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COMPANY TAX—INTRODUCTORY STUDY NOTE

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Company Tax - Introductory Study Note*

The following provides a summary of the articles and documents that are included in the LFMU Exam syllabus related to Company Taxation:

Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers: The article from *Taxing Times* discusses the major changes of the Tax Cuts and Jobs Act (“TCJA”) affecting life insurers.

Excerpt from the Joint Explanatory Statement of the Committee of Conference: The Joint Explanatory Statement is a document printed in the House portion of the Congressional Record that was created by the House and Senate conference committee for the proposed bill (H.R. 1), the TCJA. (See “Consensus Emerges in the Conference” section of the Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers article listed above). The joint explanatory statement identifies each major difference between the House version of the bill and the Senate version, along with the substitute agreed to by the conference committee. For each item in the report, the format of the document includes a summary of the “Present Law” (i.e., prior to the enactment of TCJA), then summarizes the House bill, the Senate amendment, and the conferences’ recommendation under TCJA. Note that the sections labeled “Conference Agreement” are the descriptions of the law as ultimately enacted; the “House Bill” and “Senate Amendment” sections describe other approaches considered during the legislative process but do not reflect the final law. A summary of the formal legislative language on which the conference committee has agreed is included in the conference report prepared to accompany the bill. The following excerpts from the Joint Explanatory Statement of the Committee of Conference are included in the syllabus:

- **9. Computation of life insurance tax reserves (sec. 13517 of the Senate amendment and sec.807 of the Code)**
- **11. Capitalization of certain policy acquisition expenses (sec. 13519 of the Senate amendment and sec. 848 of the Code)**

Changes to the Computation of Tax Reserves under P.L. 115-97: The article from *Taxing Times* discusses the changes to the computation of life insurance tax reserves as a result of TCJA.

Case Study – Impact of Tax Cuts and Jobs Act: The article from *The Financial Reporter* discusses certain of the changes to tax reserves as a result of TCJA and sample impacts of those changes to the profitability of certain products.

Deferred Tax Treatment of US Statutory Policyholder Liabilities in Life Insurance Companies: The article from *Taxing Times* provides a description of the treatment of deferred taxes.

*Throughout the Company Tax – Introductory Study Note there are certain items that have been highlighted, representing items that the exam committee believes to be the significant areas that students should focus. Any item that is not highlighted, while still included in the syllabus, is provided for background information.

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Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers

By James W. Kress, Surjya Mitra and Mark S. Smith

On Dec. 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (P.L. 115-97) ("TCJA," or "Act"),[1] following a flurry of legislative activity at a pace seldom seen on Capitol Hill. Ways and Means Committee Chairman Kevin Brady (R-Texas) released his original Mark of the TCJA on Nov. 3, launching a high stakes, seven-week scramble with significant financial and business consequences to life insurance companies. This issue of *Taxing Times* is devoted to a discussion of several of the major provisions that are particularly important to life insurers, with an emphasis on domestic provisions. Later issues will address international provisions, reinsurance and other matters. This article sets the stage for that discussion by providing historical context and an overview of major themes of the Act.

"TAX REFORM": IT HAPPENS

Like death and taxes, "reform" of the Internal Revenue Code every few decades is a certainty.

1959 Act

Before the Life Insurance Company Tax Act of 1959, P.L. 86-69 ("the 1959 Act"), life insurance companies were taxed at the same rates as other corporations, but only on their net investment income.[2] After this legislation, life insurers instead were taxed on all their income, but under a complicated three-phase system, remnants of which still may be seen in the Internal Revenue Code and regulations. Specifically, Phase I generally taxed a profitable life insurer's net investment income. Phase II generally taxed half of a company's underwriting income minus certain special deductions on a current basis; and Phase III taxed the special deductions and the deferred portion of a company's underwriting income when the company made future distributions from what was known as a policyholders' surplus account.[3] For purposes of computing gain from operations, tax-deductible life insurance reserves generally were equal to statutory reserves, but could actually be increased above statutory reserves if a special "section 818(c) election" was made.

Older members of the insurance tax community still invoke concepts under "the 1959 Act" and with good reason. Even though Congress later dismantled the framework of the 1959 Act, many of the concepts and, in particular, definitions under the Act still survive. Even today, the definitions of insurance company, life insurance company, and life insurance reserves have their roots in 1959 Act authorities. Moreover, the current-law limitations on consolidated returns that include both life and nonlife members were originally enacted to protect the three-phase system of taxation under the 1959 Act.

1984 Act

Twenty-five years after the 1959 Act, Congress again amended many provisions of the Internal Revenue Code, with a particular focus on the taxation of life insurers. The changes were motivated by an unusually large increase in interest rates between 1959 and 1984, and by a need to simplify the 1959 Act's complex three-phase system of taxation.

Under the Deficit Reduction Act of 1984, P.L. 98-369 ("the 1984 Act"), life insurance companies were taxed under a single-phase system, like most other corporate taxpayers. The familiar regime under section 807 for computing tax reserves was established, including computation of a Federally-Prescribed Reserve, the use of a reserve methodology determined based on when a contract was issued, reliance on prevailing interest rate and mortality tables, and application of a statutory reserves cap and net surrender value floor. The separate accounting and diversification requirements for assets supporting variable contracts were imposed.

To the disappointment of the industry, limitations that applied to consolidated returns filed by mixed life/nonlife groups were retained, even though the three-phase system that gave rise to those limitations was eliminated. Over time, new IRS guidance addressed many issues under the provisions of the 1984 Act, and authorities under the 1959 Act remained relevant as to those provisions that carried over.[4] As a younger generation of tax professionals came up through the ranks, they spoke of the 1984 Act with the same familiarity that their elders exhibited with respect to the 1959 Act.

Nontax insurance developments in the years that followed the 1984 Act put pressure on some of the rules in Subchapter L. In particular, the adoption of Life principle-based reserving (PBR) put significant pressure on the rules for determining deductible life insurance reserves.[5] Although the IRS and industry engaged constructively in ways to make those rules work appropriately,

tax policymakers were aware of the stresses that PBR placed on the system.

The Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act represents a wholesale rewrite of many of the most important features of the Internal Revenue Code. The federal corporate income tax rate dropped significantly. The paradigm for taxing U.S. corporations on their worldwide activity, and foreign corporations on U.S. activity, was radically altered. Most importantly for life insurers, provisions that are the most impactful—reserves, deferred acquisition cost (DAC) and proration—were rewritten. In order to make sense of these changes, it is important to understand the process that led up to the Act.

LEGISLATIVE PROCESS

Momentum for the most recent tax code changes had been building for many years, driven in large part by consensus that the United States had become an increasingly noncompetitive jurisdiction in which to do business. For example, at 38.9 percent, the average U.S. combined federal and state statutory corporate tax rate was 14 percentage points above the average of other countries that are members of the Organisation for Economic Co-operation and Development (OECD). Some believed that this rate differential favored foreign-parented companies which, in turn, encouraged some U.S. companies to "invert," or redomesticate offshore. For property and casualty insurers, some policymakers believed that the rate differential encouraged the use of reinsurance as a means of eroding the U.S. tax base. Rep. Richard Neal (D-Mass.) and the Obama Administration both proposed legislation to address this issue by limiting tax benefits for property and casualty reinsurance transactions with an offshore affiliate.[6] The taxation of insurance companies, specifically, was not otherwise in play, though would become important as the TCJA progressed.

Camp Bill

In 2014, then-House Ways and Means Committee Chairman Dave Camp (R-Mich.) introduced a bill known as the Tax Reform Act of 2014, or H.R. 1.[7] Several months before its introduction, a draft text of the bill was made available in the form of a "Discussion Draft," which was the subject of an entire issue of *Taxing Times*.[8] Many provisions of the bill would have had a significant effect on life insurers, and Chairman Camp talked with *Taxing Times* about the bill shortly after he left Congress.[9]

Broadly, the Camp Bill included a number of features that also are in the TCJA, and was intended to accomplish many of the same goals, such as lowering tax rates and strengthening the economy. Like the TCJA, the Camp Bill would have eliminated the corporate alternative minimum tax (AMT) and would have made a number of changes to conform the taxation of insurance companies to the general rules that apply to other corporate taxpayers. The Camp Bill also would have dramatically changed the provisions that apply to life insurance companies, such as DAC, proration and, in particular, life insurance reserves. The Camp Bill's changes to the computation of life insurance reserves would have required the use of an uneconomic discount rate to determine tax reserves. This aspect led to a number of meetings with staff on Capitol Hill to discuss with staff on the business of life insurance generally, the capitalization of DAC as compared to actual capitalizable commission expenses, the problems with the economic assumptions underlying the Camp proration proposals, the importance and measurement of reserves, the choice of discount rates, and the emergence of new reserve methodologies. The provisions included in the TCJA on proration and reserves differ dramatically from those that were included in the Camp Bill.

Unlike the TCJA, the Camp Bill was projected to be revenue-neutral.

House Republican Blueprint: "A Better Way"

Early in 2016, House Speaker Paul D. Ryan (R-Wis.) announced the creation of a new Tax Reform Task Force to develop an Internal Revenue Code that would "create jobs, grow the economy, and raise wages by reducing rates, removing special interest carve outs, and [make] our broken tax code simpler and fairer." In June, the Task Force published its 35-page report, "A Better Way: Our Vision for a Confident America."[10] The report became known as the House Republican Blueprint.

The broad themes that had been building for Tax Reform—lower rates, simplification (or at least improved consistency) and international competitiveness—formed the foundation of the Blueprint. A controversial Border Adjustment Tax would have exempted exports of products, services and intangibles from tax, and would have taxed products, services and intangibles imported into the United States regardless of where they were produced. Global American companies thus would have been taxed on a territorial basis.

The House Republican Blueprint also would have eliminated any deduction for net interest expense to help equalize the tax treatment of different kinds of financing. Only one sentence addressed how this would apply to financial service companies:

> The Committee on Ways and Means will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models.[11]

Other than this sentence, there were no specific references to the taxation of insurance companies under the Blueprint.

