SOCIETY OF ACTUARIES

Article from

Taxing Times

October 2019
Volume 15 Issue 3

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

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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). ■

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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.)