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

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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. ■

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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.