Efforts to Repeal Obamacare Raise the Stakes

Soon after President Trump's inauguration, Republicans in both the House and Senate engaged in a dedicated effort to dismantle the Affordable Care Act ("ACA"),[12] introducing several proposals to first "repeal and replace" and then to simply repeal the ACA. Beginning in March and continuing throughout much of 2017, Congress considered numerous bills, including the American Health Care Act ("AHCA"),[13] a subsequent revision titled the Better Care Reconciliation Act ("BCRA"),[14] the Obamacare Repeal Reconciliation Act ("ORRA"),[15] and eventually the Graham Cassidy amendment to the AHCA.[16] Each of these legislative efforts included significant changes to the tax and fee structure applicable to health insurers and health care consumers.

During the fall of 2017, it became clear that efforts to unwind the ACA would not succeed. Mindful of the importance of achieving some measure of legislative success, Congressional leaders set their sights on federal income tax reform, another centerpiece of their agenda and the president's campaign.

The House Chairman's Mark

On Nov. 3, 2017, House Ways and Means Committee Chairman Kevin Brady (R-Texas) released draft statutory language of the Tax Cuts and Jobs Act in the form of a Chairman's Amendment in the Nature of a Substitute to H.R. 1—the Chairman's Mark—reflecting his thinking and that of the majority members of the Committee. Directionally, the Chairman's Mark was consistent with the broad themes that had long been in play—dramatically lower the corporate income tax rate, repeal the corporate AMT, and make dramatic changes to the taxation of U.S. corporations doing business abroad and foreign multinational groups doing business in the United States. Because there had been no public hearings or other opportunities to respond to specific proposals, many provisions were made public for the first time in the Chairman's Mark.

> The pace at which the TCJA went from Chairman Brady's Mark on Nov. 3 to an enacted law on Dec. 22 was nearly unprecedented for a bill of this magnitude.

Insurance companies were singled out with an entire subtitle in the Chairman's Mark. Although some of the provisions in the subtitle were in the category of simplification, along the lines of the Camp Bill, other provisions were without precedent and would have resulted in a dramatic increase in taxable income for life insurers. Tax-deductible life insurance reserves were proposed to equal 76.5 percent of statutory reserves, with no cash surrender value floor.[17] The life insurance company proration provision would fix the company's share of net investment income—that is, the percentage of the otherwise-allowable tax benefit a company would receive for stock and tax-exempt bonds it owns—at 40 percent.[18] The DAC capitalization percentages would increase from 1.75 percent, 2.05 percent and 7.7 percent under prior law to either 4 percent or 11 percent according to whether the contracts were group or individual contracts.[19] This would have represented a 528 percent increase in the rate applied to individual annuity contracts and appeared unrelated to actual, economic acquisition costs that companies incur.

At $23 billion,[20] the revenue estimates for these three provisions were widely believed to vastly understate the actual tax cost to companies. The Nov. 3 release of the Chairman's Mark thus marked the beginning of a frantic seven-week period of work for both the industry and Hill staff to better understand the economics of the business of life insurance, the mechanics of various proposals, and appropriate estimates of the revenue that each would raise.

The House Bill

Within a week of the release of the original Chairman's Mark, a Manager's Amendment replaced the three most controversial life insurance provisions—reserves, DAC and proration—with a single provision that would retain prior law but impose an 8 percent surtax on Life Insurance Company Taxable Income (LICTI).[21] An accompanying explanation explicitly referred to the surtax as a "placeholder," while work on the issues continued.[22] The placeholder remained in the version of H.R. 1 that passed the House on Nov. 16.

The Senate Bill

Aware of the continued work in the House on the life insurance provisions, the Senate Finance Committee included its own placeholder for Chairman Brady's proposals on life insurance reserves, DAC and proration. Rather than impose a surtax on LICTI, the Senate Finance Committee's original markup would have retained current law for reserves and proration, and modified the rules for DAC. Specifically, the Senate Finance Committee would have nearly doubled the capitalization rates and would have increased the amortization period fivefold, from 120 months to 600 months.[23] This proposal was referred to by some as "super-DAC," and was scored to raise approximately the same amount of revenue as the original provisions in Chairman Brady's Mark and the surtax in the bill that passed the House.

The version of the bill that passed the full Senate[24] on Dec. 2 included an amendment by Sen. Tim Scott (R-S.C.), which largely became the basis for the TCJA life insurance provisions as passed. Under Sen. Scott's amendment, tax reserves were generally computed by applying a haircut to statutory reserves, DAC rates were increased, and the amortization period lengthened, but not as dramatically as under the Senate's "super-DAC" proposal, and a life insurer's company's share for purposes of proration was set at 70 percent.

Consensus Emerges in Conference

The life insurance provisions were not the only differences between the House and Senate bills, nor even the largest in terms of revenue. For example, the House bill would have repealed the corporate AMT, whereas the Senate bill would have made more modest changes to prior law. The House bill provided a special tax rate for personal service corporations, whereas the Senate

bill did not. The House bill would have addressed erosion of the U.S. tax base by imposing an excise tax on certain deductible payments to foreign affiliates, whereas the Senate bill would have imposed a base erosion minimum tax amount equal to the excess of 10 percent of modified taxable income over the regular tax liability for the year.

The mechanism for resolving differences between a bill passed by the House and a bill passed by the Senate is called a "conference," in which a committee comprising members of both houses reaches a comprehensive compromise on which the two Houses then vote. In the case of the TCJA, the conference committee report was released on Dec. 15, and the House and Senate both passed the amended package on Dec. 20. The president signed the bill into law on Friday, Dec. 22. With just nine days left in the calendar year, a new scramble began to determine what steps companies should take in anticipation of the new law before Dec. 31, and what disclosures would be necessary in calendar year 2017 annual statement filings and financial statements.

The pace at which the TCJA went from Chairman Brady's Mark on Nov. 3 to an enacted law on Dec. 22 was nearly unprecedented for a bill of this magnitude. As with other tax acts, legislative history will play an important role in discerning the intent of the various provisions. In addition, the staff of the Joint Committee on Taxation will likely produce its own explanation of the provisions. That explanation is commonly referred to as "the Blue Book." Although generally not considered authoritative as legislative history, it will be another data point in future years as companies do their best to make sense of the intent of various provisions.

BROAD IMPACT ON LIFE INSURERS

The nonpartisan Joint Committee on Taxation staff projected that, across all taxpayers, the Act would reduce federal revenues by $1.456 trillion over the 2018–2027 federal budget window. Some taxpayers will be winners due to a dramatic cut in corporate income tax rates and the repeal of the unpopular AMT. Other taxpayers will be losers on a net basis due to other provisions. For example, U.S.-parented groups may benefit overall from lower rates and a more territorial model for taxing corporate earnings, whereas new provisions aimed at base erosion could impose significant costs on some foreign-parented multinational groups and potentially cause them to restructure their operations. Modifications of the AMT, lower tax rates and a higher standard deduction will provide welcome relief to some individuals, whereas many individuals in high-tax states will see their tax bills increase due to a dramatic limitation of itemized deductions for state and local taxes.

For insurers, the impact is particularly acute. Like the original House Chairman's Mark, the TCJA singles out insurance companies in a unique way.

Provisions That Apply to Insurance Companies

Life insurance reserves. Under the Act, the tax-deductible life insurance reserve for a contract is generally equal to the greater of the contract's net surrender value or 92.81 percent of the statutory reserve with regard to the contract, determined based on valuation date methods. For variable contracts, only general account reserves in excess of the greater of the contract's net surrender value or separate account reserves with regard to the contract are multiplied by the 92.81 percent factor. A statutory reserves cap applies, as under prior law. The change is projected to raise $15.2 billion over the 10-year budget window, in large part from an eight-year transition rule relating to reserves on existing business, discussed later in this article. However, the industry generally supported it because it is simpler than current law and should avoid much of the uncertainty that arose under prior law as a result of the adoption of PBR methodologies. The changes to life insurance reserves are discussed at page 14 of this issue of *Taxing Times* ("Changes to the Computation of Tax Reserves Under P.L. 115-97").

The TCJA also made changes to unpaid loss reserves, such as reserves for cancellable accident and health insurance contracts. Much like proposals in the Camp Bill, those changes will incorporate a significantly higher discount rate based on a 60-month corporate bond yield curve and longer loss payment patterns. The effect of these changes will be more important for longer-tail than for shorter-tail lines of business. The changes to unpaid loss reserves are discussed at page 22 of this issue of *Taxing Times* ("Discounted Unpaid Losses: A Rate or a Curve?").

DAC. As under prior law, acquisition costs with regard to life insurance and annuity contracts are capitalized and amortized, based on a proxy percentage multiplied by net premiums received. The current-law capitalization percentages are increased by 20 percent, and the amortization period extended from 10 years to 15 years. No recomputation of existing unamortized DAC balances is required. Instead, the new capitalization percentages and amortization period apply to net premiums received in 2018 and after. As a result, companies will be able to price newly issued products and reinsurance transactions taking this change into account as appropriate. However, in-force contracts priced under the old DAC rules also will be subject to the higher rates and longer amortization period to the extent of post-2017 premiums. At $7.2 billion, this change is the second-largest life insurance-specific revenue raiser in the Act. The changes to DAC are discussed at page 24 of this issue of *Taxing Times* ("Capitalization of Certain Policy Acquisition Expenses—Changes under the Tax Cuts and Jobs Act").

Proration. For decades, prior law has required a life insurer to "prorate" net investment income between a company's share and policyholders' share in order to limit the benefits of tax-preferred income (such as dividends eligible for the Dividends Received Deduction, or DRD) on assets it owns. The computation of company's share and policyholders' share for a life insurance has historically been very complex. The Act replaces the prior law computation of the company's share and policyholders' share with fixed percentages of 70 percent and 30 percent, respectively. Like the change to life insurance reserves, this approach represents a dramatic simplification. Together with a general change of the DRD from 70 percent to 50 percent, however, this change results in an increase in the amount of dividend income that is taxed to a life insurer, albeit at a lower rate. The provision was projected to result in an increase in federal tax revenue. The impact of the provision, however, is expected to vary from company to company, and from General Account to Separate Account. The changes to life insurance proration are discussed at page 26 of this issue of *Taxing Times* ("Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One").

