradually over time.

Some of the temporary differences that regularly affect life insurance companies include:

- adjustments to insurance reserves—*e.g.*, exclusion of deficiency reserves, application of the 92.81-percent factor under the TCJA;
- DAC tax—*i.e.*, capitalization and amortization of certain expenses, based on a proxy policy acquisition expense rate;
- deferred and uncollected premiums and premiums received in advance;
- investment timing differences—*e.g.*, accrual of market discount on bonds, credit-related impairment of a debt instrument, recognition of unrealized gains and losses on certain investments; and
- depreciation of fixed assets—*e.g.*, computers, software, office furniture.

As illustrated in the formulas, loss carryforwards also create book/tax differences. When an insurance company incurs a loss, it is not necessarily able to realize a tax benefit immediately. For a life insurance company after the TCJA, ordinary losses can no longer be carried back to recover taxes already paid; NOLs may be carried forward indefinitely to realize tax benefits in future years, but they can only offset up to 80 percent of pre-NOL taxable income in any year.[4] Capital losses may be carried back three years and forward five years but can only be used to offset capital gains, not ordinary income. Tax credits (*e.g.*, for investments in subsidized housing for low-income residents) also have limitations on utilization in a given year and on carryovers to other years. These are important rules to recognize in actuarial

modeling activities, especially stress testing, and to keep in mind when analyzing deferred tax assets, which we will discuss next.

DEFERRED TAX ASSETS AND LIABILITIES

Temporary differences and loss carryforwards create *deferred tax assets* (DTAs) or *deferred tax liabilities* (DTLs). A deductible temporary difference generates a DTA because it will result in tax deductions (or reductions of pre-tax book income in order to determine taxable income) and current tax benefits in the future—*e.g.*, the future amortization of DAC tax balances. A taxable temporary difference generates a DTL because it will result in taxable income (or reduction of a pre-tax book expense) and current tax expense in the future—*e.g.*, the future inclusion of uncollected premiums that have already been recognized in statutory income. The collection of all of a company's DTAs and DTLs is known as its *deferred tax inventory*.

While the current tax provision primarily addresses the current year's tax return, deferred tax consequences may persist for years or even decades.[5] As a result, the accounting authorities have established a range of evaluation criteria for determining whether deferred tax items can be fully reflected in the financial statements in a given reporting period. In particular, a DTA represents a future tax deduction (or reduction in future pre-tax book income), so accounting rules require consideration of whether the company will have sufficient taxable income of appropriate character in those future periods to be able to realize the tax benefit. Both U.S. GAAP and SAP require a company to post a *valuation allowance* against a DTA if the company is not sufficiently likely to be able to realize the tax benefit. Additionally, SAP establishes rules for determining the *admissibility* of a DTA; nonadmitted DTAs, like other nonadmitted statutory assets, may not be counted toward the statutory surplus of the company.

A valuation allowance is applied, if necessary, to reduce gross DTAs to the amount that the company is more likely than not to be able to realize.[6] For example, a valuation allowance may be applied if a company has historically experienced losses and does not have evidence that this will change in the future, or if a company has capital DTAs (representing capital losses) but no expectation of future capital gains against which to offset them. Valuation allowance analysis is similar under U.S. GAAP and SAP, although SAP requires each entity separately to consider the realizability of its own DTAs, while U.S. GAAP generally assesses realizability for the consolidated group in accordance with U.S. consolidated tax return rules.

Under SAP, once a company has determined its "adjusted gross DTAs" after application of a valuation allowance, if any, it must also consider admissibility of those adjusted gross DTAs. This is a statutory concept not present in U.S. GAAP, and it generally reflects the focus of SAP on regulating solvency for the protection of policyholders. In short, an insurance company is not allowed to take a surplus benefit for a net DTA that would only be realized many years in the future—if the company is still profitably in business—because such tax benefits cannot be used to satisfy policyholder obligations today. As a result, SAP imposes limitations on the period of time within which net DTAs must be realized, among other limits, in order to be admitted in surplus.

Specifically, admissibility of adjusted gross DTAs under SAP is based on a three-part calculation defined in paragraph 11 of Statement of Statutory Accounting Principles No. 101 (SSAP 101). The three parts generally involve carrybacks, three-year reversals (sometimes referred to as three-year turns) and a DTL offset:

- **Paragraph 11.a. Carryback**. An insurance company is permitted to recognize DTA reversals that could be carried back to recover federal income taxes paid in prior years. For this purpose, the carryback period is as defined under applicable tax law, not to exceed three years. As mentioned previously, ordinary losses can no longer be carried back by a life insurance company under TCJA; thus, application of paragraph 11.a. is now limited to capital DTAs for companies taxed as life insurance companies.

- **Paragraph 11.b. Three-year reversals.** An insurance company is also permitted to recognize DTA reversals that can reduce taxes payable in future years. The period for which such reversals may be reflected is limited to three years, with stricter limits applying to companies that do not meet certain solvency thresholds. Additionally, the DTA admitted under paragraph 11.b. cannot exceed 15 percent of adjusted capital and surplus, again with stricter limits applying to companies that do not meet certain thresholds. This is perhaps the most "actuarial" component of SSAP 101, because it requires the projection of future statutory income, taxable income and the timing of reversals of existing DTAs, including those relating to insurance reserves.

- **Paragraph 11.c. DTL offset.** In very general terms, a company may admit adjusted gross DTAs under paragraph 11.c. in an amount equal to the lesser of (1) its adjusted gross DTAs, after subtracting the amount admitted under paragraphs 11.a. and 11.b., or (2) its gross DTLs.

There are many other complications in practice, requiring careful attention to character (ordinary vs. capital), timing, grouping of items, adjustments to prevent double-counting, application of

Table 3
2019 Statutory Tax Provision

		Current		Deferred (in Surplus)	
		Gross	Tax (at 21%)	Gross	Tax (at 21%)
Statutory pre-tax income[7]		100	21		
Permanent differences *Fines and penalties* Add back non-deductible penalty		20	4		
Temporary differences					
Reserves		400	84	(400)	(84)
Add back change in statutory reserves	9,700				
Deduct change in tax reserves	(9,300)				
DAC tax		202	42	(202)	(42)
Add DAC capitalization	209				
Deduct DAC amortization	(7)				
Taxable income; Tax expense/(benefit)		**722**	**151**	**(602)**	**(126)**

the limitations on loss utilization, changes in enacted tax rates, consideration of tax-planning strategies and other nuances. For purposes of this article, the general concepts can be illustrated through a simple example involving an insurance company that issues a single annuity contract, producing two DTA components to be considered under SSAP 101 paragraph 11.

> While the current tax provision primarily addresses the current year's tax return, deferred tax consequences may persist for years or even decades.

STATUTORY TAX PROVISION EXAMPLE

Let's assume a life insurance company sells one individual non-qualified fixed deferred annuity contract in 2019, for a single consideration of 10,000. Also:

- The DAC tax capitalization rate for individual non-qualified annuities is 2.09 percent of premium, and this is amortized over 15 years beginning in the middle of 2019. As a result, the company would capitalize 209, of which 7 would amortize in the first year and 14 each following year until the remaining balance is amortized in 2034.
- The statutory reserve at the end of 2019 is 9,700 and the net surrender value is 9,300. The tax reserve is 9,300, which is the greater of the 9,300 net surrender value, or 9,003 (92.81 percent of the 9,700 statutory reserve).
- The company has investment income of 400 and general expenses (including acquisition expenses) of 600, which includes a non-deductible penalty of 20. Aside from the DAC tax and the disallowance of the penalty, no other adjustments or limitations apply to these items.
- The company has a strong surplus position, permitting reflection of three years of DTA reversals and up to 15 percent of surplus in paragraph 11.b.
- The company has no other DTAs or DTLs.

Without regard to the limitations on admissibility of deferred tax assets, the company's tax provision for statutory reporting would be as shown in Table 3.

Note that the total tax expense in this view is 25, which is the current tax expense of 151 reflected in net income, partially offset by a deferred tax benefit of (126) recorded directly to surplus. As expected, the total tax expense is equal to statutory pre-tax income, plus permanent differences, multiplied by the 21-percent tax rate; the temporary differences are merely a current/deferred flip.

The (126) deferred tax benefit reflects that the company has established 126 of new DTAs. However, as required by SAP, the company must consider the realizability and admissibility of the DTAs. Assume the company has a strong earnings history and reasonable expectation of continued future income, so it concludes it is more likely than not to realize its DTAs and no valuation allowance is required. Then, we proceed through the three steps for determining the admitted DTA:

- **Paragraph 11.a. Carryback.** Because the reserves and DAC tax are ordinary income items, these are not eligible for carryback by a life insurance company under the TCJA, so no DTAs are admissible under paragraph 11.a.

- **Paragraph 11.b. Three-year reversals.** Assume the actuary projects that the reserve temporary difference for this contract will decrease by 80 each year for five years, until both the statutory and tax reserves are equal to the net surrender value. The DAC amortization is 14 per year (one-fifteenth of the original 209 capitalization). Thus, the total deductible temporary differences will be 94 per year during the three-year reversal period. Assume the company has a reasonable expectation of continued future earnings, with enough projected income to absorb the reversing temporary differences each year, and also that the surplus cap does not come into play. Then, the cumulative three-year reversal is 282 gross (94 per year for three years), which produces 59 of admitted DTA at 21 percent.

- **Paragraph 11.c. DTL offset.** In this example, we are assuming the company does not have any other DTAs or DTLs. Thus, there is no additional DTA to admit under paragraph 11.c.

As a result, the total admitted DTA is 59, which means the remaining 67 (that is, 126 gross DTA minus 59 admitted) is nonadmitted. The statutory Summary of Operations for 2019 would be as shown in Table 4.

Table 4
Tax Components in Summary of Operations

	Increase/(Decrease) in Surplus
Federal income taxes incurred *Current tax (expense), a component of net income*	(151)
Change in net deferred income tax *Total deferred tax benefit, recorded directly to surplus*	126
Change in nonadmitted assets *(Increase) in nonadmitted DTA, recorded directly to surplus*	(67)
Total (decrease) in surplus due to federal income tax	**(92)**

Thus, although the total tax expense in Table 3 was only 25, the reduction in surplus in 2019 due to federal income taxes is 92 after reflecting statutory limitations on DTA admissibility. As long as the company remains a going concern with sufficient income, eventually the remaining DTA will become admitted as it rolls into the three-year reversal period, and ultimately the total tax expense over time will be 25 if there are no future changes in enacted tax rates. However, there is additional surplus strain up front due to the SSAP 101 admissibility requirements. This effect has been made worse under the TCJA due to the increased DAC tax capitalization rates, generally steeper haircut on reserves and generally longer reversal patterns for both DAC tax and reserves, although these adverse effects may be mitigated over time by the reduction in the corporate tax rate from 35 percent to 21 percent.

In light of the importance of statutory surplus to company management and other stakeholders and the sometimes unintuitive surplus results that may arise due to corporate income taxes, an actuary would be well served by investing time to develop a working knowledge of the key tax law and tax accounting concepts applicable to insurance companies. This article has provided only a starting point but has hopefully encouraged the reader to collaborate across actuarial and tax functions in order to properly model the tax and surplus impacts of products and transactions under consideration. ■

The views expressed are the author's and do not necessarily reflect those of Symetra Life Insurance Company.

Kristin Norberg, FSA, MAAA, is assistant vice president and tax actuary at Symetra Life Insurance Company and may be reached at *kristin.norberg@symetra.com*.

ENDNOTES

1 The U.S. GAAP requirements for accounting for income taxes are defined under Accounting Standards Codification Topic 740. The NAIC requirements for accounting for income taxes are defined under Statement of Statutory Accounting Principles No. 101. Some companies are also subject to other accounting regimes, such as International Financial Reporting Standards or Canadian GAAP.