The TCJA also made changes in proration for nonlife companies. Under prior law, the adjustment to discounted unpaid losses for 15 percent of tax-exempt interest and DRD produced an effective tax rate of 5.25% (15% times 35%) on tax-exempt income. Under the TCJA, the adjustment increases to a percentage that preserves the same effective tax rate on tax-exempt income. Based on a corporate tax rate of 21 percent, the proration percentage for nonlife companies in 2018 is 25 percent (5.25% divided by 21%).

Net operating losses. Under prior law, net operating losses of corporate taxpayers generally were carried back two years and forward 20 years, according to the taxpayer's taxable income or loss for those years. Life insurers carried losses from operations back three years and forward 15. The TCJA changed these general rules to allow losses to be carried forward indefinitely, but not back under the TCJA. Losses carryovers are allowed to offset only 80 percent of the taxpayer's income for a particular year. The loss rules for life insurers are conformed to the loss rules for other corporations, such that there is no longer an independent set of rules for losses from operations of a life insurer. Nonlife insurance companies, however, may still carry losses back two years and forward 20 years, and use those losses without regard to the new 80 percent of taxable income limitation. The application of different rules for losses of nonlife companies and other corporate taxpayers raises complex issues for those companies that file consolidated returns for groups that include both nonlife insurance companies and noninsurance companies. The issues will be even more difficult for consolidated return filers whose groups include life insurance companies, nonlife insurance companies, and noninsurance companies under the life-nonlife consolidated return regulations.

Other insurance provisions. A number of other provisions that are specific to insurance companies will have lesser financial impact:

- Repeal of a deduction that applies only to small life insurance companies.
- A change to conform the treatment of changes in basis for computing life insurance reserves with the treatment of changes in accounting method of other corporations.
- Repeal of a special rule that applies to a small number of companies that maintain a "policyholders surplus account" based on pre-1984 Act law.

The TCJA does not change the treatment of inside buildup on life insurance and annuity contracts.

- Repeal of a special rule that permits nonlife companies not to discount unpaid losses if they make "special estimated tax payments."

The broad theme of these changes is to remove provisions that have become obsolete, and to conform the taxation of insurance companies to the taxation of other corporate taxpayers where possible. Several of these changes are discussed together at page 28 of this issue of *Taxing Times* ("Repealed: Corporate AMT and Three Insurance Tax Provisions").

Effect on life insurance products. The TCJA does not change the treatment of inside buildup on life insurance and annuity contracts. The industry has long opposed any such changes out of concern for the effects of any changes on policyholders and beneficiaries and because of the important role of the products for retirement security. Commercially, however, other changes in the TCJA could have implications for the products. For example, changes in the estate tax for individuals may dampen the market for individual life insurance contracts that are purchased for liquidity purposes as part of an estate plan; a general reduction in corporate income tax rates also may change the analysis in some cases for the purchase of life insurance by banks and other corporate taxpayers. A welcome clarification that a policyholder's tax basis is not decreased by the cost of insurance provided removes uncertainty for some life settlement transactions. However, life insurers now must consider what systems adaptations are appropriate to comply with new information reporting on life settlement transactions. Amendments to the transfer for value rule are intended to capture certain indirect transfers of a life insurance contract for value. Other changes, such as changes to the life insurance reserve rules that previously were cross-referenced in the section 7702 definition of life insurance (and now are a part of that provision) also may require further careful thought in the context of Life PBR. Consequences of the TCJA to life insurance products are discussed at page 30 of this issue of *Taxing Times* ("The Life Insurance Product Tax Provisions of H.R. 1").

Provisions That Apply to All Corporate Taxpayers

As discussed, the most significant broadly applicable elements of the TCJA are the reduction in corporate tax rates and a change in the paradigm for taxing offshore operations of U.S. corporations and U.S. operations of foreign-parented groups. Together, the reduction in tax rates and elimination of the corporate AMT were projected by the Joint Committee on Taxation staff to result in a decrease in federal income tax revenues from corporations of almost $1.4 trillion over a 10-year budget window.[25] These changes dwarf all others and approximately equal the total amount the TCJA is projected to lose over the same period.

International

By far, the next most significant changes to multinational corporate taxpayers are changes to the taxation of multinational enterprises.

Territoriality and deemed repatriation. International taxation will transition from a system that taxed worldwide income of U.S. corporations to a territorial system. The mechanism for doing so is a 100 percent DRD for certain qualified foreign-source dividends received by U.S. corporations from foreign subsidiaries. However, existing regimes that tax a U.S. corporation on earnings of certain foreign affiliates—such as "Controlled Foreign Corporations" (CFCs) and "Passive Foreign Investment Companies" (PFICs) —are retained, with modifications.

As part of the transition to a quasi-territorial system, the TCJA generally requires a U.S. shareholder of a specified foreign corporation to include in income for 2017 its *pro rata* share of the undistributed, non-previously taxed, post-1986 foreign earnings of the corporation. The TCJA permits a deduction in an amount necessary to result in a 15.5 percent tax on foreign earnings held in cash or cash equivalents, and an 8 percent tax on foreign earnings held in illiquid assets. Foreign taxes paid with respect to such foreign earnings may be treated as partly creditable. For insurance companies, the higher cash equivalent rate generally will apply, since insurance companies typically hold liquid assets.

Base erosion. To prevent erosion of the U.S. tax base that could result from making deductible payments to foreign affiliates, the TCJA imposes a "base erosion and anti-abuse" tax ("BEAT") on certain "base erosion payments" paid to foreign affiliated companies. Companies subject to the tax must pay the excess of tax computed at a 10 percent rate (5 percent in 2018) on an expanded definition of taxable income over their regular tax liability. The tax would not apply to companies with "base erosion tax benefits" less than 3 percent of total deductions of the taxpayer. Both the statutory language and the conference report identify premiums paid for reinsurance as base erosion payments. Other issues arise in practice as a result of different forms of reinsurance transactions. This change is particularly important to foreign-parented groups if there are reinsurance treaties of which U.S. members are a part. As the BEAT applies to reinsurance payments paid or accrued from Jan. 1, 2018, companies continue to consider what changes to their existing reinsurance treaties are appropriate to manage their BEAT liability.

PFIC insurance exception. U.S. shareholders of certain "Passive Foreign Investment Companies," or PFICs, are required to pay tax—or interest on tax that would be owed—on their share of offshore income earned by the PFIC. An exception applies to investment income earned in the active conduct of an insurance business, and the IRS proposed regulations interpreting this exception as recently as 2015.[26] The TCJA limits the active insurance exception to cases where a foreign insurance company has insurance liabilities that constitute more than 25 percent of its total assets. An alternate test is available to a company whose insurance liabilities constitute at least 10 percent of its assets, if its reserves percentage falls below 25 percent solely due to run-off or rating-related circumstances. Because for this purpose insurance liabilities do not include unearned premiums or deficiency or contingency reserves, insurers with assets materially greater than their reserves, such as companies that insure catastrophic risks, may find it difficult to qualify for the PFIC insurance exception as amended. Some bona fide offshore insurance companies that have difficulty satisfying this test may have to consider reinsuring additional risks, such as certain types of life insurance business, to continue to qualify for the exception.

International tax issues under the TCJA, and their implications for life insurers, will be explored further in the October 2018 issue of *Taxing Times*.

Other Non-Insurance Changes

Repeal of the Corporate AMT. The TCJA repealed the corporate AMT. The Tax Reform Act of 1986 established the corporate AMT in order to ensure that no taxpayer with substantial economic income could avoid a tax liability through the "excessive" use of exclusions, deductions, and credits. Beginning with the 2018 tax year, taxpayers no longer will be subject to AMT and will use credits for AMT previously paid to offset their regular tax liabilities and to claim refunds for the balance not absorbed by regular tax liabilities. The TCJA requires the government to refund 50 percent of the remaining balance of AMT credits carried forward to taxpayers in each of the tax years 2018–2020, with any remaining uncredited balance fully refunded in 2021.

Limitation on interest deduction. The TCJA generally limits the deduction for business interest to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year; unused deductions can be carried forward indefinitely. Because insurance companies typically earn significant interest income as part of their insurance business, applying this limitation on a consolidated group basis[27] would result in most life-life and life-nonlife consolidated return groups having business interest income that exceeds their business interest expense.

Changes in the taxable year for recognizing income. The TCJA imposes a new "conformity" rule on accrual-method taxpayers that may require them to recognize some items of income no later than the tax year in which that income is taken into account as revenue in an applicable financial statement. The new rule does not apply, however, where special methods of accounting apply. Subchapter L of the Code provides special rules for the taxation of insurance companies, which may provide important exceptions to the new conformity rule. For example, under Subchapter L, the starting point for computing taxable income is the National Association of Insurance Commissioners (NAIC) annual statement, and explicit rules allow nonaccrual of market discount of life insurance companies. In addition, the Conference Report explains that the conformity rule does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.[28]

Other provisions. Other important changes to the taxation of corporations under the TCJA include increased expensing (rather than capitalization and depreciation) of business assets, changes in rules for business tax credits, new limitations on excessive employee remuneration, new limitations on entertainment expenses, and changes in the tax deductibility of employee fringe benefits. The impact of these other provisions is beyond the scope of what *Taxing Times* will cover, but may nevertheless be important to some companies.

Transition

The transition rules for the many changes made by the TCJA are varied. The most significant of the insurance provisions—changes to both life insurance and unpaid loss reserves—entail the computation of a transition reserve adjustment that is taken into account over eight years. Other significant provisions, such as changes in rates, changes in DAC and proration, and changes in the utilization of losses, are generally effective for tax years beginning after 2017. Throughout this issue of *Taxing Times* and the next, each article about a specific provision or change will include a discussion of the transition rules and issues that arise as they apply to life insurers.