2 Note that there would likely also be related adjustments involving reserves and loading.

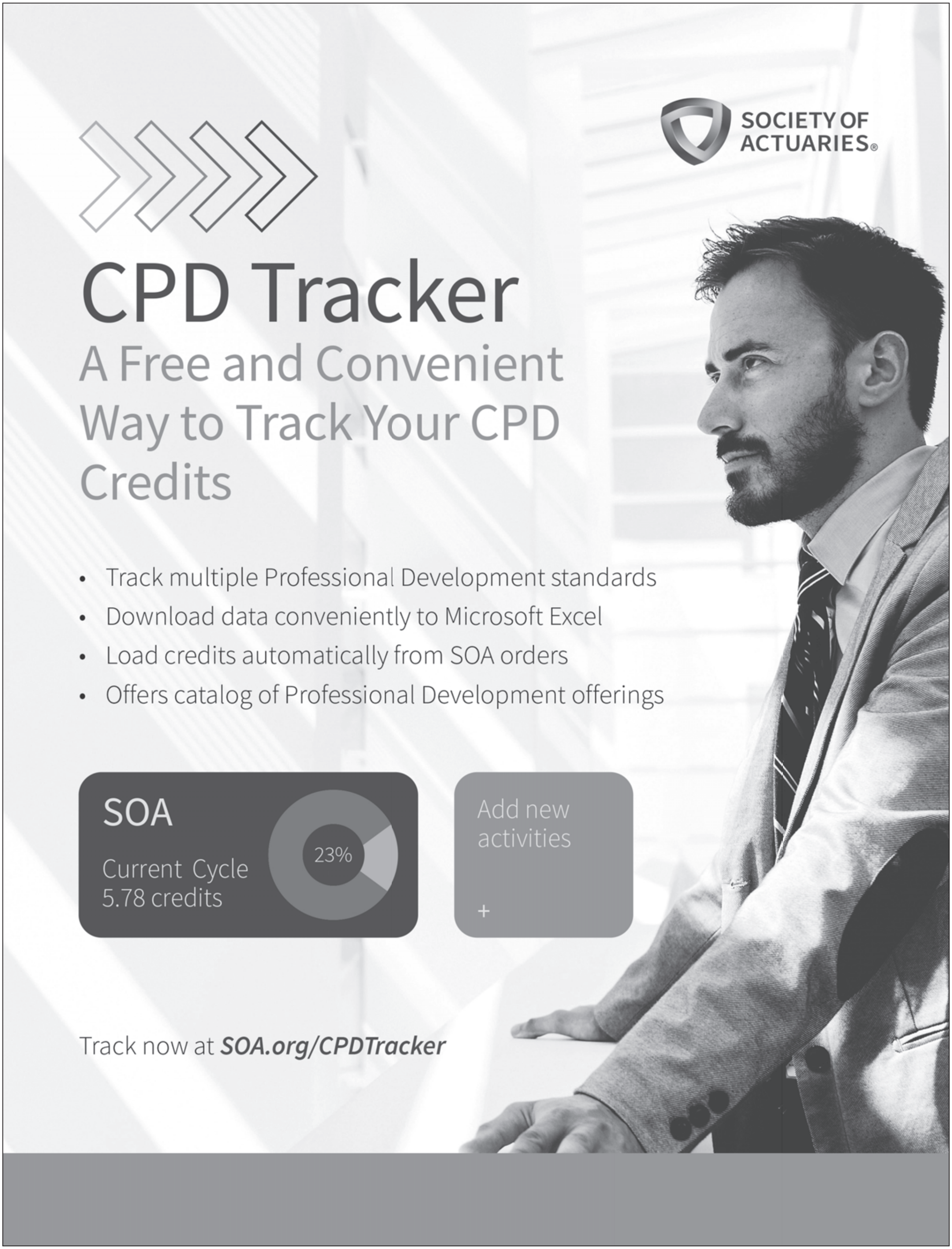
3 Pub. L. No. 115-97, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," enacted Dec. 22, 2017.

4 Insurance companies that do not qualify as life insurance companies for federal income tax purposes continue to be subject to the two-year NOL carryback/20-year NOL carryforward periods that applied to such companies prior to the TCJA, with no 80-percent limitation. Life and non-life insurance companies have the same rules for utilization of capital losses.

5 Of course, examinations by the Internal Revenue Service and any resulting controversy may also take years to reach final resolution.

6 It can sometimes be confusing to discuss DTAs and DTLs because the term "gross" may be used to mean either (1) not tax-effected, *e.g.*, the amount of a temporary difference before multiplying by 21 percent, or (2) the DTAs or DTLs separately, *e.g.*, a gross DTA of 21 combined with a gross DTL of (14) produces a net DTA/(DTL) of 7. This ambiguity can usually be resolved through context.

7 Statutory pre-tax income is 10,000 premium plus 400 investment income, less 9,700 increase in reserves and 600 expenses.


SOCIETY OF ACTUARIES®
CPD Tracker
A Free and Convenient Way to Track Your CPD Credits
• Track multiple Professional Development standards
• Download data conveniently to Microsoft Excel
• Load credits automatically from SOA orders
• Offers catalog of Professional Development offerings
SOA
Current Cycle
5.78 credits
23%
Add new activities
+
Track now at SOA.org/CPDTracker

Proposed Regulations on Reporting Requirements for Transfers for Value of Life Insurance Contracts

By Craig Springfield and Kristin Norberg

On March 22, 2019, the Internal Revenue Service ("IRS") and the Department of the Treasury ("Treasury") issued proposed regulations regarding federal tax reporting of transfers for value of life insurance contracts and certain other transactions under section 6050Y,[1] which was added to the Internal Revenue Code ("Code") by the so-called Tax Cuts and Jobs Act of 2017 ("TCJA").[2] These proposed regulations also address modifications to the transfer-for-value rule of section 101(a)(2) that were made by the TCJA. In this article, we provide an overview of the key points addressed by the proposed regulations, and we briefly address comments requested by IRS/Treasury and comments submitted by the insurance industry and other interested parties.

OVERVIEW

Section 6050Y imposes tax reporting requirements in connection with certain transfers of life insurance contracts, which can be summarized as follows:

- **Acquirer reporting upon a reportable policy sale ("RPS").** First, upon a "reportable policy sale," within the meaning of section 101(a)(3)(B), the acquirer of a life insurance contract (or an interest therein) must file an information return with the IRS and furnish written statements to the issuer of the contract and to each "reportable policy sale payment recipient" reporting certain information with respect to the RPS.[3] The proposed regulations refer to the statement furnished to the issuer as a "reportable policy sale statement," or "RPSS."[4]

- **Issuer reporting upon RPS.** Second, upon receipt of the RPSS from the acquirer or upon notice of a transfer of a life insurance contract to a foreign person, the issuer of the contract must file an information return with the IRS and furnish a statement to the seller reporting the "investment in the contract" within the meaning of section 72(e)(6) and certain other information with respect to the RPS or transfer.[5]

- **Issuer reporting of reportable death benefits.** Third, when a "reportable death benefit" within the meaning of section 6050Y(d)(4) is paid, the issuer must file an information return with the IRS and furnish a statement to each "reportable death benefits payment recipient," reporting certain information, including an estimate of the buyer's investment in the contract.[6]

The TCJA also modified the transfer-for-value rule of section 101(a)(2). Under this rule, where there has been a transfer for value, the exclusion from income for life insurance death benefits generally is limited to the consideration the transferee pays for a contract. However, this limitation generally does not apply to a transfer where (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract (referred to herein as the "Carryover Basis Exception")[7] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder (referred to herein as the "Related-Party Transfer Exception").[8] The TCJA added section 101(a)(3) to the Code, which provides that these two exceptions to the limitation on the death benefit exclusion will not apply to a transfer of a life insurance contract, or any interest therein, which is a "reportable policy sale."[9] An RPS, in turn, is defined as "… the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract."[10] Section 101(a)(3) also clarifies that for purposes of this definition, the term "indirectly" "applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract." These changes to the transfer-for-value rule apply to transfers after Dec. 31, 2017.[11]

Prior to the issuance of the proposed regulations, the IRS provided guidance in Notice 2018-41.[12] A discussion of such guidance is set forth in the sidebar to the article "The Life Insurance Product Tax Provisions of H.R. 1," which was published in the June 2018 issue of *Taxing Times*.[13]

PROPOSED REGULATIONS ON SECTION 6050Y REPORTING REQUIREMENTS

As noted, the TCJA enacted section 6050Y, which imposes a tax reporting regime on acquirers of life insurance contracts (with reporting on Form 1099-LS at the time of the acquisition) and issuers of life insurance contracts (with reporting on Form 1099-SB at the time of the acquisition or transfer to a foreign person and on Form 1099-R or Form 1042-S when "reportable death benefits" are paid). Each of these reporting requirements will be discussed in turn.

Acquirer Reporting (Form 1099-LS)

The proposed regulations require a person that acquires a life insurance contract (directly or indirectly) in an RPS to file an information return with the IRS and furnish a statement to certain parties reporting specific information relating to the acquisition. The information required to be reported under the proposed regulations largely mirrors the statute: identifying information about the acquirer, the payment recipient and the contract issuer, along with the policy number, the date of the RPS and the amount of the payment.[14] The proposed regulations define a number of terms for this purpose:

- **RPS payment.** The amount of the payment to be reported includes not only cash transferred in exchange for the life insurance contract, but also the fair market value of any other consideration, including debt assumed by the acquirer.[15] Further, the definition includes amounts "transferred, or to be transferred," in an RPS; the preamble clarifies that RPS payments to be made in installments are all reportable in the year of the RPS and that RPS payments reported with respect to the seller include only the amount transferred to the seller, including debt assumed, but would not include amounts retained by a broker or other intermediary.[16]

- **RPS payment recipient.** Under the proposed regulations, the term "recipient of payment" in the statute is read broadly to include brokers and other intermediaries, in addition to the seller.[17] The acquirer is required to file a separate information return for and furnish a separate statement to each such recipient, showing that recipient's portion of the proceeds. As IRS/Treasury observed in the preamble to the proposed regulations, this broad definition does not necessarily follow comments received in response to Notice 2018-41, but the matter is still under consideration and IRS/Treasury requested additional comments, particularly with respect to ancillary costs and expenses.[18]

- **Issuer.** The proposed regulations define "issuer" differently depending on the particular reporting requirement being discussed. For purposes of the acquirer's reporting under section 6050Y(a), the "6050Y(a) issuer" is the issuer responsible for administering the contract, including collecting premiums and paying death benefits, on the date of the RPS.[19]

In addition to filing Form 1099-LS with the IRS and furnishing statements to the RPS payment recipients, an acquirer that acquires a life insurance contract directly in an RPS is also required to furnish a statement (referred to as the RPSS) to the 6050Y(a) issuer with respect to the seller.[20] Notably, if the acquisition is indirect, the acquirer is not required to furnish an RPSS to the issuer,[21] so an issuer may not have any knowledge of such an acquisition. Additionally, if the acquirer is a foreign person, the acquirer is only required to report with respect to an RPS if either the insured is a U.S. person at the time of the sale or the sale is subject to state laws (in U.S. states or the District of Columbia) pertaining to acquisitions or sales of life insurance contracts or interests therein.[22]

For an insurance company, the acquirer's reporting requirements are important primarily because the Form 1099-LS notifies the company that an RPS has occurred, triggering the company's own reporting obligations under sections 6050Y(b) and (c). While the regulations are in the process of being finalized, insurers should be considering operational aspects of the requirements, such as how to ensure that the Form 1099-LS is routed promptly to the proper team for processing, how the information from Form 1099-LS will be captured and stored, and how contracts that have been transferred in an RPS can be identified and tracked for subsequent reporting by the insurer.

Issuer Reporting at Acquisition (Form 1099-SB)

The statute and the proposed regulations require an issuer to report the seller's basis when a contract is transferred in a reportable policy sale or to a foreign person. There are two separate triggers for the issuer's reporting obligation:

- **Receipt of the RPSS, *i.e.*, Form 1099-LS.** Both the statute and the proposed regulations condition the issuer's reporting obligation under section 6050Y(b) upon receipt of the RPSS from the acquirer (or upon notice of transfer to a foreign person, discussed next).[23] Thus, if an issuer does not receive Form 1099-LS or an appropriate substitute form, and there has been no notice of transfer to a foreign person, then the issuer presumably does not have an obligation to report under section 6050Y(b).

- **Receipt of notice of transfer to a foreign person.** If the acquirer or transferee is a foreign person, both the statute and the proposed regulations require reporting by the issuer upon notice of a transfer to a foreign person;[24] there is no IRS-designated form for providing such notice. The legislative history of the TCJA indicates that Congress intended this trigger to be quite broad:

  > Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.[25]

  Appropriately, the proposed regulation narrows the concept slightly to clarify that there must be a "transfer of title to, possession of, or legal ownership of" the contract, but the proposed regulation then goes on to state that notice includes information provided for nontax purposes (such as a change of address for purposes of sending statements or with respect to loans, premiums or death benefits) "unless the 6050Y(b) issuer knows that no transfer of the life insurance contract has occurred or knows that the transferee is a United States person."[26] In this regard, the proposed regulations provide that if an issuer has a Form W-9 or valid substitute form indicating that the transferee is a U.S. person and providing a U.S. taxpayer identification number, the issuer may rely on this to conclude there has been no transfer to a foreign person.[27]

The statute and the proposed regulations also require an issuer to report "reportable death benefits."

Regardless of which trigger applies, the issuer will be required to file and furnish Form 1099-SB, containing identifying information about the seller, the policy number and the "investment in the contract" as defined in section 72(e)(6) with respect to such seller, as well as the "amount the seller would have received if the seller had surrendered the life insurance contract on the date of the [RPS] or the transfer of the contract to a foreign person."[28] The surrender value is not specifically enumerated in section 6050Y(b)(1). As discussed in the preamble to the proposed regulations, the IRS and Treasury concluded that reporting this value both to the seller and to the IRS is required in order to properly identify the portion of gain that is ordinary income (*i.e.*, the excess of the contract's surrender value over the seller's basis) and the portion, if any, that is capital gain (*i.e.*, any proceeds from the sale in excess of the surrender value).[29]

If the seller was the original owner of the contract, the issuer would generally have information on file to compute the seller's investment in the contract properly under section 72(e)(6). If the contract has been previously transferred (in an RPS or otherwise), the issuer may not have such information. The proposed regulations accommodate this by requiring the issuer to provide the "estimate of investment in the contract" with respect to a person other than the original policyholder, with such estimate defined on any date as "the aggregate amount of premiums paid for the contract by that person before that date, less the aggregate amount received under the contract by that person before that date to the extent such information is known to or can reasonably be estimated by the issuer or payor."[30] Note that the definition does not include the purchase price that a buyer paid for the in-force contract; generally, an insurer will not be privy to that information. Note also that the "aggregate amount received under the contract" in the estimate is not limited to the portion that was excludable from gross income, as would normally be the case under section 72.[31] In both respects, the estimate will tend to understate the taxpayer's actual basis, and the onus will be on the taxpayer to properly compute his or her basis and taxable income.