MISSED OPPORTUNITIES

Although the changes made by the TCJA were comprehensive by any standard, they did not include at least two items that are important to life insurers and would have been appropriate as a matter of policy: updating of the rules that apply to consolidated returns that include both life and nonlife insurance companies, and correction of a mismatch in the character of income and loss recognized by insurance companies.

Life/Nonlife Consolidated Returns

Current law imposes significant limitations on the ability of a life insurer to join in a consolidated income tax return that also includes group members that are not life insurance companies. Prior to the 1984 Act, the regime for taxing life insurance companies differed significantly from the regime that applied to other corporate taxpayers. In order to protect differences between those regimes, the tax law restricted a life insurer's ability to consolidate and share losses with nonlife affiliates.[29]

The 1984 Act removed the primary differentiating three-phase system of life insurance company taxation, and the taxation of life insurers became largely consistent with the taxation of nonlife and non-insurance companies. Following the 1984 Act, life insurance company taxable income includes premium and investment income and allows deductions for underwriting losses and general business expenses. Regardless of this parity with other taxpayers, life insurance companies remain subject to complex rules that include a five-year waiting before joining a consolidated group and a restriction on the utilization of losses generated by affiliates.[30] The simplification provisions of the TCJA did not remove these restrictions.

Character of Gain/Loss on Asset Disposals

Banks and other similar financial institutions invest in bonds and other debt instruments to fund deposit liabilities and reserve obligations undertaken in the ordinary course of business. These financial institutions have long enjoyed the benefit of characterizing gains and losses on the disposal of bonds and other debt instruments as ordinary (not capital) in keeping with the ordinary nature of the obligations they support.[31] For this reason, many such financial institutions are not burdened by limitation on the use of capital losses. This relief is not, however, afforded to insurance companies.

Much like banks and other financial institutions, insurance companies invest in bonds and other debt instruments to support policy reserves and other underwriting obligations undertaken in their ordinary course of business. Insurers utilize interest income and maturity proceeds to fund anticipated claims. Although interest income from these securities is generally taxed as ordinary income, gains and losses on disposal are not. Insurers often dispose of bond and other investment holdings prior to maturity to pay claims arising from unforeseen events, or to better match asset and liability duration. The Internal Revenue Code characterizes losses on the disposal of these investments as capital in nature, unavailable to offset taxable income from ordinary operations. Though these capital losses may carry forward to offset future capital gains, insurers face the risk that such carryforwards will expire before recognizing sufficient capital gains, particularly in rising interest rate environments. The TCJA did not address this issue.

Technical Corrections

The text of the TCJA itself was hundreds of pages long, representing a Herculean legislative effort in a small number of weeks. Unsurprisingly, as companies, practitioners, and the IRS work through the new law, minor errors become apparent. The process for correcting those errors is known as "technical corrections." The term technical correction is a term of art, and generally refers to a drafting mistake, or an error where the plain language of a provision is contrary to its clear intent, and correcting the error will have no effect on federal tax revenue. At some point, Congress likely will correct those errors in what is known as a technical corrections bill. Where such errors have been identified for provisions affecting life insurers, the relevant articles in this issue of *Taxing Times* will discuss them.

NONTAX CONSEQUENCES OF THE TCJA

The pervasive and dramatic changes enacted in the TCJA so close to calendar year-end 2017 caused significant challenges with respect to the accounting and financial statement reporting of the related effects. The breadth of the changes to the taxation of life insurance companies resulted in additional turmoil within the industry, particularly for companies with both U.S. and non-U.S. operations.

In recognition of the TCJA's widespread impact to U.S. taxpayers and the related challenges to year-end 2017 financial reporting, the Securities and Exchange Commission ("SEC") quickly published Staff Accounting Bulletin 118, allowing companies to report the effects of the change in tax law as those effects are reasonably determined, but no later than year-end 2018. In early February, the NAIC Statutory Accounting Principles Working Group issued INT 18-01, *Updated Tax Estimates under the Tax Cuts and Jobs Act*, which generally adopted the concepts outlined in SAB 118 and provided additional guidance with respect to reporting tax effects of the TCJA in the statutory annual statement. This guidance helped to ease the burden of year-end 2017 reporting. Significant questions remain as to the impact of future guidance from Treasury and the proper financial statement reporting of the tax balances impacted by the base erosion provisions of the TCJA.

Given the effective date for many of the TCJA provisions, life insurers are working expeditiously to consider what changes in their business are appropriate in response to the new legislation. Insurance contracts are being reevaluated for compliance with the new provisions; systems and processes are being reconsidered; income tax accounting frameworks are being reconsidered; processes to monitor tax law and accounting changes are being strengthened; and the response of the various states are being monitored to be sure that companies and their products are in compliance and transactions are reconsidered to avoid traps for the unwary.

Many of these activities bear directly on the work of actuaries, company tax professionals, outside consultants, and tax and nontax regulators. Whatever your role, we hope you find this issue of *Taxing Times* helpful. ■

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ENDNOTES

1 More precisely, "An act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97, enacted Dec. 22, 2017.

2 More specifically, the Revenue Act of 1921 taxed life insurers only on net investment income. Before then life insurers were taxed on all their income.

3 For a more detailed description of the 1959 Act, *See* William B. Harman, Jr., "The Pattern of Life Insurance Company Taxation under the 1959 Act," presented at the 15th Annual Tulane Tax Institute Sept. 28, 1965 and published by the *Journal of Taxation*. The late Bill Harman was a giant in the field of insurance company taxation. He was the attorney at the Treasury Department Office of Tax Policy specializing in insurance at the time the 1959 Act was enacted, and was a founding partner of Davis & Harman, LLP.

4 The 1984 Act legislative history expressly directs that in the absence of contrary guidance, authorities under the 1959 Act provisions are to serve as interpretive guides to the new provisions. S. Rep. No. 98-169, 98th Cong., 2d Sess. 524 (1984).

5 *See, e.g.*, Notice 2008-18, 2008-1 C.B. 363; Peter Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *Taxing Times*, Vol. 12, Issue 1, at 21 (March 2016).

6 *See* H.R. 6270, 114th Cong., 2d Sess. (2016); Treasury Department, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," page 21 (February 2016).

7 H.R. 1, 114th Cong., 2d Sess. (2014).

8 *Taxing Times*, Vol. 10, Issue 3—Supplement (October 2014).

9 Kristin Norberg, "The Road to Tax Reform—An Interview with Chairman Dave Camp," *Taxing Times*, Vol. 11, Issue 3, at 4 (October 2015).

10 House Republican Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

11 *Id.*, page 26.

12 Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), together the "ACA."

13 American Health Care Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

14 Better Care Reconciliation Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

15 Obamacare Repeal Reconciliation Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

16 S.Amdt. 1030 to the American Health Care Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

17 Chairman's Mark, section 3703.

18 Chairman's Mark, section 3705.

19 Chairman's Mark, section 3710.

20 The Ways and Means Committee Majority Staff's Section-by-Section Summary of the Act, released Nov. 3, 2017, estimated that the reserves provision would raise $14.9 billion (page 51), the DAC provision would raise $7.0 billion (page 55), and the life insurance proration provision would raise $1.1 billion (page 52) during the 10-year scoring window.

21 Life Insurance Company Taxable Income already is a defined term in the Internal Revenue Code and is the base on which income tax of life insurers is computed.

22 H. Rept. No. 115-409, 115th Cong., 1st Sess., page 319 (2017) ("[T]he bill includes a surtax on life insurance company taxable income that is intended to have the same overall revenue consequences as reforms that were proposed [for reserves, DAC, and proration] in the introduced version of the bill. The surtax is intended only as a placeholder and the Committee intends to develop reforms in those three areas as the bill moves through the legislative process.")

23 The Senate Finance Committee DAC proposal was described by the staff of Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), Nov. 9, 2017, at page 139.

24 *Tax Analysts* Doc. No. 2017-98547.

25 H.R. Conf. Rept. 115-466, 115th Cong., 1st Sess., Table, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,'" page 8 (2017).

26 Prop. Treas. Reg. section 1.1297-4.

27 *See* Notice 2018-28, 2018-16 I.R.B. 492 (April 16, 2018).

28 H.R. Conf. Rept. 115-466, 115th Cong., 1st Sess., page 275, footnote 872 (2017).

29 The rules that apply to the filing of consolidated returns by a group that includes both life and nonlife members are set forth at Treas. Reg. section 1.1502-47. Industry comments on the need for updating and simplifying the regulations are set forth in comments of the American Council of Life Insurers (ACLI), Tax Analysts Doc. No. 2002-18864 (July 26, 2002).

30 *See generally* Treas. Reg. section 1.1502-47.

31 Internal Revenue Code section 582(c).

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 1), the Tax Cuts and Jobs Act, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment that is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

9. Computation of life insurance tax reserves (sec. 13517 of the Senate amendment and sec. 807 of the Code)

Present Law

In general

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[982] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

In computing the net increase or net decrease in reserves, six items are taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations under insurance and annuity contracts that do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both.

Life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules, but may not exceed the statutory reserve with respect to the contract (for regulatory reporting). In computing the Federally prescribed reserve for any type of contract, the taxpayer must use the tax reserve method applicable to the contract, an interest rate for discounting of reserves to take account of the time value of money, and the prevailing commissioners' standard tables for mortality or morbidity.

Interest rate

The assumed interest rate to be used in computing the Federally prescribed reserve is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate. The applicable Federal interest rate is the annual rate determined by the Secretary under the discounting rules for property and casualty reserves for the calendar year in which the contract is issued. The prevailing State assumed interest rate is generally the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning the calendar year in which the contract is issued. In determining the highest assumed rates permitted in at least 26 States, each State is treated as permitting the use of every rate below its highest rate.

A one-time election is permitted (revocable only with the consent of the Secretary) to apply an updated applicable Federal interest rate every five years in calculating life insurance

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[982] Sec. 807.

reserves. The election is provided to take account of the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration. The use of the updated applicable Federal interest rate under the election does not cause the recalculation of life insurance reserves for any prior year. Under the election no change is made to the interest rate used in determining life insurance reserves if the updated applicable Federal interest rate is less than one-half of one percentage point different from the rate used by the company in calculating life insurance reserves during the preceding five years.