One final observation on the issuer's reporting obligation at acquisition relates to the identification of the issuer. As noted previously, the definition of "issuer" in the proposed regulations depends on the context, but the general definition includes "any person that bears any part of the risk with respect to the life insurance contract on that date and any person responsible on that date for administering the contract, including collecting premiums and paying death benefits."[32] This explicitly includes a reinsurer that has reinsured all or a portion of the risks of a contract through an indemnity reinsurance treaty.[33] Although the proposed regulations helpfully provide for unified reporting, allowing one issuer to satisfy the reporting obligations of all issuers with respect to section 6050Y(b) reporting for a contract,[34] the inclusion of indemnity reinsurers in the definition may create additional administrative complications and penalty exposure for entities that typically do not have access to the information needed for such reporting.[35]

Issuer Reporting at Death (Forms 1099-R and 1042-S)

The statute and the proposed regulations also require an issuer to report "reportable death benefits," defined as "amounts paid by reason of the death of the insured under a life insurance contract that are attributable to an interest in the life insurance contract that was transferred in a reportable policy sale."[36] The information to be reported after death includes identifying information about the payor and recipient, the date of the payment, the gross amount of payments made to the recipient, and the payor's estimate of the investment in the contract with respect to the buyer.[37]

The IRS has updated the 2018 and 2019 Form 1099-R and associated instructions to accommodate reporting under section 6050Y(c). This includes a new distribution code, code C, and a new field for the date of the payment.[38] Additionally, the instructions appear to allow companies to check the "Taxable amount not determined" box and leave the "Taxable amount" (Box 2a) blank for reportable death benefits, although the estimate of the investment in the contract must always be included in Box 5.[39]

The IRS has also updated the 2019 Instructions for Form 1042-S to include a new income code, providing the following guidance: "Use code 55 (taxable death benefits on life insurance contracts) to report taxable death benefits, such as benefits paid on an insurance contract that was acquired on a transfer for valuable consideration. See section 101 for when death benefits are taxable."[40] Interestingly, the instructions do not refer to "reportable death benefits" but rather the broader term "taxable death benefits." This arguably reflects the possibility that certain death benefits reportable under Treas. Reg. section 1.1461-1 may not be "reportable death benefits" as defined by section 6050Y(d)(4).

Summary of Proposed Reporting Requirements

Figure 1 summarizes the reporting requirements described earlier, including the deadlines for reporting of events that occur after final regulations are published.[41]

For transition relief, the proposed regulations provide transition deadlines for reporting on transactions occurring after Dec. 31, 2017, and before the date final regulations are published in the Federal Register. For an RPS occurring during that transition period, the acquirer must furnish the RPSS (Form 1099-LS) to the issuer by 60 days after the date final regulations are published in the Federal Register (or the applicable date from Figure 1, if later).[43] For all other information returns to be filed with the IRS or furnished to RPS payment recipients, sellers, transferors or reportable death benefits payment recipients, the transition deadline is 90 days after the date final regulations are published in the Federal Register (or the applicable date from Figure 1, if later).[44]

Figure 1
Summary of Proposed Reporting Requirements

Direct RPS		To: Insurer[a]	To: Recipient / Seller	To: IRS
From	Acquirer	1099-LS / RPSS Jan. 15 at latest[b]	1099-LS Feb. 15	1099-LS Feb. 28[c]
From	Insurer		1099-SB Feb. 15	1099-SB Feb. 28[c]

Indirect RPS[d]		To: Insurer	To: Recipient	To: IRS
From	Acquirer		1099-LS Feb. 15	1099-LS Feb. 28[c]
From	Insurer			

Transfer to foreign person		To: Transferor	To: IRS
From	Insurer	1099-SB Feb. 15[e]	1099-SB Feb. 28[c,e]

Reportable death benefits: U.S.		To: Recipient / Beneficiary	To: IRS
From	Insurer	1099-R Jan. 31	1099-R Feb. 28[c]

Taxable death benefits: foreign person[f]		To: Recipient / Beneficiary	To: IRS
From	Insurer	1042-S Mar. 15	1042-S Mar. 15

a. The "Insurer" represents the 6050Y(a) issuer, 6050Y(b) issuer and payor of reportable death benefits.
b. The RPSS must be furnished to the 6050Y(a) issuer by the later of 20 calendar days after the RPS, or five calendar days after the end of the applicable state law rescission period, but in no event later than Jan. 15 of the year following the calendar year in which the RPS occurred.
c. If Form 1099-LS, 1099-SB or 1099-R is filed with the IRS electronically, the deadline for such electronic filings is Mar. 31. Other extensions may also be available.
d. That is, an RPS for which the acquirer is not required to, and does not, provide an RPSS pursuant to Prop. Reg. section 1.6050Y-2(d)(2)(B). If the insurer receives an RPSS for an RPS that was made indirectly, then the insurer would apparently file and furnish Form 1099-SB following the "Direct RPS" section of this chart.
e. If the issuer does not receive notice of transfer to a foreign person until after Jan. 31 of the year following the transfer, the proposed regulations allow 30 days after the date notice is received.[42]
f. Taxable death benefits to foreign persons include reportable death benefits and any death benefits for which reporting is otherwise required, such as under Treas. Reg. section 1.1461-1.

PROPOSED REGULATIONS ON THE TRANSFER-FOR-VALUE RULE

As noted, if a life insurance contract is transferred for value, the exclusion from income under section 101 for the death benefit generally is limited by the transfer-for-value rule of section 101(a)(2) to the sum of the consideration paid by the transferee for the contract and the premiums and other amounts subsequently paid by the transferee for the contract.[45] Also, reflecting new section 101(a)(3), the proposed regulations provide that the Carryover Basis Exception and the Related-Party Transfer Exception to the transfer-for-value rule's limitation on the amount of the excludable death benefit will not apply if the transfer is an RPS.[46] Thus, ascertaining whether a transfer should be characterized as an RPS is a threshold inquiry in determining whether the exclusion for death benefits under section 101 will be limited by section 101(a)(2)'s transfer-for-value rule. The proposed regulations also provide other guidance and clarifications relating to the Carryover Basis and Related-Party Transfer Exceptions that are noteworthy. We next examine each of these points in turn.

Reportable Policy Sale (RPS) Definition

Mirroring the statutory definition in section 101(a)(3)(B), the proposed regulations generally define an RPS as "… any direct or indirect acquisition of an interest in a life insurance contract if the acquirer has, at the time of the acquisition, no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in the life insurance contract."[47]

The proposed regulations address the scope of RPSs in part by defining the phrase "interest in a life insurance contract" and also by defining "direct" and "indirect" acquisitions of an interest in a life insurance contract.[48] For example, an "indirect" acquisition of an interest in a life insurance contract occurs when "a person (acquirer) becomes a beneficial owner of a partnership, trust, or other entity that holds (whether directly or indirectly) the interest in the life insurance contract."[49] Significantly, the proposed regulations state that, for this purpose, the term "other entity" "does not include a C corporation, unless more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts.…"[50] Thus, purchasing stock in a C corporation with life insurance holdings that do not meet this threshold would not be an RPS with respect to that stock purchaser, and a transfer of the contract by a C corporation that does not meet this threshold would not be an indirect transfer of the contract by the C corporation's shareholders.

The proposed regulations also clarify that naming a revocable beneficiary is not a transfer of an interest in a life insurance contract; in contrast, an irrevocable beneficiary designation would be such a transfer.[51] Also, the preamble to the proposed regulations clarifies that the granting of an enforceable right to name the beneficiary is a transfer of an interest in a contract.[52] Further, the assignment or pledge of a contract as a collateral assignment is not a transfer of an interest in the contract.[53] In addition, the issuance of a life insurance contract is not treated as a transfer of an interest in the contract, "other than the issuance of a policy in an exchange pursuant to section 1035."[54] (The preamble to the proposed regulations requested comments on "[w]hether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts." In this regard, the ACLI comment letter indicated that, in light of the definition of an RPS, an acquirer would be unlikely to meet insurable interest requirements with respect to an insured and thus would be unlikely to be able to purchase a new policy in exchange for a policy that had been acquired in an RPS. The ACLI thus recommended that no additional provisions be added to the regulations for this circumstance.)

The proposed regulations also include two groups of situations where a transfer of a contract is not an RPS: The first group is a list of specific transactions that will not be treated as RPSs. The second group addresses transfers where the acquirer will be considered to have at the time of the acquisition a *substantial* family, business, or financial relationship with the insured, which based on section 101(a)(3) are not treated as RPSs.

> The proposed regulations clarify that naming a revocable beneficiary is not a transfer of an interest in a life insurance contract.

Specific Transactions That are not Treated as RPSs

The proposed regulations specify that the following transfers of interest in life insurance contracts are not RPSs:

- A transfer between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20 percent ownership interest from that beneficial owner's ownership interest in the transferee entity.[55] For this purpose, if there is a series of transfers, this exception is applied by comparing the beneficial owners' ownership interest in the first transferor entity and the last transferee entity.[56] Also, where a trust's beneficial ownership of a life insurance contract is involved, the ownership interest of each beneficial owner of the trust is determined by the broadest possible exercise of a trustee's discretion in the beneficial owner's favor.[57]

- A transfer between corporations in the same affiliated group (as defined in section 1504(a)) that files a consolidated U.S. income tax return for the taxable year in which the transfer occurs.[58]

- The indirect acquisition of an interest in a life insurance contract if the entity that directly holds the interest acquired it in an RPS that was reported as required by section 6050Y(a) and Treas. Reg. section 1.6050Y–2.[59]

- The indirect acquisition of an interest in a life insurance contract if, prior to the acquisition, no more than 50 percent of the gross value of the assets of the partnership, trust, or other entity directly holding the interest consists of life insurance contracts, and with respect to that entity, the person indirectly acquiring the interest in the contract (acquirer) and his or her family members own no more than a 5 percent interest.[60] Whether a 5 percent interest is held must be determined based on total combined voting power and value of all classes of stock (for S corporations), corpus and annual income rights, assuming the maximum corpus and income that can be distributed for the benefit of the acquirer and his or her family members (for trusts), and capital and profits interests (for partnerships and other noncorporate/nontrust entities).[61] As noted above, an indirect transfer of an interest occurs with respect to a C corporation only where more than 50 percent of the gross value of the assets of the C corporation consists of life insurance contracts.[62] As noted earlier, where less than 50 percent of gross value consists of such contracts, a transfer of a contract by such a C corporation would not be treated as an indirect transfer of that contract by the corporation's shareholders. (A transfer of a contract by a shareholder to a C Corporation could, however, be an RPS.[63])[64]

Transactions Where the Acquirer is Considered to Have a Substantial Family, Business, or Financial Relationship With the Insured

As noted, the second group of transfers that are not treated as RPSs are transfers where the acquirer is considered, at the time of the acquisition, to have a substantial family, business, or financial relationship with the insured. The proposed regulations provide more specific rules for these "substantial" relationship exceptions to RPS treatment, as follows:

- **Substantial family relationship.** The following "family members" have a substantial family relationship with the insured: spouse (including a registered domestic partner and civil union); parents, grandparents and great-grandparents of the individual and spouse; and lineal descendants of any of these individuals and their spouses (and the lineal descendants of such spouses).[65] A substantial family relationship also exists where there is a transfer to (or in trust for) a former spouse incident to divorce.[66] Further, a substantial family relationship generally exists between an insured and family partnerships or family trusts if all beneficial owners of those entities have a substantial family relationship with the insured.[67]

- **Substantial business relationship.** The insured has a substantial business relationship with a trade or business where the insured "is a key person … of, or materially participates … in, an active trade or business as an owner, employee, or contractor, and at least 80% of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or the beneficial owners of the acquirer."[68] Also, if certain requirements are met, a substantial business relationship exists where the acquirer acquires a life insurance contract in connection with the acquisition of an active and continuing trade or business (that does not involve investments in life insurance contracts) and the insured is an employee, director or highly compensated individual of such trade or business.[69]

- **Substantial financial relationship.** The acquirer has a substantial financial relationship with the insured if the acquirer, directly or indirectly, has "a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable."[70] A substantial financial relationship also exists where the acquirer maintains the life insurance contract to "provide funds to purchase assets or satisfy liabilities following the death of the insured."[71] In addition, a substantial financial relationship exists where the acquirer is a charitable organization meeting certain criteria that previously received financial support in a substantial amount or significant volunteer support from the insured.[72]

With respect to the latter two types of "substantial" relationships, an acquirer of an indirect interest in a life insurance contract is deemed to have a substantial business and financial relationship with the insured if the direct holder of the interest has a substantial business or financial relationship with the insured immediately before and after the acquisition of that indirect interest.[73] Being a partner of the insured or a partnership in which the insured is a partner does not in and of itself establish a substantial business or financial relationship with the insured.[74] The same is the case where the acquirer is a corporation and the insured is a shareholder or officer.[75] At the same time, these types of relationships are not prerequisites to the existence of a "substantial" relationship with the insured.[76]

Application of Exceptions to Transfer-for-Value Rule

In circumstances where a transfer is not an RPS, the proposed regulations include a number of additional rules for the Carryover Basis and Related-Party Transfer Exceptions. The proposed regulations indicate that the Carryover Basis Exception will apply only if the Related-Party Transfer Exception does not apply.[77] Where the Carryover Basis Exception applies, the death benefit proceeds that are excludable from income under section 101(a)(1) is limited to the amount that would have been excludable by the transferor (had the transfer not occurred) and the premiums and other amounts subsequently paid by the transferee.[78] This limitation applies regardless of whether there has been a prior transfer and the nature of prior transfers.[79] Further, with respect to the Related-Party Transfer Exception, the proposed regulations state that this exception is available only if the interest in the life insurance contract was not previously transferred in an RPS.[80] However, the proposed regulations provide that if the exception would have been available but for a prior transfer that was an RPS, then the death benefit proceeds that are excludable from income under section 101(a)(1) is limited to the higher of the amount that would have been excludable by the transferor (had the transfer not occurred) or the value of consideration paid by the transferee, plus the premiums and other amounts subsequently paid by the transferee.[81]

Due to these rules, even if a transfer avoids characterization as an RPS, the transfer nonetheless may constitute a transfer for value for which neither the Carryover Basis Exception nor the Related-Party Transfer Exception applies. As an illustration of this point, Example 1 of Prop. Reg. section 1.101-1(g)(1) addresses the treatment of a sale of a life insurance contract originally owned and covering a father (A) to his son (B) for the contract's fair market value and concludes that the transfer-for-value rule limits the exclusion from income when the death benefit is paid to B. The Carryover Basis Exception does not apply in this example because the basis of B's interest is not determined in whole or in part by reference to the basis of the interest in the hands of the transferor, A. Also, the Related-Party Transfer Exception does not apply, since B is not the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

Example 3 of Prop. Reg. section 1.101-1(g)(3) modifies Example 1 by assuming that the son, B, sells the contract back to A for the contract's fair market value. Because the transfer is to the insured, the Related-Party Transfer Exception applies under this fact pattern, and thus the exclusion from income under section 101 is not limited by the transfer-for-value rule.[82] Example 5 of Prop. Reg. section 1.101-1(g)(5) is similar in that the contract is originally purchased by (and covers) A, is sold to another person (in this case, C, an unrelated person) and is eventually repurchased by A for its fair market value. Here, the Related-Party Transfer Exception does not apply since the transfer of the contract to C was an RPS, and thus the transfer-for-value rule limits the exclusion from income to the sum of (1) the higher of the amount C could have excluded (had the transfer back to A not occurred) or the actual value of the consideration for that transfer paid by A, and (2) any premiums and other amounts paid by A after the transfer back to A.[83]

Gratuitous Transfers

The proposed regulations principally address transfers of a life insurance contract (or an interest therein) for valuable consideration, since that is the circumstance where the section 101(a)(1) exclusion from income for the death benefit is limited. However, the proposed regulations also include a rule for gratuitous transfers, and they assert that in some circumstances such transfers could be RPSs. For all gratuitous transfers of an interest in a life insurance contract, including any that might be RPSs, the proposed regulations state that the exclusion from income is limited to the sum of the amount of the proceeds that would have been excludable by the transferor (had the transfer not occurred) and the premiums and other amounts subsequently paid by the transferee.[84] If a transfer is in part for valuable consideration and in part gratuitous, each part is treated as a separate transaction and is subject to the rules applicable to the transfers of the respective parts.[85]

Example 6 of Prop. Reg. section 1.101-1(g)(6) extends Example 5, but assumes that C gratuitously transferred the contract back to A (the original owner and covered insured who previously transferred the contract to C in an RPS). On these facts, the Related-Party Transfer Exception does not apply, since the transfer of the contract to C was an RPS. Also, the exclusion limitation equals the amount C could have excluded (had the transfer back to A not occurred) plus the premiums and other amounts paid by A after the gratuitous transfer back to A.[86]

The ACLI comment letter questioned the appropriateness of imposing reporting requirements for gratuitous transfers. The ACLI pointed out that the transfer-for-value rule applies only where there is a "transfer for valuable consideration" and said that this limitation on scope extended to the RPS definition as a matter of statutory construction; the ACLI also expressed concern about taxpayer confusion from tax reporting for transactions that do not result in the realization of income.[87]

Health Insurance Death Benefits

In addition to the previously described changes, the proposed regulations under section 101 make further modifications to existing regulations to reflect changes in the law. In this regard, the preamble to the proposed regulations states that these changes "update § 1.101-1(a)(1) of the existing regulations to reflect … the addition of section 7702 (definition of life insurance contract) in 1984 [and] section 101(j) (treatment of certain employer-owned life insurance contracts) in 2006… ."[88] These changes include the elimination of the following sentence from Treas. Reg. section 1.101-1(a)(1), which has been part of that regulation since 1957: "Death benefit payments having the characteristics of life insurance proceeds payable by reason of death under contracts, such as workmen's compensation insurance contracts, endowment contracts, or accident and health insurance contracts, are covered by this provision."[89]

While the enactment of section 7702 adopted a comprehensive definition of "life insurance contract" for tax purposes, there is no specific indication in the legislative history of that enactment that Congress intended to reverse the tax treatment of death benefits from health insurance contracts that were within the ambit of this provision. Further, although the proposed deletion is based on the premise that this sentence is merely deadwood, this does not appear to be the case. It is fair to observe, for example, that insurance contracts sometimes include combinations of different types of coverage, one of which could be health insurance and another of which could be life insurance coverage. State regulation may focus on the predominant coverage as a matter of convenience, but this does not change the nature of the nondominant coverage. If the nondominant coverage constitutes life insurance under state or other governing law (*i.e.*, "applicable law" within the meaning of section 7702(a)) and the contract by its terms has no cash value (and thus would satisfy the cash value accumulation test of section 7702(b)), it certainly seems that the death benefit of the life insurance portion of the contract would be excludable under section 101.[90] Life insurance death benefit treatment also may be appropriate for death benefits provided under some employer group health insurance contracts. Ascertaining when a life insurance benefit should be treated as satisfying the "applicable law" standard is a complicated question that depends on the facts and state law regime. In these circumstances, it seems that the original sentence should be retained in the regulations.[91]

Requests for Comments

In the preamble to the proposed regulations, Treasury and the IRS set forth an enumerated request for comments on the following topics:

1. electronic statements,
2. the timing of payments and ancillary costs relating to RPSs (and existing reporting requirements for payments),
3. whether only issuers should be considered payors of reportable death benefits,
4. whether a substantial business relationship or substantial financial relationship should be considered to exist between the acquirer and insured in circumstances not included in the proposed regulations,
5. whether the proposed regulations should include additional provisions regarding the treatment of section 1035 exchanges of life insurance contracts, and
6. whether the exceptions to reporting by 6050Y(b) issuers and payors under Prop. Reg. sections 1.6050Y-3(f)(1) and 1.6050Y-4(e)(1) (covering sellers and reportable death benefit payment recipients documented as foreign beneficial owners) are appropriate, and also whether the proposed reporting requirements are duplicative or could be combined with other reporting requirements.[92] (Written or electronic comments were due by May 9, 2019.)

Effective Date

For purposes of section 6050Y, the proposed regulations generally apply to RPSs occurring after Dec. 31, 2017, and to reportable death benefits paid after Dec. 31, 2017.[93] For other purposes, the proposed regulations generally apply to transfers of life insurance contracts (or interests therein) made after the date of publication of final regulations in the Federal Register.[94] The ACLI and the Association for Advanced Life Underwriting ("AALU") requested clarification that the proposed regulations with respect to section 101(a)(3) could be relied upon for all transfers after Dec. 31, 2017.[95]

CONCLUDING THOUGHTS

The proposed regulations offer helpful clarifications—for example, with respect to common corporate transactions that are not directed toward effecting a transfer for value of life insurance. It is of course necessary that the regulations appropriately implement the statute's requirements, but congressional intent and the practical challenges faced by insurers and others in administering the new reporting regime also should be kept in mind. We encourage the IRS and Treasury to continue the dialogue with the various stakeholders in the process leading toward the issuance of final regulations. ■

Craig Springfield is a partner with Davis & Harman LLP and may be reached at *crspringfield@davis-harman.com*.

Kristin Norberg, FSA, MAAA, is assistant vice president and tax actuary at Symetra Life Insurance Company and may be reached at *kristin.norberg@symetra.com*.

ENDNOTES

1 Except as otherwise noted, references herein to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

2 Pub. L. No. 115-97, title I, § 13520. The proposed regulations were published in the Federal Register on March 25, 2019. *See* 84 FR 11009 (March 25, 2019).

3 Code section 6050Y(a) and Prop. Reg. section 1.6050Y-2(a) and (d).

4 Prop. Reg. sections 1.6050Y-1(a)(17) and 1.6050Y-2(d)(2)(i).

5 Code section 6050Y(b) and Prop. Reg. section 1.6050Y-3.

6 Code section 6050Y(c) and Prop. Reg. section 1.6050Y-4.

7 Upon a sale of property, including a life insurance contract, taxable gain generally must be recognized under the rules of section 1001, and for this purpose gain equals the excess of the amount realized upon the sale over the taxpayer's adjusted basis in the property. Code section 1001(a); Rev. Rul. 2009-13, 2009-21 I.R.B. 1029. "Adjusted basis" is defined by section 1011 and generally equals the cost of the property to the taxpayer with certain adjustments. Where a taxpayer acquires property by gift, however, section 1015(a) generally provides that the taxpayer's basis upon the gift "shall be the same as it would be in the hands of the donor," subject to certain limitations and adjustments. Other examples where adjusted basis carries over from one taxpayer to another include section 362(a) and (b) (for certain contributions by a shareholder to a corporation and upon certain reorganizations), section 334(b) (relating to liquidations of corporations), and section 723 (for contributions by a partner to a partnership).

8 Code section 101(a)(2).

9 Code section 101(a)(3)(A).

10 Code section 101(a)(3)(B).

11 TCJA § 13522(c). In addition to the previously described changes, the TCJA clarified that the adjusted basis of a life insurance contract under section 1011, which is relevant to the tax treatment of sales and other dispositions of property under section 1001, is not reduced by "mortality, expense, or other reasonable charges incurred under [a] … life insurance contract." TCJA § 13521(a). This amendment reverses the position the IRS had adopted regarding the treatment of mortality charges in Rev. Rul. 2009-13. The amendment is effective for transactions entered into after Aug. 25, 2009, which was the effective date of the revenue ruling. TCJA § 13521(b).

12 2018-20 I.R.B. 584.

13 John T. Adney, Brian G. King and Craig R. Springfield. The Life Insurance Product Tax Provisions of H.R. 1, *Taxing Times*, Vol. 14, Issue 2, at 30–39 (June 2018), *https://www.soa.org/globalassets/assets/library/newsletters/taxing-times/2018/june/tax-2018-vol-14-iss2.pdf* (accessed September 20, 2019).

14 Code section 6050Y(a)(1) and Prop. Reg. section 1.6050Y-2(a).

15 Prop. Reg. section 1.6050Y-1(a)(15).

16 84 FR 11009, 11010-11 (March 25, 2019); the latter amounts would instead be reportable to the broker or intermediary.

17 Prop. Reg. section 1.6050Y-1(a)(16).

18 84 FR 11009, 11011 (March 25, 2019). The Life Insurance Settlement Association ("LISA") submitted comments describing the many types of ancillary costs that may arise in an RPS, stating that such costs would already be reportable under section 6041 and requesting that they be excluded from the definition of RPS payments. Letter of Christopher Conway and Bryan Nicholson to IRS (May 8, 2019) (the "LISA comment letter"). The Institutional Longevity Markets Association ("ILMA") made a similar request. Letter of John Kelly to IRS (May 9, 2019) (the "ILMA comment letter").

19 Prop. Reg. section 1.6050Y-1(a)(8)(ii).

20 Prop. Reg. section 1.6050Y-2(d)(2). No reporting to the issuer is required with respect to brokers or other intermediaries; additionally the amount of the RPS payment made to the seller is not required to be disclosed to the issuer.

21 Prop. Reg. section 1.6050Y-2(d)(2)(i)(B).

22 Prop. Reg. section 1.6050Y-2(f). If the acquirer, insured, and governing law for the acquisition are all non-U.S., then presumably the IRS would not have jurisdiction to require information reporting by the acquirer.

23 Code section 6050Y(b)(1) ("Upon receipt of the statement required under [section 6050Y(a)(2)]") and Prop. Reg. section 1.6050Y-3(a) ("each 6050Y(b) issuer, that receives a RPSS").

24 Code section 6050Y(b)(1) and Prop. Reg. section 1.6050Y-3(a).

25 H.R. Rep. No. 115-466 (2017) (Conference Report) at 485.

26 Prop. Reg. section 1.6050Y-1(a)(10).

27 *Id.* The American Council of Life Insurers ("ACLI") submitted a comment letter requesting a number of clarifications and changes to the proposed regulations. One such request was to modify the definition of "notice of a transfer to a foreign person" to include only notices that contain foreign indicia (*e.g.*, a foreign address or foreign taxpayer identification number). Letter from Regina Rose and Mandana Parsazad, ACLI, to Helen Hubbard, Alexis MacIvor, and Kathryn Sneade of the IRS and Angela Walitt of Treasury (May 9, 2019) (the "ACLI comment letter").

28 Prop. Reg. section 1.6050Y-3(a).

29 84 FR 11009, 11013 (March 25, 2019). *See also* Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, regarding the character of income realized upon sale of a life insurance contract. The preamble cites sections 6050Y(b)(1), 6011(a), and 7805 as providing authority for the IRS to require reporting of the surrender value. 84 FR 11009, 11013 (March 25, 2019).

30 Prop. Reg. section 1.6050Y-1(a)(7).

31 Code section 72(e)(6)(B). Note, however, that if the issuer is preparing a Form 1099-SB for the original policyholder, it should follow the regular rules under section 72(e)(6)(B).

32 Prop. Reg. section 1.6050Y-1(a)(8)(i).

33 *Id.*

34 Prop. Reg. sections 1.6050Y-3(b) and 1.6050Y-3(d)(3).

35 The ACLI comment letter recommended that the definition of issuer exclude "a reinsurer in an indemnity contract covering all or a portion of the risks that the original issuer (and continuing contract administrator) might otherwise have incurred with respect to a life insurance contract," as the IRS had originally proposed in Notice 2018-41.