House Bill

No provision.

Senate Amendment

The provision provides that for purposes of determining the deduction for increases in certain reserves of a life insurance company, the amount of the life insurance reserves for any contract (other than certain variable contracts) is the greater of (1) the net surrender value of the contract (if any), or (2) 92.87 percent of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined. In the case of a variable contract, the amount of life insurance reserves for the contract is the sum of (1) the greater of (a) the net surrender value of the contract, or (b) the separate-account reserve amount under section 817 for the contract, plus (2) 92.87 percent of the excess (if any) of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined over the amount determined in (1). In no event shall the reserves exceed the amount which would be taken into account in determining statutory reserves. No amount or item shall be taken into account more than once in determining any reserve. As under present law, no deduction for asset adequacy or deficiency reserves is allowed. The amount of life insurance reserves may not exceed the annual statement reserves. The provision provides reserve rules for supplemental benefits and retains present-law rules regarding certain contracts issued by foreign branches of domestic life insurance companies.

Effective date.–The proposal applies to taxable years beginning after December 31, 2017. For the first taxable year beginning after December 31, 2017, the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of such reserve determined as if the proposal had applied for that year is taken into account for each of the eight taxable years following that preceding year, one-eighth per year.

Conference Agreement

The conference agreement follows the Senate amendment except that, instead of 92.87 percent, the percentage relating to the statutory reserve is 92.81 percent. More specifically, the provision provides that for purposes of determining the deduction for increases in certain reserves of a life insurance company, the amount of the life insurance reserves for any contract (other than certain variable contracts) is the greater of (1) the net surrender value of the contract (if any), or (2) 92.81 percent of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined. In the case of a variable contract, the amount of life insurance reserves for the contract is the sum of (1) the greater of (a) the net surrender value of the contract, or (b) the separate-account reserve amount under section 817 for the contract, plus (2) 92.81 percent of the excess (if any) of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined over the amount determined in (1). In no event shall the reserves exceed the amount which would be taken into account in determining statutory reserves. As under present law, no deduction for asset adequacy or deficiency reserves is allowed.

The amount of life insurance reserves may not exceed the annual statement reserves. A no-double-counting rule provides that no amount or item is taken into account more than once in determining any reserve under subchapter L of the Code. For example, an amount taken into account in determining a loss reserve under section 807 may not be taken into account again in determining a loss reserve under section 832. Similarly, a loss reserve determined under the tax reserve method (whether the Commissioners Reserve Valuation Method, the Commissioner's Annuity Reserve Valuation Method, a principles -based reserve method, or another method developed in the future, that is prescribed for a type of contract by the National Association of Insurance Commissioners) may not again be taken into account in determining the portion of the reserve that is separately accounted for under section 817 or be included also in determining the net surrender value of a contract.

The provision provides reserve rules for supplemental benefits and retains present-law rules regarding certain contracts issued by foreign branches of domestic life insurance companies. The provision requires the Secretary to provide for reporting (at such time and in such manner as the Secretary shall prescribe) with respect to the opening balance and closing balance or reserves and with respect to the method of computing reserves for purposes of determining income. For this purpose, the Secretary may require that a life insurance company (including an affiliated group filing a consolidated return that includes a life insurance company) is required to report each of the line item elements of each separate account by combining them with each such item from all other separate accounts and the general account, and to report the combined amounts on a line-by-line basis on the taxpayer's return. Similarly, the Secretary may in such guidance provide that reporting on a separate account by separate account basis is generally not permitted. Under existing regulatory authority, if the Secretary determines it is necessary in order to carry out and enforce this provision, the Secretary may require e-filing or comparable filing of the return on magnetic medial or other machine readable form, and may require that the taxpayer provide its annual statement via a link, electronic copy, or other similar means.

Effective date.–The provision applies to taxable years beginning after December 31, 2017. For the first taxable year beginning after December 31, 2017, the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of such reserve determined as if the proposal had applied for that year is taken into account for each of the eight taxable years following that preceding year, one-eighth per year.

House Bill

No provision.

Senate Amendment

The provision modifies the life insurance company proration rule for reducing dividends received deductions and reserve deductions with respect to untaxed income. For purposes of the life insurance proration rule of section 805(a)(4), the company's share is 70 percent. The policyholder's share is 30 percent.

Effective date.–The provision applies to taxable years beginning after December 31, 2017.

Conference Agreement

The conference agreement follows the Senate amendment.

11. Capitalization of certain policy acquisition expenses (sec. 13519 of the Senate amendment and sec. 848 of the Code)

Present Law

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and generally are amortized over the 120-month period beginning with the first month in the second half of the taxable year.[998]

A special rule provides for 60-month amortization of the first $5 million of specified policy acquisition expenses with a phase-out. The phase-out reduces the amount amortized over 60 months by the excess of the insurance company's specified policy acquisition expenses for the taxable year over $10 million.

Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for all other specified insurance contracts, the percentage is 7.7.

With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof. A group life insurance contract is any life insurance contract that covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor, the premiums for which are determined on a group basis, and the proceeds of which are payable to

[998] Sec. 848.

(or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

House Bill

No provision.

Senate Amendment

The provision extends the amortization period for specified policy acquisition expenses from a 120-month period to the 180-month period beginning with the first month in the second half of the taxable year. The provision does not change the special rule providing for 60-month amortization of the first $5 million of specified policy acquisition expenses (with phaseout). The provision provides that for annuity contracts, the percentage is 2.1 percent; for group life insurance contracts, the percentage is 2.46 percent; and for all other specified insurance contracts, the percentage is 9.24 percent.

Effective date.—The provision applies to taxable years beginning after December 31, 2017.

Conference Agreement

The conference agreement follows the Senate amendment with modifications. Under the conference agreement, the amortization period is 180 months. For annuity contracts, the percentage is 2.09 percent; for group life insurance contracts, the percentage is 2.45 percent; and for all other specified insurance contracts, the percentage is 9.20 percent.

12. Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules (secs. 13518 through 13520 of the Senate amendment and secs. 101, 1016, and 6050X of the Code)

Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[999]

[999] Sec. 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). Sec. 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally,

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Changes to the Computation of Tax Reserves under P.L. 115-97

By Kristin Norberg and Jeffrey Stabach

One of the more groundbreaking changes in the insurance provisions of Public Law No. 115-97[1] (the Act) was the introduction of a modified framework for computing tax-basis life insurance reserves. The previous proposal for comprehensive tax reform, in 2014,[2] would have maintained the general prior-law structure requiring a distinct tax reserve based on a specified method, mortality or morbidity table, and interest rates, changing only the approach for determining the interest rates. The Act took a very different approach, generally defining tax reserves as a percentage of statutory reserves with a net surrender value floor. This has the benefit of improving conformity with statutory accounting, especially as the National Association of Insurance Commissioners (NAIC) continues implementation of principle-based reserve (PBR) approaches. There are, however, several important nuances, potential pitfalls and unanswered questions, which we will explore in this article.

The Act changed not only life insurance reserves held under Internal Revenue Code (I.R.C.)[3] §807(c)(1), but also reserves held under I.R.C. §807(c)(3) for insurance and annuity contracts not involving life contingencies, and discounted unpaid losses computed under I.R.C. §846 relating to property/casualty (P&C) insurance contracts and some types of accident and health (A&H) insurance. The new requirements are briefly summarized in the sidebar and discussed in more detail below.

This article will focus on reserves held under I.R.C. §§807(c)(1) and (3). A separate article in this issue of *Taxing Times* will address changes made to discounted unpaid losses under I.R.C. §§807(c)(2) and 805(a)(1). The Act also made significant revisions to I.R.C. §807(f) relating to treatment of changes in the basis for determining reserves; because the industry and IRS are currently engaged in discussions on the guidance that may be

A SHORTHAND GUIDE TO INSURANCE RESERVES UNDER THE ACT

Life insurance reserves (non-variable contracts)—The tax reserve is generally the greater of:

1. The contract's net surrender value, or
2. 92.81 percent of the reserve computed using the "tax reserve method," which generally is the CRVM/CARVM[4] reserve.

Life insurance reserves (variable contracts)—The tax reserve is generally:

1. The greater of:
   a. The entire contract's net surrender value, or
   b. 100 percent of the portion of the CRVM/CARVM reserve that is separately accounted for under I.R.C. §817,

plus

2. 92.81 percent of any excess of the entire contract's CRVM/CARVM reserve over the amount in paragraph 1.

Insurance and annuity contracts not involving life or A&H contingencies—The tax reserve is generally the greater of:

1. The contract's net surrender value, or
2. 100 percent of the discounted value of the obligations, using the highest discount rate or rates permitted by the NAIC as of the date the reserve is determined.

Other considerations

- Life insurance reserves continue to be subject to a contract-level statutory cap.
- Items that were not previously deductible (*e.g.*, deficiency reserves, reserves attributable to deferred and uncollected premiums if the premiums are not included in taxable income, and excess interest reserves) remain nondeductible and are excluded prior to applying the percentage factor.
- CRVM/CARVM (or other NAIC method if the contract is not subject to CRVM or CARVM) is as prescribed by the NAIC and in effect as of the date the reserve is determined.

necessary for implementing the changes to I.R.C. §807(f), we have deferred that topic to a later issue of *Taxing Times*. Reserves held under I.R.C. §§807(c)(4), (5) and (6) were unchanged by the Act.

LIFE INSURANCE RESERVES FOR NON-VARIABLE CONTRACTS

Prior to the Act, life insurance reserves were computed using prescribed methods and assumptions that were generally determined when a contract was issued and not changed thereafter. The federally prescribed reserve was determined using the tax reserve method, the prevailing commissioners' standard mortality or morbidity tables, and the greater of the applicable federal interest rate (AFIR) or the prevailing state assumed interest rate (PSAIR). The tax reserve method was generally the commissioners' reserve valuation method (CRVM) for contracts subject to CRVM, the commissioners' annuity reserve valuation method (CARVM) for contracts subject to CARVM, and one- or two-year preliminary term methods for noncancellable A&H insurance contracts. The prevailing tables and PSAIR were determined based on the rates that at least 26 states permitted to be used for valuation. The federally prescribed reserve was subject to a net surrender value floor and a statutory reserve cap, both applied at the contract level.