36 Prop. Reg. sections 1.6050Y-4(a) and 1.6050Y-1(a)(12). *See also* Code sections 6050Y(c) and 6050Y(d)(4).

37 Code section 6050Y(c)(1) and Prop. Reg. section 1.6050Y-4(a).

38 It is unclear from the "Guide to Distribution Codes" chart in the current versions of the instructions (dated July 13, 2018, for the 2018 tax year and Dec. 18, 2018, for the 2019 tax year) whether code C is intended to be used with code 4. The charts do consistently reflect that the new code C may be used with code D (relating to the Medicare surtax on net investment income under section 1411), if applicable.

39 The ACLI comment letter also requests guidance on whether income tax withholding should be based on the gross payment or the net payment (*i.e.*, the reportable death benefits less the issuer's estimate of investment in the contract).

40 2019 Instructions for Form 1042-S (Jan. 7, 2019).

41 *See* Prop. Reg. sections 1.6050Y-2(c) and (d), 1.6050Y-3(c) and (d), and 1.6050Y-4(b) and (c). *Also see* 2018 Instructions for Form 1099-LS (Feb. 19, 2019), 2019 Instructions for Form 1099-SB (Feb. 21, 2019), 2018 Instructions for Forms 1099-R and 5498 (July 13, 2018), and 2019 Instructions for Form 1042-S (Jan. 7, 2019).

42 Prop. Reg. sections 1.6050Y-3(c) and 1.6050Y-3(d)(2). This extension only applies to delayed receipt of notice of transfer to a foreign person. The ACLI comment letter requested that a parallel extension be granted if the issuer does not receive an RPSS until after Jan. 31 of the year following the RPS. Additionally, the ACLI comment letter requested broader, permanent penalty relief for issuers unable to meet the filing due date for reasons beyond the control of the issuer.

43 Prop. Reg. section 1.6050Y-1(b)(1).

44 Prop. Reg. section 1.6050Y-1(b)(2). The ACLI comment letter requested that the transition filing deadline for reporting under section 6050Y(b) and (c) be extended to 120 days, rather than 90 days, after final regulations are published in the Federal Register.

45 Prop. Reg. section 1.101-1(b)(1)(i).

46 Prop. Reg. section 1.101-1(b)(1)(ii)(A) and (B).

47 Prop. Reg. section 1.101-1(c)(1).

48 Prop. Reg. section 1.101-1(e).

49 Prop. Reg. section 1.101-1(e)(3)(ii).

50 *Id.* The methodology for determining the gross value of assets is set forth in Prop. Reg. section 1.101-1(f)(4). Where an entity is publicly traded, if the entity's Form 10-K does not contain information demonstrating that more than 50 percent of the entity's assets consist of life insurance contracts, one can assume (absent actual knowledge otherwise) that no more than 50 percent of the gross value of the entity's assets consist of such contracts. Prop. Reg. section 1.101-1(f)(4)(ii). Also, a safe harbor is provided under which the cash value of life insurance contracts and the adjusted basis of other assets may be used to identify gross value. Prop. Reg. section 1.101-1(f)(4)(iii).

51 Prop. Reg. section 1.101-1(e)(2).

52 84 FR 11009, 11016 (March 25, 2019).

53 Prop. Reg. section 1.101-1(e)(2).

54 *Id.*

55 Prop. Reg. section 1.101-1(c)(2)(i). This exception to RPS treatment is illustrated by Prop. Reg. section 1.101-1(g)(10), Example 10.

56 Prop. Reg. section 1.101-1(c)(2)(i).

57 *Id.*

58 Prop. Reg. section 1.101-1(c)(2)(ii).

59 Prop. Reg. section 1.101-1(c)(2)(iii)(A). The ILMA comment letter stated that this exception should apply to circumstances where the direct holder acquired its interest prior to 2018 and the entity otherwise reports properly with respect to contracts acquired after 2017. The LISA comment letter similarly requested relief where an investment vehicle has acquired life insurance contracts in transactions prior to 2018.

60 Prop. Reg. section 1.101-1(c)(2)(iii)(B). The gross value of assets is determined under the rules of Prop. Reg. section 1.101-1(f)(4). Also, the application of this 5 percent interest rule is illustrated by Prop. Reg. section 1.101-1(g)(12), Example 12.

61 Prop. Reg. section 1.101-1(c)(2)(iii)(B).

62 Prop. Reg. section 1.101-1(e)(3)(ii).

63 *See*, *e.g.*, Prop. Reg. section 1.101-1(g)(9), Example 9.

64 The LISA comment letter requested the elimination of reporting for certain indirect investors, such as where such reporting would be duplicative, impractical or might not produce meaningful information. The LISA comment letter also requested that the reporting obligation not apply to investors in an investment vehicle who have a 5 percent or lesser economic and voting interest in that vehicle and who are not officers or directors of the vehicle. Further the LISA comment letter requested relief for situations where life insurance contracts are held directly by nominees or securities intermediaries, but the partnership or other entity in which investors beneficially invest in such contracts does not hold a direct interest in the contracts.

65 Prop. Reg. section 1.101-1(d)(1) and (f)(3).

66 Prop. Reg. section 1.101-1(d)(1).

67 *Id.* Michael L. Van Cise, Esq., submitted a comment letter in which he questioned the need of requiring that all beneficial owners have a substantial family relationship, such as in circumstances where other beneficial owners have either a substantial business or substantial financial relationship with the insured. Letter of Michael L. Van Cise to Michael Desmond, William Paul, and Drita Tonuzi of IRS (May 9, 2019). Also, a comment letter submitted by Steven Gorin requested that relief extend to circumstances where the transfer is to a trust established to benefit charities. Letter of Steven B. Gorin to IRS (May 9, 2019).

68 Prop. Reg. section 1.101-1(d)(2)(i). The application of the substantial business relationship exception to the RPS definition is illustrated by Prop. Reg. section 1.101-1(g)(7) and (8), Examples 7 and 8.

69 Prop. Reg. section 1.101-1(d)(2)(ii).

70 Prop. Reg. section 1.101-1(d)(3)(i).

71 Prop. Reg. section 1.101-1(d)(3)(ii). A comment letter submitted on behalf of MB Schoen & Associates requested clarification that a substantial financial relationship exists for certain pooling arrangements through partnerships of bank-owned life insurance used to fund employee benefit obligations. Letter of Bryan W. Keene and Craig R. Springfield to IRS (May 8, 2019).

72 Prop. Reg. section 1.101-1(d)(3)(iii). A comment letter submitted by Steven Gorin requested relief for circumstances where a transfer of a contract to a charity is in part charitable and in part for value. Letter of Steven B. Gorin to IRS (May 9, 2019).

73 Prop. Reg. section 1.101-1(d)(4)(i). An indirect acquirer's substantial business or financial relationship is illustrated by Prop. Reg. section 1.101-1(g)(11), Example 11.

74 Prop. Reg. section 1.101-1(d)(4)(ii).

75 *Id. See also* Prop. Reg. section 1.101-1(g)(9), Example 9, regarding a transfer of a life insurance contract by a shareholder to a corporation. The exclusion from income under section 101 for the death benefit payable to the corporation was limited by the transfer-for-value rule. The example concludes that no substantial business or financial relationship exists on this fact pattern.

76 *Id.*

77 Prop. Reg. section 1.101-1(b)(1)(ii)(A).

78 *Id.* The amount that would have been excludable by the transferor had the transfer not occurred seemingly should be determined by assuming that the transferor continues to hold his or her interest in the contract (*e.g.*, 100 percent ownership) through the date of the insured's death. *See* Prop. Reg. section 1.101-1(g)(8), Example 8.

79 *Id.*

80 Prop. Reg. section 1.101-1(b)(1)(ii)(B)(1).

81 Prop. Reg. section 1.101-1(b)(1)(ii)(B)(2). *See also* Prop. Reg. section 1.101-1(g)(5), Example 5.

82 A comment letter submitted by Steven Gorin requested that the example be revised to describe the transfer as being for value, and not necessarily for fair market value. Letter of Steven B. Gorin to IRS (May 9, 2019). This letter also requested that the regulations permit a "clean start" where there has been no prior RPS of the contract if the insured pays fair market value for the policy.

83 Prop. Reg. section 1.101-1(g)(5), Example 5; Prop. Reg. section 1.101-1(b)(1)(ii)(B)(2). The ACLI comment letter requested that insurers be permitted to check "taxable amount not determined" on Form 1099-R in certain situations where multiple transfers have occurred, such as when an RPS is followed by another transfer that is not an RPS. The ACLI comment letter references this Example 5 and also Example 6, discussed next, as examples of situations where such reporting is appropriate.

84 Prop. Reg. section 1.101-1(b)(2)(i). *See also* Prop. Reg. section 1.101-1(g)(2) and (6), Examples 2 and 6. If a contract has never been transferred for value, no limitation on the excludable death benefit should apply by reason of section 101(a)(2) or (3). Also, as noted earlier, the amount that would have been excludable by the transferor had the transfer not occurred seemingly should be determined by assuming that the transferor continues to hold his or her interest in the contract through the date of the insured's death. Thus, for example, if the transferor held 100 percent of the contract before the transfer and was not subject to any limitation on the excludable death benefit, then 100 percent of the death benefit would be excludable to the transferee who received the contract gratuitously from that transferor. Since the limitation on the transferee's exclusion is due to a carryover of a tax attribute from the transferor, seemingly a similar carryover of the attribute of any substantial family, financial, or business relationship that the transferor had with the insured should apply.

85 Prop. Reg. section 1.101-1(b)(2)(iii).

86 Prop. Reg. section 1.101-1(g)(6), Example 6; Prop. Reg. section 1.101-1(b)(2)(i).

87 ACLI comment letter, referencing the statutory language of section 101(a)(2) and (3).

88 84 FR 11009, 11015 (March 25, 2019).

89 T.D. 6280, 22 FR 10103, 10104 (Dec. 17, 1957). This sentence was included in the notice of proposed rulemaking published in the Federal Register at 20 FR 7484 (Oct. 7, 1955).

90 The legislative history of section 7702, in addressing contracts that under state law are treated as a combination of life insurance and an annuity, indicates that only the portion of the contract that is life insurance under state law is treated as a life insurance contract under section 7702. *See*, *e.g.*, S. Prt. No. 98-169, vol. I, at 572 (1984).

91 The ACLI comment letter requested that the sentence in the regulations be retained.

92 84 FR 11009, 11019 (March 25, 2019).

93 Prop. Reg. section 1.101-6(b).

94 *Id.*

95 Letter from Marc Cadin, AALU, to Secretary Steven Mnuchin of Treasury and Commissioner Charles Rettig of the IRS (May 9, 2019).

Final Regs on Discounting Cancellable A&H (and Property-Casualty) Claim Reserves Under § 846

By Gregory K. Oyler

On June 17, 2019, the Internal Revenue Service (IRS) published Final Regulations[1] implementing changes to loss reserve discounting under section 846 of the Internal Revenue Code (Code) made by the Tax Cuts and Jobs Act (TCJA).[2] Earlier articles in this newsletter have looked at issues raised by this TCJA provision a few months after enactment[3] and shortly after proposed regulations were issued.[4] This note addresses changes made in the Final Regulations, particularly modification of rules for determining the interest rate used for discounting, in response to comments from taxpayers on the proposed regulations.

The IRS has recently followed up with a revenue procedure (Rev. Proc. 2019-31[5]) providing revised discount factors under section 846 for the 2018 accident year and prior accident years, as well as factors for the 2019 accident year. At the same time, the IRS has set automatic consent procedures (Rev. Proc. 2019-30[6]) for changes in accounting methods to comply with the new law. While discounting is of great significance for unpaid losses of property-casualty (P-C) insurance companies, it also applies to claim liabilities on cancellable accident and health (A&H) insurance (other than disability income) written by life insurance companies.

TCJA CHANGES

Under section 846, discount factors for each line of business and accident year are determined based upon "applicable loss payment patterns" and an "applicable interest rate" (determined annually). Under prior law, the applicable interest rate was a 60-month average of the "applicable Federal mid-term rate"—a rate used for Original Issue Discount (OID) and below-market loans under section 1274(d), derived from U.S. obligations with maturities over three but not more than nine years ("3.5 to 9 years"). The TCJA changed the applicable rate to a 60-month average of the "corporate bond yield curve" (sometimes referred to as the High Quality Market, or HQM Curve), a set of monthly spot rates under section 430(h)(2)(D)(i) used for certain pension funding standards, derived from investment-grade corporate bonds, with maturities from 0.5 year to 100 years. After the TCJA amendment, section 846 no longer specifies a particular set of maturities for determining the applicable interest rate. As Kristin Norberg noted in her article, "It is unclear how Congress intended the IRS to translate the corporate bond yield curve into 'a rate.'"[7]

The TCJA also modified how loss payment patterns are determined.[8] It repealed the experience election of prior law, which permitted an electing taxpayer to compute discount factors itself using its own historical loss payment patterns for all lines of business. This change requires all taxpayers to use discount factors published by the IRS, based on aggregate, industry-wide payment patterns. The TCJA also changed the computational rules of section 846(d) for extending loss payment patterns for long-tail lines (auto liability, other liability, medical malpractice, workers compensation, multiple peril). Under the new law, the 10-year pattern reported on the annual statement is extended up to 14 more years, with the average of payments in seventh, eighth and ninth years repeated to the extent necessary, and any final balance treated as paid in the 24th year. (This extension is potentially nine years longer than prior law and has the effect of increasing the amount of discount and decreasing the current deduction for losses incurred.) For short-tail lines, the TCJA did not change the prescribed pattern, which treats losses unpaid at the end of the first year after the accident year as paid equally in the second and third years. The TCJA also repealed special rules for international and reinsurance lines and use of additional annual statement data.

Effective for the 2018 tax year, these TCJA changes include a transition adjustment spread over eight years. The adjustment is equal to the difference between the amount of year-end 2017 loss and loss adjustment expense reserves discounted under the old law, and the recomputed amount of those reserves discounted according to the new discounting tables applicable (using new-law interest rate and payment patterns) for the 2018 accident year.

PROPOSED REGULATIONS (PROPOSED REGS)

Because of the variety of interest rates provided by the HQM Curve, there was discussion among taxpayers before proposed regulations were issued about whether the IRS should provide for use of multiple rates (*e.g.*, one for short-tail lines of business and another for long-tail lines) in regulations under the new law. In fact, the Preamble to the Proposed Regs[9] noted that a "more accurate measure of the present value" would result from use of multiple interest rates, directly applying the rate from the HQM Curve at the maturity that matches the expected maturity of the liability, based on loss payment pattern for each line.[10]

Although (as the Preamble explained) the IRS considered this multiple-rate approach, the IRS instead proposed a single rate to apply for all lines of business, because the TCJA amendments "do not clearly indicate an intent to change from the historical practice of applying a single rate to all loss payment patterns."

On the important question of which bond maturities to employ in determining the rate, the Proposed Regs specified that the applicable interest rate would be the average of the HQM Curve's monthly spot rates with times to maturity of not more than 17.5 years (0.5 to 17.5 years). The Preamble explained that the 0.5- to 17.5-year maturity range was selected because the resulting single interest rate came closest to the results of the "more accurate" approach of directly applying multiple rates, based on modeling done by the Department of the Treasury. At the same time, the Preamble imputed congressional intent to match industry investments, explaining, "The change from using the average of the applicable Federal mid-term rates to the averaged corporate bond yield curve, however, indicates 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 [actually, paid] in the future by insurance companies."

With respect to loss payment patterns, the Proposed Regs described a detailed adjustment process to avoid negative payment amounts and otherwise produce a stable pattern of positive discount factors less than one (based on broad discretion to make needed adjustments). Further, although the IRS had provided since 1988 for use of composite discount factors for discounting losses not separately reported by accident year on the annual statement, the Proposed Regs would have eliminated this use of the composite method and required taxpayers with unpaid losses not separately reported by accident year to compute discounted unpaid losses for the accident year using the discount factor published by the Secretary for that year and line. With respect to discounting salvage and subrogation (salvage), the Proposed Regs indicated that Treasury anticipated publishing guidance that estimated salvage recoverable was to be discounted using the published loss discount factors. They also included proposed cleanup of provisions of existing regulations that are no longer relevant, such as the experience election, the 1986 fresh start transition rule and others. Finally, Treasury requested comments on a variety of issues, including the length of payment patterns for non-proportional reinsurance and international lines and whether net payment data (net of salvage recovered) should be used to compute loss discount factors.

Rev. Proc. 2019-6

Rev. Proc. 2019-6[11] provided tables of discount factors under the Proposed Regs applicable for 2018 and prior accident years for the 2018 tax year. The same proposed factors (at correlative stages of development) were applicable for 2017 and prior accident years in the recomputation of all discounted loss reserves at year-end 2017 required by the TCJA transition adjustment. The revenue procedure also provided tables for discounting 2018 and prior accident years in subsequent tax years (at later stages of development). Consistent with the Proposed Regs, all these tables reflected an annual interest rate for 2018 of 3.12 percent, based on monthly spot rates on corporate bonds with maturities of not more than 17.5 years (average of monthly yields from January 2013 to December 2017 [60 months]). The factors were based on aggregate loss payment data on the 2015 annual statement and reflected smoothing adjustments (which the IRS found necessary under the process described in the Proposed Regs) for only one line: Other Liability-Claims Made. The revenue procedure also provided discount factors for taxpayers using the composite method for unpaid losses for accident years not separately reported on their annual statement. Finally, the revenue procedure provided that the same factors were applicable for discounting salvage, as the IRS had provided in prior years.

Rev. Proc. 2019-6 also set out the options available to a taxpayer if final regulations include changes that result in revised discount factors for the 2018 accident year after a tax return has been filed using the original proposed factors. A taxpayer could either

- file an amended return(s) using the revised factors, or
- calculate the adjustment resulting from use of revised factors at end of the last year the proposed factors were used, and take that adjustment into account either
  - all in the first year the taxpayer uses revised factors, or
  - ratably over the remaining years in the TCJA eight-year period of adjustment.

Taxpayer Reaction to the Proposed Regs

Comments on the Proposed Regs were filed by all the P-C insurance trade associations[12] and by a group of 10 P-C companies. Comments were also filed by the American Council of Life Insurers because unpaid losses on certain A&H insurance business written by life insurance companies also are subject to section 846 discounting. Commenters generally recommended, in determining the interest rate, use of shorter bond maturities than the 0.5 to 17.5 years of the Proposed Regs, and a number supported use of 3.5- to 9-year maturities employed by the prior statute (or alternatively 0.5 to 13 years). Commenters also supported the stated purpose of the Proposed Regs to more closely match the industry's bond investments. Some commenters recommended a single interest rate and others were silent on the issue. It was also suggested that if final regulations did not specify shorter maturities (such as 3.5 to 9 years) generally, then the final regulations should include a "guardrail" to limit longer maturities used in times of an anomalous yield curve. One trade association suggested that the final regulations provide for the IRS to re-select, every five years, an appropriate range of HQM Curve maturities (based on then-current conditions) that best approximated the industry's investment yield. Commenters also supported the smoothing adjustments outlined in the Proposed Regs, sought continuation of the composite method and contended treatment of non-proportional reinsurance and international lines as short-tail lines was required by the statute, absent a technical amendment.

In particular, commenters reached the conclusion that there was friction between the Proposed Regs' statement of congressional purpose to "more closely match" the industry's bond investments and those same Proposed Regs' theory that a "more accurate measure of the present value" would result from selecting rates based on matching with expected maturities of the industry's losses, accident year by accident year. Unlike many life insurance companies, P-C insurers generally do not match maturities of their bond investments with expected payments of their loss liabilities. Rather, for P-C insurers, loss volatility, investment strategies and long-term regulatory capital requirements play a greater relative role in their selection of bond maturities. Or, put another way, although valuing a book of insurance liabilities by matching rates and liabilities by expected maturities might be an accepted approach, the HQM Curve, without adjustment, would not be an appropriate set of interest rates for valuing P-C insurance. Since the TCJA specified use of the HQM Curve for loss reserve discounting, it was necessary to focus on matching the industry's actual bond investments rather than claims payout.

In this regard, commenters noted that P-C insurers' actual bond average weighted maturities were between 6.4 years and 7.1 years in 2008–2017, while the 0.5-to-17.5-year spread specified in the Proposed Regs reflected an average maturity of nine years. More importantly, commenters argued, the Proposed Regs' durations were even more excessive. The zero-coupon bonds reflected in the HQM Curve have a duration equal to maturity, but P-C insurers invest in coupon bonds that, because of periodic interest payments, have a duration shorter than maturity. Commenters suggested that the weighted average duration of the P-C industry's aggregate bond investments was about five years—significantly shorter than the 6.4- to 7.1-year maturities of those bonds. The commenters recommended that the regulations should select durations from the HQM Curve to match the five- to six-year average industry bond duration. In addition, commenters pointed out, the distortion of the duration mismatch was amplified by the fact that, at the 17.5-year extended maturity of the Proposed Regs, rates were usually significantly higher than on P-C bond investments. Further, the difference between a rate based on a 0.5- to 17.5-year range and a 0.5- to

13-year range (or 3.5 to 9 years) was often quite small, except in periods of a "steeper" yield curve (*i.e.*, with a greater gap between the lowest interest rate and highest interest rate in the maturity range employed). P-C companies were concerned that, historically, periods of steep yield curve had occurred during or just after recessions and had generally corresponded to periods of economic stress for P-C insurers—particularly when they coincided with downturns in an underwriting cycle—when the industry could least afford its capital to be reduced by inflated tax liabilities.

THE FINAL REGULATIONS (FINAL REGS)

The Final Regs adopt the Proposed Regs with certain revisions (as the Preamble to the Final Regs explains) made in response to the comments. Most significantly, the Final Regs specify use of a single annual interest rate based on HQM Curve bond maturities from 4.5 years to 10 years (narrowed and reduced from the 0.5- to 17.5-year range of the Proposed Regs). This change results in an interest rate for 2018 of 2.94 percent (compared to 3.12 percent under the Proposed Regs). The Preamble to the Final Regs explains that Treasury and the IRS declined to adopt the maturity ranges suggested by commenters (3.5 to 9 years, or 0.5 to 13 years) because the suggested ranges would typically understate the P-C industry's investment yield as compared to the range adopted in the Final Regs. Table 1 summarizes these changes.

Table 1
Summary of Significant Changes in the Final Regs

Issue	Proposed Regulations	Final Regulations
Range of HQM Curve maturities used in determining applicable interest rate *Final Regs more in line with average maturities of aggregate P-C industry bond investments*	0.5–17.5 years	4.5–10 years
Resulting interest rate for 2018	3.12%	2.94%
Use of composite discount factors for losses not separately reported by accident year on annual statement	Not permitted	Permitted

In addition, again in response to comments, the Final Regs allow continued use of the composite method, reversing the position of the Proposed Regs. The Preamble explains the IRS will continue to publish composite discount factors annually. Commenters supported the smoothing adjustments described in the Proposed Regs and Rev. Proc. 2019-6 and, therefore, the Final Regs adopt the smoothing adjustment provisions as proposed. Similarly, commenters supported the proposed use of

the discount factors applicable to unpaid losses as the discount factor for salvage, and the Preamble states that future guidance will continue to provide that estimated salvage recoverable is to be discounted using the published discount factors applicable to unpaid losses. The Preamble noted that no responses were received with respect to a request for comments on whether net payment data and net losses incurred data should be used to compute loss discount factors, and as a result, Treasury and the IRS will continue to use payment data unreduced by salvage recovered and losses incurred data unreduced by salvage recoverable to compute loss discount factors. Further, the Preamble reports that commenters agreed that the TCJA's repeal of the special rule for international and reinsurance lines means that the amended statute requires non-proportional reinsurance and international lines of business to be treated as short-tail lines of business with three-year loss payment patterns. Finally, the Preamble states that Treasury and the IRS plan to issue guidance that provides simplified procedures for an insurance company to obtain automatic consent to change its method of accounting to comply with the amendments to section 846.

The Final Regs show that the IRS and Treasury considered thoughtfully the comments provided in response to the Proposed Regs. Although the Final Regs reflect an accommodation of the comments, they did not go as far in reducing the bond maturities used as commenters had requested. The Final Regs represent a compromise, producing an interest rate generally in the middle between the rate resulting from the 0.5- to 17.5-year maturity range of the Proposed Regs, and the result of the 3.5- to 9-year or 0.5- to 13-year range sought by commenters.

As anticipated, on July 22, 2019, the IRS released Rev. Proc. 2019-31, providing revised discount factors based on the 2.94 percent interest rate for the 2018 calendar year resulting from the Final Regs (but based on the same payment patterns used in preparing Rev. Proc. 2019-6). As under Rev. Proc. 2009-6, the revised discount factors include composite factors and are to be used in computing both discounted unpaid losses and estimated salvage recoverable. In addition to providing revised factors for the 2018 accident year and earlier accident years, Rev. Proc. 2019-31 also sets out factors for the 2019 accident year.

On the same date, the IRS also released Rev. Proc. 2019-30, which provides procedures for an insurance company to obtain automatic consent to change its method of accounting to comply with section 846, as amended by the TCJA, for the first (and potentially second) taxable year beginning after Dec. 31, 2017.[13] Most importantly, Rev. Proc. 2019-30 provides that the requirement for the company to file Form 3115, *Application for Change in Accounting Method*, is waived. This new revenue procedure clarifies that a company may take a favorable salvage adjustment into account separately all in one year and, for a company changing from proposed discount factors to revised factors, spells out in detail the transition options outlined in Rev. Proc. 2019-6. Thus, a taxpayer that has already filed its 2018 return using the proposed discount factors of Rev. Proc. 2019-6 will have to decide whether to file an amended return for 2018 to apply the revised discount factors of Rev. Proc. 2019-31, or to take a supplemental adjustment for the revised factors into account on the 2019 return (either all in that year or spread over the remaining seven years of the TCJA adjustment period). ■

Gregory K. Oyler is a partner with the Washington, D.C., law firm of Scribner, Hall & Thompson LLP and may be reached at *goyler@scribnerhall.com*.

ENDNOTES

1 T.D. 9863.

2 Pub. L. No. 115-97.

3 Kristin Norberg, Discounted Unpaid Losses: A Rate or a Curve?, *Taxing Times*, Vol. 14, Issue 2, at 22–23 (June 2018), *https://www.soa.org/globalassets/assets/library/newsletters/taxing-times/2018/february/tax-2018-vol-14-iss1.pdf* (accessed September 20, 2019).

4 Jay Riback, IRS's Proposed LRD Rules for Nonlife Reserves are Out, *Taxing Times*, Vol. 15, Issue 1, at 29–31 (Feb. 2019), *https://sections.soa.org/publication/?i=570716&p=&pn=#{%22issue_id%22:570716,%22view%22:%22articleBrowser%22,%22article_id%22:%223317358%22}* (accessed September 20, 2019).