This highly prescribed framework, and particularly the "locking in" of methods and assumptions at issue, had not kept pace with the direction taken by the NAIC. Through PBR initiatives including Actuarial Guideline 43 (AG 43, now incorporated in Valuation Manual section 21 (VM-21)) for variable annuities and Valuation Manual section 20 (VM-20) for individual life insurance, the NAIC had moved toward a more dynamic, economically responsive framework that better recognized company-specific and product-specific risk characteristics. Fitting the square peg of PBR into the round hole of the pre-2018 Code had been a challenge, leading to a Priority Guidance Plan project, an IRS Large Business and International Division campaign, and an ongoing industry issue resolution project.[5] The Congressional tax-writing committees were aware of these challenges and were interested in a solution that would simplify the process of determining tax reserves.[6]

The solution Congress ultimately adopted was to use a percentage of reserves computed under CRVM, CARVM or other NAIC-prescribed reserve methods. The methods are those "in effect as of the date the reserve is determined," significantly improving the alignment with NAIC approaches and apparently

eliminating the issues (for tax years after 2017) raised by the *American Financial* case decided in 2012.[7] The new definition appears to contemplate changes in methodology after issue, whether the change is specifically prescribed by the NAIC or a company changes between two alternative permissible methods within CRVM/CARVM. Companies will still need to determine whether a particular change in method should be considered an I.R.C. §807(f) change in basis.

The Act did not change several tax-specific adjustments that existed prior to 2018:

- *Deferred and uncollected premiums.* Reserves attributable to deferred and uncollected premiums, when the premiums are not properly included in taxable income, cannot be deducted. *See* I.R.C. §§811(c)(1) and 807(d)(4).

- *Deficiency reserves.* Reserves held "because the net premium (computed on the basis of assumptions required under [I.R.C. §807(d)]) exceeds the actual premiums or other consideration charged for the benefit," *i.e.*, deficiency reserves, cannot be deducted. *See* I.R.C. §807(d)(3)(C).[8]

- *Excess interest reserves.* Reserves held for contracts that guarantee interest at a rate that exceeds the PSAIR must be modified to take into account such excess interest guarantee only up to the end of the taxable year. *See* I.R.C. §811(d).[9]

The new law does not contain any provisions relating to the treatment of asset adequacy testing reserves, which may be required for an actuary to issue the actuarial opinion required under section 3 of the Standard Valuation Law. Accordingly, the

treatment of such reserves would appear to be unchanged from the treatment under prior law; the Committee Reports to the Act indicate that asset adequacy reserves are not deductible.[10]

Also, it appears that life insurance companies may still be challenged on their deductions of unpaid loss adjustment expenses that do not meet the all-events test under I.R.C. §461, as Congress indicated in the Committee Reports to the Tax Reform Act of 1986.[11] The current Congress did not identify any changes to this intention in the 2017 Act or its legislative history.

Permitted or Prescribed Practices

States sometimes permit or require reserve methodologies that differ from the NAIC-prescribed methods. For example, New York generally requires the use of "continuous" CARVM for deferred annuities, requiring consideration of available values at any time within a contract year and not just "at the end of each respective contract year" as stated in the Standard Valuation Law.[12] The IRS determined in a 1994 technical advice memorandum[13] that CARVM as defined in the Standard Valuation Law was based only on end-of-year values; continuous CARVM was not the NAIC-prescribed method, so it could not be used under the then-current Code. It is foreseeable that the IRS would apply similar reasoning with regard to a state-specific variation under the new law; *i.e.*, it is the method prescribed by the NAIC that is relevant for tax reserves, not state-specific deviations from that method. This will, in turn, likely lead to further scrutiny around what it means to be prescribed by the NAIC.

Similarly, not all states have yet enacted the 2009 version of the Standard Valuation Law that enables use of the Valuation Manual, so VM-20 is not available for valuation of individual life insurance contracts in those states. If a state has not enacted the enabling legislation by 2020 (when the three-year transition to VM-20 expires), it is possible that a company that computes reserves under such state's laws for contracts issued after 2019 that are otherwise in the scope of VM-20 could be required to recompute its reserves for such contracts using VM-20, before applying the 92.81 percent factor under new I.R.C. §807(d)(1)(A)(ii).

Also, U.S. taxpaying companies not subject to NAIC reporting (*e.g.*, non-NAIC captives in certain U.S. jurisdictions, or non-U.S. insurance companies electing under I.R.C. §953(d) to be treated as U.S. taxpayers) may be required to recompute reserves using the NAIC-prescribed methods prior to applying the 92.81 percent factor.

Assumptions

Mortality, morbidity and interest rate assumptions are no longer explicitly prescribed in the law; only the method is prescribed. The removal of a specific prescription for assumptions suggests that, so long as assumptions selected for statutory reserve purposes are consistent with CRVM/CARVM and actuarial standards, they should carry over for tax purposes. In any event, companies may find it beneficial to develop documentation in support of their interpretations. If the intent of Congress was to simplify reserve computations by basing them on statutory reserves, the simplest way to do this would be to use the statutory reserves as determined for the annual statement, so long as they are consistent with CRVM/CARVM and the tax-specific exclusions mentioned above have been applied.

It appears the IRS may hold this view, based on Rev. Rul. 2018-13[14] released April 26, 2018. In Schedule A of the ruling, which would normally provide the PSAIRs for life insurance contracts issued in 2018, the rates are marked "N/A" with a footnote that reads, in part (emphasis added):

> Section 807(d), as amended, ***requires use of the rate used for statutory reserving***, as life insurance reserves for taxable years beginning after December 31, 2017, are determined, in part, based on the reserve computed as required by the National Association of Insurance Commissioners (NAIC) at the time the reserve is determined.

Where an interest or mortality assumption is specifically prescribed within the NAIC's definition of the method,[15] taxpayers may need to consider whether their tax reserve computation can be based on a reported statutory reserve developed using a more conservative assumption.

To the extent a company changes reserve assumptions after a contract is issued, it may need to consider whether I.R.C. §807(f) applies.

Other Aspects of Life Insurance Reserves

A few other brief remarks can be made on life insurance reserves for non-variable contracts:

- *Supplemental benefits.* The supplemental benefits listed in I.R.C. §807(e)(2)(C) (whether qualified or not) are now subject to the 92.81 percent factor, rather than held equal to the statutory reserve as under prior law. Similar rules apply for aggregation as under prior law; *i.e.*, a qualified supplemental benefit (QSB) is treated as a separate contract, so the net surrender value and statutory cap comparisons would be done separately for the base contract and the QSB.
- *Qualified substandard risks.* Prior I.R.C. §807(e)(5), providing rules for reserves on qualified substandard risks, was repealed. It appears that these would now be subject to the 92.81 percent factor, to the extent the reserve is determined under the method prescribed by the NAIC.
- *Modified guaranteed contracts.* I.R.C. §817A was amended to remove a cross-reference to the calculation of required interest for proration purposes,[16] but it was otherwise unchanged by the Act despite the modified framework for tax reserves. As a result, I.R.C. §817A(e)(2) continues to provide authority to Treasury to prescribe regulations for determining "interest rates applicable under sections 807(c)(3) and 807(d)(2)(B) with respect to a modified guaranteed contract."[17] However, I.R.C. §807(d)(2)(B) no longer exists. In the absence of technical corrections or other authoritative clarification, it may be reasonable to apply the 92.81 percent factor to the NAIC-basis reserve for life-contingent modified guaranteed contracts with reserves held under I.R.C. §807(c)(1), while continuing to apply Treas. Reg. §1.817A-1 to modified guaranteed contracts for which reserves are held under I.R.C. §807(c)(3).

> This highly prescribed framework, and particularly the "locking-in" of methods and assumptions at issue, had not kept pace with the direction taken by the NAIC.

LIFE INSURANCE RESERVES FOR VARIABLE CONTRACTS

There is perhaps no greater example under prior law of the tax issues resulting from the implementation of PBR than when AG 43 was adopted for variable annuities. AG 43 was effective Dec. 31, 2009, but it applied by its terms to variable annuity contracts issued on or after Jan. 1, 1981. However, there has been some uncertainty with regard to the tax treatment of AG 43. The Treasury Department and the IRS issued Notice 2010-29,[18] which provided a "safe harbor" for contracts issued on or after Dec. 31, 2009. This ultimately created non-parallel tax treatment for variable annuities valued under AG 43 depending on the year of issue. The fact that the safe harbor did not extend to contracts issued prior to Dec. 31, 2009, resulted in companies using a variety of approaches for calculating tax reserves for these contracts (*e.g.*, AG 33/43 hybrid approaches or AG 39). The Act would seem to simplify this non-parallel treatment for variable annuity contracts by using the method that is "applicable to the contract and in effect as of the date the reserve is determined." It would appear that for contracts subject to AG 43 or VM-21 on a statutory basis, reserves for tax purposes should now be determined under AG 43/VM-21.

Further complicating the calculation of tax reserves under prior law was the fact that Notice 2010-29 allowed some provisions of AG 43 (*i.e.*, the Standard Scenario Amount (SSA)) to be taken into account, but excluded others (*i.e.*, the Conditional Tail Expectation (CTE) Amount) from the federally prescribed reserve under the safe harbor. Among the IRS's stated concerns with the inclusion of the CTE Amount were: (1) the nature of an aggregate calculation rather than one on a policy-by-policy basis, (2) the fact that assumptions were based on company experience and subject to change on an annual basis, and (3) difficulty in auditing.[19] Despite these concerns, it appears Congress's intent in the Act was to include the entire NAIC-prescribed reserve method (*see* endnote 6). The CTE Amount is not a "solvency" or "contingency" reserve as the IRS suggested

in Notice 2008-18, but rather a core part of the method developed by the NAIC that is necessary in order to recognize the risks inherent in contracts subject to AG 43.