5 2019-33 I.R.B. 643.

6 2019-33 I.R.B. 638.

7 Norberg, *supra*, at 22.

8 These changes generally do not affect life insurance companies. As noted in the Norberg article, the TCJA did not change the statutory loss payment pattern for cancellable A&H insurance other than disability income, and for cancellable disability income insurance (other than credit disability), both the payment pattern and the interest rate are disregarded. Norberg, *supra*, at 22.

9 REG-103163-18, released Nov. 5, 2018.

10 In the preamble of both proposed and final regulations, the IRS typically discusses comments received, different approaches considered and the reasons for the decisions made. Each preamble is a record of the administrative decision process, which can be important under the standard of judicial deference to the agency in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), if the reasonableness of the regulation is challenged in court. This discussion also can be a great help to taxpayers trying to understand the resulting regulation.

11 2019-2 I.R.B. 284, released Dec. 19, 2018.

12 These include Reinsurance Association of America (RAA), National Association of Mutual Insurance Companies (NAMIC), Property Casualty Insurers Association of America (PCIAA), American Insurance Association (AIA), and after the merger of the last two, American Property Casualty Insurance Association (APCIA).

13 Although the release of final revised discount factors after some companies have filed their 2018 returns is a complicating factor, it is not clear otherwise that such accounting change guidance would be necessary, as the TCJA mandates how to determine opening reserves for the first year under revised section 846 and spells out the calculation and application of the transition adjustment. After *Capital One Financial Corp. v Commissioner*, 659 F.3d 316 (4th Cir. 2011), *affg*. 130 T.C. 147 (2008), the IRS is perhaps cautious about its procedural responsibilities where Congress mandates a change in accounting treatment and puts the transition rule in non-codified statutory language. (*Capital One* held that where an amendment to section 1272 affected timing of income, the accompanying non-codified statutory transition rule, which specified that any required change of accounting method "shall be treated as made with the consent of the Secretary of the Treasury," was not effective as a waiver of the requirement of section 446(e) that a taxpayer must obtain the consent of the Treasury to change its accounting method.)

TCJA's NOL Changes and Their Potential Impact on Reinsurance Transactions

By Eli Katz and Lauren Allen

The sweeping changes brought about by the Tax Cuts and Jobs Act of 2017 ("TCJA")[1] are resulting in significant impacts to the taxation of reinsurance transactions and continue to factor into business decisions with respect to amounts, types and counterparties for reinsurance transactions. The significant TCJA changes—such as the lowering of the United States federal income tax rate to 21 percent, the base broadening measures and the changes to the U.S. taxation of foreign operations, as well as cross-border transactions—alter the underlying economics of reinsurance transactions. This article focuses on the TCJA's changes to the provisions for net operating losses ("NOLs") and highlights some of the challenges surrounding the NOL provisions that insurance companies may face when making business decisions around reinsurance agreements.

NET OPERATING LOSSES

The TCJA made significant changes to the utilization of NOLs generated in taxable years after Dec. 31, 2017, resulting in several complexities, in particular, for life and nonlife insurance companies included within a consolidated return.[2] For losses arising in taxable years beginning after Dec. 31, 2017, life insurance companies are now subject to the same general section[3] 172 NOL rules that apply to regular non-insurance companies (C-corporations), which provide for no carrybacks and indefinite carryovers. Additionally, the TCJA imposed a limitation whereby most entities seeking to utilize an NOL will be allowed a deduction only for an amount equal to the lesser of (1) the aggregate of the NOL carryovers to the taxable year or (2) 80 percent of its current year taxable income computed without regard to the deduction allowable under section 172.[4]

An interesting twist to these changes is that the TCJA retained the two-year carryback and 20-year carryover periods for nonlife (or property-casualty ["P&C"]) insurance companies and provided an explicit exception to exclude nonlife insurance companies from the 80 percent taxable income limitation on use of NOLs as described earlier.[5] To make matters more complicated, old law continues to apply to any NOLs generated prior to Jan. 1, 2018, for calendar year taxpayers. Table 1 provides a summary of the old versus new rules that apply to the various types of NOLs.

Table 1
Old vs. New Rules That Apply to NOLs

Company Type	Old Law	New Law
P&C *(Form 1120-PC)*	2 years Carryback 20 years Carryover	2 years Carryback 20 years Carryover *(Not subject to 80% TI limitation)*
C-Corporation *(Form 1120)*	2 years Carryback 20 years Carryover	0 years Carryback Indefinite Carryover *(+ 80% TI limitation)*
Life *(Form 1120-L)*	3 years Carryback 15 years Carryover	0 years Carryback Indefinite Carryover *(+ 80% TI limitation)*

As a result of these NOL changes, taxpayers in the insurance industry have had to come up with potential interpretations when certain issues arise requiring additional guidance and clarification that has yet to be published by the Internal Revenue Service ("IRS") or the Department of the Treasury ("Treasury"). For example, an issue has emerged regarding how to apply the 80 percent taxable income limitation when a taxpayer has both pre-2018 NOL carryovers and post-2017 NOL carryovers. One interpretation is that the 80 percent limit is determined without regard to any NOL carryovers—whether pre-2018 or post-2017. A second interpretation is that it is determined only without regard to post-2017 carryovers—*i.e.*, after reduction by pre-2018 carryovers. In December 2018, the "Bluebook"[6] explanation of the TCJA issued by the Joint Committee on Taxation took the latter view. However, the Bluebook is not official guidance, and no further clarification has yet addressed this specific issue.

Within the consolidated return framework, there are numerous complications that arise in handling these new NOL provisions, which include but are not limited to the interaction of the utilization of pre-2018 and post-2017 NOLs; interaction of 80 percent-limited losses with losses that are not limited; dealing with the ordering of the 35 percent crossover limitation between life and nonlife subgroups per section 1503 and the 80 percent limitation; and the interaction of the new NOL rules with the new international provisions such as the Global Intangible Low-Taxed Income ("GILTI") tax, the section 250 deduction and the Base Erosion and Anti-Abuse Tax ("BEAT").[7]

Due to the cyclical nature of insurance and market forces that cause occasional loss years, insurance companies may have to grapple with these loss usage rules more frequently than other industries. Further, these complexities are likely to impact indemnity reinsurance transactions, as gains or losses are created for the ceding company and the assuming company in the year the reinsurance transaction occurs. For example, to the extent a loss is generated by a life reinsurer as a result of an indemnity reinsurance transaction and such loss exceeds the reinsurer's other taxable income, the reinsurer might not obtain the same tax benefit as under prior law due to its inability to carry back such loss and the limitation on use of carryovers only to the extent of 80 percent of taxable income. This is illustrated in Figure 1, a simplified Life Insurers Illustration (next page). In order to avoid covering a myriad of other topics, we have ignored some potential adjustments to taxable income, such as deferred acquisition costs ("DAC"[8]) and the ceding and assuming companies' tax basis of life insurance reserves.[9] We also have ignored the 20 percent alternative minimum tax ("AMT") under pre-2018 law, which would have limited the NOL carryback to 90 percent of taxable income in the carryback year.

In 2018, Assuming Company pays a ceding commission of $400, per the terms of the agreement, resulting in a tax deduction and an overall taxable loss for the year, to Assuming Company. Under prior tax law, Assuming Company had the ability to carry back $200 of the $300 loss to fully offset its prior year income of $200 and receive a tax refund of $70 at the 35 percent tax rate; however, under the TCJA, Assuming Company is no longer allowed to carry back the life NOL that was generated in 2018 and can only carry it indefinitely to tax years when a 21 percent tax rate applies. Assuming Company is left with a full $300 NOL carryover to 2019, as it was not able to utilize it in a carryback year.

In 2019, under prior tax law, Assuming Company could have used its remaining NOL carryover in its entirety to fully offset its taxable income in the current year. Under the TCJA, however, Assuming Company is limited to $80 of NOL utilization in 2019, as a life insurance company is allowed a deduction only for an amount equal to the lesser of the aggregate of the NOL carryovers to the taxable year (total $300) or 80 percent of its current year taxable income (total $80). Moreover, the overall impact between the two years shows a cash tax benefit of $74 under prior tax law when compared to the TCJA regime, due in part to the tax rate differential and in part to deferred utilization of the NOL. As the example demonstrates, a large reinsurance transaction with an up-front ceding commission that results in, or increases, a taxable loss may not result in the same immediate tax benefit as could have been available under prior tax law. Insurance companies will need to be aware of their overall taxable income or loss position for the year when factoring taxes into reinsurance pricing, as deductions might not result in an immediate cash tax savings as they could have in pre-2018 tax years.

CONSOLIDATED TAX RETURNS

Significant complexity exists when trying to apply these new NOL rules within a consolidated tax return. The new NOL provisions that apply differently to different types of companies must now fit within a consolidated return framework that may include life insurance, nonlife insurance and non-insurance companies. The existing consolidated return framework under Treas. Reg. § 1.1502-21 for the consolidated NOL ordering rules and Treas. Reg. § 1.1502-47 for the life/nonlife subgroup rules does not adequately address this differential treatment of NOLs for the various entities within the same consolidated tax return. Although the IRS is currently analyzing the potential changes needed under these rules, the timing for releasing revised regulations is still uncertain.[10]

Two of the primary questions when P&C insurance companies are included in a consolidated return are how the overall NOLs (not including NOLs of any life insurance companies) would be allocated to P&C companies (and therefore eligible for carryback) and how such allocated NOLs would be absorbed by income in the carryback year. The answers to these questions may or may not involve a "P&C subgroup." A potential interpretation of how the nonlife TCJA NOL rules might apply under the no-P&C subgroup approach is illustrated in Figure 2, Nonlife Insurers Illustration (page 31). In this example, current year losses of members offset current year income of other members prior to any carryforwards or carrybacks. Also, the 80 percent limitation does not apply to current year NOLs offsetting current year income. Each entity's proportional share of the nonlife consolidated NOL is then proportionally allocated to those members with losses. To the extent that the nonlife consolidated NOL is attributable to the nonlife insurance company members, it may be carried back to the two prior years.[11] Consistent with new section 172(b)(1)(A), a nonlife consolidated NOL attributable solely to separate NOLs experienced by the non-insurance company members cannot be carried back.

Figure 1
Life Insurers Illustration

Assumptions:
Indemnity Reinsurance
Ceding Company and Assuming Company are life insurers.
Assuming Company has $200 of taxable income in 2017.

	Old Law		New Law		
	Ceding Company	Assuming Company	Ceding Company	Assuming Company	***Difference***
2018					
Income/(Loss) Separate from Reinsurance	100	100	100	100	
Reinsurance Premium Income/(Expense)	(8,000)	8,000	(8,000)	8,000	
(Increase)/Decrease in Reserves	8,000	(8,000)	8,000	(8,000)	
Ceding Commission - Reinsurance Income/(Loss)	400	(400)	400	(400)	
Reinsurance Transaction Income/(Loss)	400	(400)	400	(400)	
2018 Taxable Income/(Loss)	**500**	**(300)**	**500**	**(300)**	
2018 NOL Generated	–	300	–	300	
NOL Amount Carried Back to 2017*	–	(200)	–	–	
Applicable Corporate Tax Rate		*35%*		*35%*	
Cash Taxes (Refund)		*(70)*		–	*(70)*
2018 NOL Carryover	**–**	**100**	**–**	**300**	
2019					
2019 Taxable Income/(Loss) before NOL Utilization	**100**	**100**	**100**	**100**	
Current Year NOL Utilization (80% limitation under new law)	–	(100)	–	(80)	
2019 Taxable Income/(Loss) after NOL Utilization	**100**	**–**	**100**	**20**	
Applicable Corporate Tax Rate		*35%*		*21%*	
Cash Taxes Impact		–		*4*	*(4)*
2019 NOL Carryover	**–**	**–**	**–**	**220**	
Total Cash Taxes (Benefit) Between Old & New Law		*(70)*		*4*	***(74)***

*Disregarding old law AMT for purposes of simplicity.

Figure 2
Nonlife Insurers Illustration

Assumptions:
Indemnity Reinsurance
All companies file a nonlife consolidated federal income tax return.
Nonlife Consolidated Group has $200 of taxable income in 2017.

	Old Law				New Law				
	P&C Company	C-Corp Company 1	C-Corp Company 2	Nonlife Consolidated Return	P&C Company	C-Corp Company 1	C-Corp Company 2	Nonlife Consolidated Return	*Difference*
2018									
Income/(Loss) Separate from Reinsurance	100	(300)	300	100	100	(300)	300	100	
Ceding Commission – Reinsurance Income/(Loss)	(400)	–	–	(400)	(400)	–	–	(400)	
2018 Taxable Income/(Loss)	**(300)**	**(300)**	**300**	**(300)**	**(300)**	**(300)**	**300**	**(300)**	
Allocate 2018 Consolidated NOL	**150**	**150**		**300**	**150**	**150**		**300**	
Income in 2017 Carryback Period	200	**–**	**–**	**200**	200	**–**	**–**	**200**	
NOL Amount Carried Back to 2017*	(100)	(100)		**(200)**	(150)	**–**		**(150)**	
Applicable Corporate Tax Rate				*35%*				*35%*	
Cash Taxes (Refund)				*(70)*				*(53)*	***(18)***
2018 NOL Carryover	**50**	**50**	**–**	**100**	**–**	**150**	**–**	**150**	
2019									
Gross Income	100	150	150	400	100	150	150	400	
General Deductions (reserve changes and general expenses)	(100)	(100)	(100)	(300)	(100)	(100)	(100)	(300)	
2019 Taxable Income/(Loss) before NOL Utilization	**–**	**50**	**50**	**100**	**–**	**50**	**50**	**100**	
Current Year NOL Utilization (80% limitation under new law)				(100)	–	(40)	(40)	(80)	
2019 Taxable Income/(Loss) after NOL Utilization				**–**				**20**	
Applicable Corporate Tax Rate				*35%*				*21%*	
Cash Taxes Impact				*–*				*4*	***(4)***
2019 NOL Carryover				**–**				***70***	
Total Cash Taxes (Benefit) Between Old and New Law				***(70)***				***(48)***	***(22)***

*Disregarding old law AMT for purposes of simplicity.