Treatment of General and Separate Accounts

For a contract meeting the definition of a variable contract in I.R.C. §817(d), the Act first requires a company to determine the greater of the contract's net surrender value (both general and separate accounts) or the portion of the reserve that is separately accounted for under I.R.C. §817. The 92.81 percent factor is then applied to the excess, if any, of the CRVM/CARVM reserve (for the entire contract) over this amount.

What is "the portion of the reserve that is separately accounted for under I.R.C. §817"? I.R.C. §817(c) requires that a company separately account for items attributable to variable contracts using "the method regularly employed by such company, if such method is reasonable." As a general rule, reserves supporting guaranteed benefits on a variable contract (such as a guaranteed minimum death benefit) must be held in the company's general account.[20] There is some flexibility in the allocation method beyond that rule,[21] but as long as a company's allocation method for statutory reporting purposes is reasonable, it appears that "the portion of the reserve that is separately accounted for under I.R.C. §817" would generally be the amount in Exhibit 3 of the company's separate account annual statement.

An example may be helpful to clarify the process and terminology. Assume that a company issues a variable annuity contract that has an account value of 1,000, a surrender charge of 8 percent, a Basic Reserve (as defined in AG 43) of 940, and a total CARVM reserve of 970. The contract holder has allocated 80 percent of his funds to the separate account, and the company uses a proportional approach to allocate the Basic Reserve between the general and separate accounts. Table 1 illustrates the application of I.R.C. §807(d)(1)(B) to this contract:

Table 1

	General (GA)	Separate (SA)	Total
Account Value (AV)	200	800	1,000
Net Surrender Value (NSV) (8% Surrender Charge)	184	736	920
Basic Reserve (BR) (Proportional to AV)	188	752	940
Statutory CARVM Reserve (GA = Excess over SA BR)	218	752	970
Max (NSV, SA Reserve)	Max (920, 752)		920
Excess CARVM Reserve	(970 – 920)		50
Excess * 92.81%	(50 * 0.9281)		46.41
Tax Reserve	Min (920 + 46.41, 970)		**966.41**

This special reserve definition for variable contracts can possibly produce different results, depending on the contract holders' distribution of the fund value and the allocation method for the CARVM reserve. In addition, the definition of the product (*i.e.*, as variable or non-variable) may create other differences. For example, a living benefit rider attached to a fixed indexed annuity (which is not a "variable contract" under I.R.C. §817(d)) may generate a lower tax reserve than a similar rider attached to a variable annuity.

RESERVES FOR INSURANCE AND ANNUITY CONTRACTS WITHOUT LIFE CONTINGENCIES

While the interest rate assumptions are no longer explicitly prescribed in the law for calculating life insurance reserves, that is not the case for insurance and annuity contracts without life, accident or health contingencies that are subject to I.R.C. §807(c)(3). The amounts are to be held, discounted using the highest rate or rates permitted to be used by the NAIC as of the date the reserve is determined. The determination of interest rates is a departure from prior law, where the assumed discount rate was generally based on the greatest of the PSAIR, AFIR and the contract guaranteed rate, all determined at issuance of the contract (or when the obligation first did not involve life, accident or health contingencies). Unlike prior law, the Act will generally require a separate tax-specific calculation of amounts under I.R.C. §807(c)(3) only where maximum interest rates permitted by the NAIC differ from those being used in the statutory valuation of contracts (*e.g.*, when using more conservative interest rates or rates that differ based on the state of domicile).

Similar to issues mentioned previously with states yet to adopt VM-20, the treatment of I.R.C. §807(c)(3) amounts for term-certain income annuities subject to Valuation Manual section 22 (VM-22) raises additional considerations. If a company is domiciled in a state that has not yet adopted VM-22, it is possible a company may be required to compute I.R.C. §807(c)(3) amounts for contracts issued after 2017 using the highest discount rate or rates specified under VM-22, which may differ from the rates under such state's laws.

TRANSITION RULES FOR I.R.C. §807

The Act provides for certain "transition relief" to account for differences in reserves calculated under the prior-law definition vs. those calculated under the Act. The amount of reserve difference is determined as of Dec. 31, 2017 and spread equally over the following eight taxable years (*i.e.*, one-eighth of the amount in each year from 2018 through 2025). As the Act refers to the transition amount as the difference in the amount of reserves determined under the prior-law vs. new-law definitions of I.R.C. §807(d), which only defines the computation of life insurance reserves, it is unclear if I.R.C. §807(c)(3) amounts would be included in the amount spreadable under the Act's transition rules. This may have been an inadvertent oversight, but in the absence of explicit inclusion in the transition rule, the change in basis of computation of I.R.C. §807(c)(3) amounts might be viewed as a change in method of accounting requiring an adjustment under I.R.C. §481(a) pursuant to the new provisions of I.R.C. §807(f).

Once calculated, there is generally no difference in treatment whether the amount is an increase or a decrease in reserve (with the possible exception of I.R.C. §807(c)(3) amounts if viewed as a change in accounting method).[22] Increases in reserves are deducted under I.R.C. §§805(a)(2) or 832(c)(4), while decreases in reserves are included in income under I.R.C. §§803(a)(2) or 832(b)(1)(C). It is interesting to note that Congress did not permit a "fresh start" as in 1984 when the federally prescribed reserve framework was first enacted, nor a grandfathering of existing contracts as in 1988 when the AFIR was introduced. The redetermination of tax reserves on in-force contracts and the so-called transition relief in the Act were necessary in order to produce Congress's desired amount of revenue from the life insurance industry to offset part of the cost of the broader tax cuts.

LIFE INSURANCE COMPANY RESERVES— HOW DID WE GET HERE?

Before closing, it is worth taking a step back to consider how we ended up at the final rules in the Act. The original H.R. 1, introduced Nov. 2, 2017, had a very different approach. It would have repealed all of prior I.R.C. §§807(c), (d) and (e), replacing them with a single method for determining "reserves for future unaccrued claims." The tax reserve was generally defined as 76.5 percent of the annual statement reserve, with no net surrender value floor. "Reserves for future unaccrued claims" had only three components:

- Life insurance reserves.
- Unpaid losses (which were discounted under I.R.C. §846 prior to applying 76.5 percent).
- The amount (not included in the first two bullets) of "reserves solely for claims with respect to insurance risks."

The original H.R. 1 explicitly excluded "any amount of asset adequacy reserves, contingency reserves, unearned premium reserves, or any other amount not constituting reserves for future unaccrued claims as provided in guidance by the Secretary."[23] As in the version ultimately enacted, the rules would have applied to all in-force reserves, with an eight-year spread of the impact.

Had H.R. 1 been enacted as originally introduced, it would have been devastating to the life insurance industry. A factor of 76.5 percent without a net surrender value floor would have created reserves that were significantly lower than the aggregate level of tax reserves under prior law. Income and deductions would not have been matched at all: Unearned premiums, premiums paid in advance, and amounts applied to premium deposit funds would still have been included in income under I.R.C. §803(b), but the corresponding reserve deductions would all have been repealed. Similarly, considerations paid for insurance or annuity contracts not involving life contingencies (*i.e.*, deposit-type contracts under NAIC classifications) would have been included in gross income, but it is not clear whether the corresponding reserves would have been considered "reserves solely for claims with respect to insurance risks." After all, the first sentence of the NAIC's definition of such contracts is: "Deposit-type contracts do not incorporate insurance risk."[24] Further, with no net surrender value floor, the reserve rule in the original H.R. 1 was akin to taxing banks on 23.5 percent of their deposits (but even worse, because a significant portion would have been taxed at 100 percent, as just described).

The Joint Committee on Taxation estimated that the original insurance reserves provision would have raised $14.9 billion of tax revenue over 10 years. The industry, led by the American Council of Life Insurers (ACLI), gathered data suggesting that the actual impact of the proposed changes would have been many times that amount. In light of this, the industry and ACLI engaged in a significant undertaking during November and December with members of Congress and their staff, tax-writing committees, and revenue estimators on these issues. The result of this effort was an approach that (1) maintained the reserve categories and net surrender value floor of prior law, (2) retained and refined Congress's original attempt to define tax reserves as a percentage of statutory reserves in order to

accommodate PBR methods, and (3) was reasonably in line with Congress's revenue target of $15 billion[25] from the provision. Although the life insurance industry was still targeted with base broadeners in a way few other industries were and will incur significant tax costs especially during the eight-year spread, the reserve provisions in the final version of the Act provide a compromise that is far better than the catastrophic alternative in the original H.R. 1. ■

Note: The views expressed are those of the authors and do not necessarily reflect those of Ernst & Young LLP or Symetra Life Insurance Company.

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ENDNOTES

1 "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.

2 The Tax Reform Act of 2014, released as a discussion draft on Feb. 26, 2014, and introduced by House Ways and Means Committee Chairman Dave Camp (R-Mich.) as H.R. 1 (113th Cong.) on Dec. 10, 2014.

3 References to the I.R.C. or Code are to the Internal Revenue Code of 1986, as amended. Unless otherwise specified, this includes the amendments made by the Act.

4 Throughout this article, the term "CRVM/CARVM" is used as shorthand for the tax reserve method as defined in I.R.C. §807(d)(3). This includes not only CRVM and CARVM in the case of contracts covered by such methods, but also other reserve methods prescribed by the NAIC that cover a contract, and, in a case where the NAIC has not prescribed a method for a particular type of contract, a reserve method that is consistent with an NAIC-prescribed method (whichever is most appropriate). Under the Act, the relevant methods are those in effect as of the date the reserve is determined.

5 *See* the 2012–2013 and subsequent Priority Guidance Plans and the Jan. 31, 2017 announcement of the initial 13 Large Business and International campaigns (*www.irs.gov/businesses/large-business-and-international-launches-compliance-campaigns*, accessed May 10, 2018).