In 2018, under prior tax law, the consolidated group has the ability to carry back $200 of the group's $300 loss to fully offset its prior year income of $200 and receive a tax refund of $70 at the 35 percent tax rate; however, in this illustration, the total 2018 nonlife consolidated NOL generated for the year of $300 is allocated to the loss entities in proportion to the losses that were generated for each entity, respectively. Only the P&C Company's proportional share of the consolidated loss is carried back to prior years. P&C Company and C-Corp Company 1 are each allocated $150 of the 2018 total $300 loss, as each of these two companies was responsible for half of the 2018 total nonlife consolidated group loss in 2018. Therefore, P&C Company may carry back $150 of the $300 loss to offset at 35 percent $150 of the prior year income of $200 and the group would receive a tax refund of $53.

In 2019, under prior tax law, since none of the entities are subject to a taxable income limitation, the nonlife consolidated group would have been able to use the 2018 NOL carryover of $100 in its entirety to fully offset its taxable income of $100 at the 21 percent tax rate in the 2019 tax year. Under the TCJA, however, the nonlife consolidated group is limited to using only $80 of the NOL, as a non-insurance company is allowed a deduction only for an amount equal to the lesser of the aggregate of the NOL carryovers (total $150) or 80 percent of its current year taxable income (total $80). Further, the nonlife consolidated group would have $20 of remaining taxable income for 2019 and an NOL carryover of $70 going into the 2020 tax year, which can be carried forward indefinitely. The overall impact between the two years shows a cash tax benefit of $22 under prior tax law when compared to the TCJA regime, again due in part to the tax rate differential and in part to deferred utilization of the NOL. Further, additional complexities arise when dealing with a life/nonlife consolidated return, but such discussion is beyond the scope of this article.[12]

Overall, the type of loss generated affects whether it may be carried back or whether it expires; the year the loss is generated affects whether post-2017 or pre-2018 law impacts the ordering rules and limitations; and the type of income being offset—*e.g.*, nonlife insurance, life insurance or non-insurance—impacts whether the loss is subject to the 80 percent of taxable income limitation. Depending on potential guidance, the consolidated group's ability to use a loss generated by a nonlife insurance company could be limited as a result of the profiles of other companies included in the consolidated return. The examples provided in this article illustrate just one potential interpretation of applying the new NOL rules within the existing consolidated return framework.

CONCLUSION

There are several potential interpretations of how to apply the TCJA's new NOL rules, especially in the life/nonlife consolidated return context. Various considerations must be analyzed when modeling reinsurance scenarios, especially where losses are expected in the year a reinsurance transaction occurs. As the tax law continues to evolve, it will be imperative for actuaries and reinsurance groups to evaluate reinsurance agreements in light of the impact that the TCJA may have on the profitability and pricing of such transactions. ■

Eli Katz is a managing director in Deloitte Tax LLP's insurance tax practice located in Washington, D.C., and can be reached at *elikatz@deloitte.com*.

Lauren Allen is a manager in Deloitte Tax LLP's insurance tax practice located in New York and can be reached at *laallen@deloitte.com*.

ENDNOTES

1 Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

2 *See generally* Treas. Reg. § 1.1502-47. Section 810 was repealed for losses generated after Dec. 31, 2017.

3 Unless otherwise specified, all references to "Section" and "§" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg." references are to the regulations promulgated thereunder.

4 *See* I.R.C. § 172(a), (f).

5 I.R.C. §§ 172(b)(1)(C), (f).

6 Joint Committee on Taxation, General Explanation of Public Law 115–97, JCS-1-18 at 180 (December 2018).

7 *See generally* I.R.C. §§ 59A, 172, 250, 382, 951A and 1503. *See also* Treas. Reg. §§ 1.1503-2, 1.1502-15, 1.1502-21 and 1.1502-47.

8 *See generally* I.R.C. § 848. For a more detailed discussion of the tax reform impact to DAC, *see* Daniel Stringham, Capitalization of Certain Policy Acquisition Expenses—Changes Under the Tax Cuts and Jobs Act, Taxing Times, Vol. 14, Issue 2, at 24 (June 2018), *https://www.soa.org/globalassets/assets/library/newsletters/taxing-times/2018/june/tax-2018-vol-14-iss2.pdf* (accessed September 20, 2019). The increased capitalization rates and amortization period are factors impacting the pricing of new reinsurance transactions post-2017, which will need to be accounted for during negotiations.

9 For some considerations around DAC and reserves in long-term care transactions, *see* Peter J. Sproul, with contributions from Peggy Hauser and Mark S. Smith, Unique Tax Issues in LTC Transactions, Taxing Times, Vol. 15, Issue 1, at 10 (February 2019), *https://sections.soa.org/publication/?i=570716&p=&pn=#{%22issue_id%22:570716,%22view%22:%22articleBrowser%22,%22article_id%22:%223317344%22}* (accessed September 20, 2019).

10 Emily L. Foster, NOL Complexity Prompts Development of Rules by 'Layering,' 163 Tax Notes 1558 (June 3, 2019), *https://www.taxnotes.com/tax-notes-federal/corporate-taxation/nol-complexity-prompts-development-rules-layering/2019/06/03/29kby* (accessed September 23, 2019).

11 I.R.C. § 172(b)(1)(C).

12 I.R.C. § 1503(c)(1); *See generally* Treas. Reg. § 1.1502-47.

ACLI Update

By Mandana Parsazad and Regina Rose

SECTION 807 REGULATORY PROJECT

In the 2019–2020 Priority Guidance Plan ("PGP"), the Internal Revenue Service ("IRS") and Department of the Treasury ("Treasury") have indicated their intent to provide "[g]uidance under § 807 regarding the determination of life insurance reserves for life insurance and annuity contracts, including guidance to implement changes under section 13517 of the TCJA." No activity has been noted to date on the quarterly updates to the PGP related to this item.

In public statements at tax conferences earlier this year, the IRS laid out several areas that will be covered as part of the Section 807 guidance. First, the IRS has indicated that the Section 807 regulations will address asset adequacy reserves. Asset adequacy is a non-tax, actuarial concept that doesn't exist outside of the NAIC Valuation Manual. Asset adequacy reserves are not part of CRVM or CARVM and are covered by a separate section (chapter 30) of the NAIC Valuation Manual. As a result, under Section 807(d), no deduction is allowed (or ever has been allowed) for asset adequacy reserves. The General Explanation of Public Law 115-97 (otherwise known as the "Blue Book") published following the Tax Cuts and Jobs Act ("TCJA") indicates that "under NAIC-prescribed principle-based reserve methodology in effect at the time of the enactment of the [reserve] provision, principle-based reserves for any contract do not include any asset adequacy reserve component." Given the statutory deference to NAIC principles for reserves in Section 807, it is unclear how the IRS may be approaching asset adequacy guidance or whether guidance is even necessary.

A second item that the IRS has indicated will be covered by the Section 807 regulations is further guidance under Section 807(f). Section 807(f) governs changes in basis for computing life insurance reserves. The TCJA amended Section 807(f) to require that the difference between the old basis and the new basis of reserves "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." In Rev. Proc. 2019-10 (which provides procedural guidance for post-TCJA reserve basis changes under Section 807(f)), the IRS deemed certain holdings of previous Section 807(f) rulings (Rev. Ruls. 94-74 and 2002-6) inconsistent with the general rules for changing a method of accounting under Section 446(e) and Section 1.446-1(e), and modified those rulings to the extent they were deemed to be so inconsistent. While the new Section 807(f) provision makes reference to Section 481 of the IRC to prescribe spread periods consistent with general rules for other changes in accounting method, there is no mention in the statute of Section 446 or an intent to subject life reserve basis changes to all other accounting method rules. In fact, Section 811, not Section 446, contains the general rule for accounting methods of a life insurance company, including reserves. It is fundamental to the taxation of life insurers and would need to be carefully considered if any further guidance is proposed on the application of Section 446 to reserve basis changes.

Apart from the Section 811/446 matter, ACLI believes additional guidance under Section 807(f) would be useful and has advocated for such, particularly with regard to what is and what is not a Section 807(f) change in basis. Rev. Rul. 94-74 provided such guidance under pre-TCJA law but is now largely obsolete post-TCJA. ACLI believes that this revenue ruling should be updated to provide guidance promoting consistent application of basis change rules across the industry. Many of the future questions that will arise about reserve basis changes under Section 807(f) will be driven either by existing NAIC reserving methodologies or future NAIC-mandated changes in reserving methodologies applicable to every company in the industry, and guidance would promote consistency and reduce controversy. Dating back even further, there is a long history of IRS guidance on reserve basis changes. While much of this prior guidance is now obsolete, substantial portions of it remain potentially relevant, and ACLI has advocated an update of the relevant guidance as part of the Section 807 project.

Given the statutory deference to NAIC principles for reserves in Section 807, it is unclear how the IRS may be approaching asset adequacy guidance or whether guidance is even necessary.

A third area of guidance the IRS expects to cover in Section 807 regulations is the requirement of expanded reserve reporting requirements. Section 807(e)(6) of the IRC instructs the Secretary to require reporting with respect to the opening balance and closing balance of reserves and with respect to the method of computing reserves for purposes of determining income. The IRS has indicated it is working to require additional reporting

in three areas: (1) electronic filing of all insurance tax returns, whether included in a consolidated group or filed individually; (2) electronic filing of annual statements with returns; and (3) modification of Form 1120L to add lines for expanded reporting that would assist revenue estimators and examiners in the future, particularly as it relates to reporting for separate accounts.

The fourth item the IRS has publicly acknowledged it plans to cover in Section 807 regulations is cleanup of obsolete references in the IRC and regulations. There are many sections of the regulations, in particular, that are wholly or partially obsolete as a result of both the 1984 Tax Act and the TCJA. A thorough job of cleanup would involve deletion of obsolete regulations, retention and update of still-relevant regulations, and renumbering of regulation sections to correspond with the current IRC sections.

The ACLI has been working to provide information to Treasury and the IRS that would be helpful as part of the 807 regulation project. To date, there is no estimated timeline for the release of Section 807 regulations.

FINAL, TEMPORARY AND PROPOSED REGULATIONS IMPLEMENTING TCJA INTERNATIONAL RULES

On June 21, Treasury and the IRS published final and temporary regulations to implement the global intangible low-taxed income ("GILTI") ("Final GILTI Regulations"). Treasury and the IRS confirmed in this guidance that in determining the tested income or loss of a controlled foreign corporation ("CFC"), the rules of IRC sections 953 and 954(i) would apply, including the rules of reserve computation under section 954(i).

While the Final GILTI Regulations confirmed prior guidance issued in September 2018, that the GILTI high tax exclusion applies only to income that is excluded from foreign base company income ("FBCI") and insurance income solely by reason of an election made to exclude the income under the high tax exception of IRC section 954(b)(4), proposed regulations also published on June 21 ("Proposed GILTI Regulations") provided an expanded high tax exclusion from the GILTI tax base.

In the Proposed Regulations, the GILTI high tax exclusion was expanded to include certain high-taxed income even if that income would not otherwise be FBCI or insurance income. Gross income subject to foreign income tax that is subject to an effective rate of 18.9 percent (90 percent of the U.S. statutory corporate tax rate) or higher would be excluded from the GILTI tax base. Such an effective rate is determined on a qualified business unit by qualified business unit basis. Treasury and the IRS outline the options considered regarding the scope and basis for determining income that would qualify for the newly proposed GILTI high tax exclusion, and request comments.

The Proposed Regulations provide for a revocable election, which U.S. shareholders may make to avail themselves of the high-taxed exclusion; such election, once made, is binding on all U.S. shareholders and may not be revoked for 60 months. Moreover, the Proposed Regulations state, "if a CFC is a member of a controlling domestic shareholder group, the election applies with respect to each member of the domestic shareholder group." The Proposed Regulations also state that the proposed expanded GILTI high-taxed exclusion will be effective as of the date the guidance is finalized.

The TCJA also amended the passive foreign investment company ("PFIC") rules under section 1297. On July 11, Treasury and the IRS issued proposed regulations under sections 1291, 1297 and 1298 regarding the determination of ownership in a PFIC, when a foreign corporation is a qualifying insurance company, and the amounts of income and assets such a company may exclude from passive income and assets pursuant to section 1297(a). The guidance also clarified the application and scope of rules that determine whether a foreign corporation is a PFIC and whether a U.S. person who holds stock in a PFIC is treated as a shareholder of a PFIC. ■

Mandana Parsazad is vice president, Taxes & Retirement Security, for the American Council of Life Insurers and may be reached at *mandanaparsazad@acli.com*.

Regina Rose is senior vice president, Taxes & Retirement Security, for the American Council of Life Insurers and may be reached at *reginarose@acli.com*.

SOCIETY OF ACTUARIES®

475 N. Martingale Road, Suite 600
Schaumburg, Illinois 60173
p: 847.706.3500 f: 847.706.3599
w: www.soa.org

NONPROFIT ORGANIZATION
U.S. POSTAGE PAID
SAINT JOSEPH, MI
PERMIT NO. 263