6 *See, e.g.*, Ways and Means Committee Majority Tax Staff, *Tax Cuts and Jobs Act*, H.R. 1: Section-by-Section Summary (Nov. 2, 2017) at 51. This was a summary of the original version of the bill as introduced in the House; the insurance provisions in the original H.R. 1 differed significantly from those in the final Act, but the original also provided for tax reserves to be based on a percentage of the NAIC reserve. The Ways and Means summary noted with respect to PBR:

> Insurance regulators have been changing how life insurance companies must calculate and maintain reserves. The current rules in the Tax Code do not provide how reserves measured in the new [manner] should be taken into account for tax purposes.

This suggests that the original H.R. 1 and the Act as ultimately enacted do provide for reserves measured in the new manner, and they do so by generally accepting the NAIC's methods, subject to a percentage factor.

7 *American Financial Group v. U.S.*, 678 F.3d 422 (6th Cir., 2012), *aff'g* 726 F. Supp. 2d 802 (S.D. Ohio, 2010).

8 As under prior law, presumably, deficiency reserves remain part of the statutory cap. *See* Notice 2013-19, 2013-1 C.B. 743 (Feb. 26, 2013).

9 I.R.C. §811(d) previously referred to interest in excess of the greater of the PSAIR or AFIR. Due to the removal of the AFIR, the Act included a conforming amendment to I.R.C. §811(d) to refer only to interest in excess of the PSAIR, as now defined in I.R.C. §808(g). The excess interest provision was otherwise unchanged.

10 Tax Cuts and Jobs Act, Conference Report to Accompany H.R. 1, H.R. Rep. No. 115-466, at 478 (December 2017).

11 Tax Reform Act of 1986, Conference Report, H.R. Rep. No. 99-841, at II-361 (September 1986).

12 NAIC Model 820 (2009), section 5a.B. Compare New York requirements at 11 CRR-NY §99.4(e).

13 TAM 9452001 (Aug. 26, 1994).

14 2018-20 I.R.B. 576.

15 For example, the NAIC has indicated that VM-20 is the CRVM for contracts to which it applies (VM-20 section 1.A.), and VM-20 section 3.C.2. defines the interest rates that "shall" be used in determining the net premium reserve.

16 As discussed at page 26 of this issue of *Taxing Times* ("Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One"), proration of the dividends received deduction has been greatly simplified under the Act and the calculation of required interest is no longer necessary.

17 Treasury had exercised this authority under prior law by issuing Treas. Reg. §1.817A-1 in May 2003.

18 2010-1 C.B. 547 (April 12, 2010).

19 *See* Notice 2008-18, 2008-1 C.B. 363 (Feb. 4, 2008).

20 *See* NAIC Statement of Statutory Accounting Principles No. 56, *Separate Accounts* (as of March 2018), paragraph 7. *See also* the last sentence of I.R.C. §817(d), which requires this same approach for tax purposes: "obligations under [a guarantee on a variable contract] which exceed obligations under the contract without regard to such guarantee shall be accounted for as part of the company's general account."

21 For example, some companies may hold as a separate account reserve only the portion of the net surrender value attributable to the separate account fund options, allocating the rest of the reserve to the general account. Other companies may apply the approach mentioned in the answer to Question 3.9.a. of the AG 43/C-3 Phase II Practice Note:

> One simplification for determining the portion of the Basic Reserve attributable to the variable portion of the contracts might be to split the Basic Reserve for each contract between General Account and Separate Account based on the ratio of the total fund value of the contract in each fund type (General Account or Separate Account).

See American Academy of Actuaries Variable Annuity Practice Note Work Group, *A Public Policy Practice Note: The Application of C-3 Phase II and Actuarial Guideline XLIII* (March 2011), Q3.9.a.

22 Under the general accounting method rules, there is a different adjustment period depending on whether the change generates additional income or deductions. A positive §481(a) adjustment (*i.e.*, income) is generally spread over four taxable years, while a negative §481(a) adjustment (*i.e.*, deduction) is generally made in full in the year of change. *See, e.g.*, Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (Jan. 16, 2015), §7.03(1).

23 H.R. 1 as introduced Nov. 2, 2017, §3703(a).

24 NAIC Statement of Statutory Accounting Principles No. 50, *Classifications of Insurance or Managed Care Contracts* (as of March 2018), paragraph 43.

25 Hence the oddly specific factor of 92.81 percent, determined by the staff of the Joint Committee on Taxation in order to meet the identified revenue target.

SOCIETY OF ACTUARIES®

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Case Study—Impact of Tax Cuts and Jobs Act

By Dylan Strother and Chris Zuiker

The Tax Cuts and Jobs Act of 2017 (TCJA) slashed the corporate tax rate by 40 percent, from 35 percent to 21 percent. If you follow the news through social media (or other outlets, but particularly Twitter), you may have heard that many corporations, including some insurance companies, used the reduction to the tax rate to pay bonuses to their employees. Entities paying less taxes to the Internal Revenue Service (IRS) obviously retain more income, and for many companies, including some insurance companies, this can result in more take-home pay for employees. But are the implications of the new tax law all positive? Is this an act of generosity by the federal government to corporations, including insurance companies?

Not exactly. While TCJA contains certain provisions beneficial for corporate entities as well as individual tax payers, Part IV of the law is titled "Provisions Related to Specific Entities and Industries," and Subpart B of Part IV is labeled "Insurance Reforms." This section of the law contains adjustments to insurance regulation that offset much of the increase to profitability realized from the decrease in the corporate tax rate. The offsets come in the form of changes to the methodology used to calculate tax reserves and changes to components of Tax DAC. In addition, while not part of TCJA nor revenue to the IRS, changing the corporate tax rate generally increases target capital, due to how the corporate tax rate is incorporated to risk-based capital (RBC) calculations, and is another opposing force to gains in profitability.[1]

We examined the impact of the major changes to insurance tax law within TCJA for two types of recently issued contracts, a term life insurance policy and a whole life insurance policy. For these product types, we started with a baseline model and profitability results consistent with pre-TCJA tax law. We then stepped through each implication of TCJA and attributed a change in profitability to each component. Table 1 lists the steps of our attribution, each of which are described in detail within the article. Results included are displayed after each incremental step and compared to the prior step.

We examined two types of policies—a 20-year level term policy and a whole life policy. Both policies were issued to a 40-year-old male preferred non-smoker with a face amount of $250,000. We assumed that these contracts were issued after TCJA was effective. The primary metrics used to measure profitability were profit margin, defined as the present value of distributable earnings divided by present value of premium, and the internal rate of return (IRR). Throughout the analysis, we note that differences to profitability between the two types of products are primarily due to the duration of the products as well as product features. Whole life has a much longer duration as compared to term, as well as a cash value feature.

Table 1
TCJA Profitability Attribution Summary

Baseline—**Pre-TCJA**	Profitability calculated based on Pre-TCJA basis
Corporate Tax Rate	Reduced corporate tax rate to 21 percent
Tax Reserve Method	Implemented TCJA tax reserve methodology
Tax DAC	Increase Tax DAC capitalization rates and amortization length
RBC Factors—**Post-TCJA**	Updated corporate tax rate to 21 percent in capital calculations

Table 2 Reduced Corporate Tax Rate								
	FIT Corporate Rate	Tax to Stat Reserve Ratio	DAC Tax	RBC	20-Year Level Term		Whole Life	
					Profit Margin	*IRR*	*Profit Margin*	*IRR*
Before	35%	100%	Pre-TCJA	Pre-TCJA	5.7%	14.7%	5.2%	15.0%
After	21%	100%	Pre-TCJA	Pre-TCJA	9.1%	17.2%	7.5%	16.6%
Impact	**14%**	-	-	-	**3.4%**	**2.5%**	**2.3%**	**1.6%**

CORPORATE TAX RATE

As noted, TCJA reduced the corporate tax rate from 35 percent to 21 percent. Generally, for an entity making a profit, a lower corporate tax rate will decrease the amount of taxes owed and paid. From the base case, the change in corporate tax is as advertised, an increase to both profit margin and IRR for both contract types, as shown in Table 2.

INSURANCE REFORM

We next analyzed the update to the tax reserves calculation. TCJA revises the methodology used to calculate tax reserves to be the maximum of 92.81 percent of the NAIC prescribed reserve method[2] (CRVM for life insurance contracts) and the net surrender value. Some call this the "haircut methodology" and it is a change to the previous federally prescribed tax reserve methodology, which was similar to the current statutory basis, but substituted federally prescribed assumptions, generally resulting in tax reserves being lower than statutory reserves.

Tax reserves were, and still are, capped at the statutory reserves. It is beneficial for insurance companies to minimize the difference between statutory and tax reserves, thereby maximizing the tax reserve. You can think about tax reserves as a tax deduction, which reduces taxable income.

Therefore, setting tax reserves as a percentage of statutory reserves (92.81 percent to be exact) results in decreased profitability for most life insurance contracts issued since 2009. This is because during that time many of the methodologies and assumptions (mortality and discount rate) used to calculate tax reserves have been the same as statutory, meaning the tax and statutory reserves have been equal.

Explicitly, before TCJA, for many life insurance contracts, a company could account for 100 percent of the change in statutory reserves when calculating taxable income, whereas now only 92.81 percent can be accounted for. For our analysis, since we were looking at recently issued products, we realized a decrease to profitability, both for the IRR and the Profit Margin, as shown in Table 3.

Table 3 Update Tax Reserve Methodology								
	FIT Corporate Rate	Tax to Stat Reserve Ratio	DAC Tax	RBC	20-Year Level Term		Whole Life	
					Profit Margin	*IRR*	*Profit Margin*	*IRR*
Before	21%	100.00%	Pre-TCJA	Pre-TCJA	9.1%	17.2%	7.5%	16.6%
After	21%	92.81%	Pre-TCJA	Pre-TCJA	8.9%	16.9%	6.4%	15.4%
Impact	✓	**7.19%**	-	-	**-0.3%**	**-0.3%**	**-1.2%**	**-1.2%**

Table 4
Increase Tax DAC Capitalization & Amortization Length

	FIT Corporate Rate	Tax to Stat Reserve Ratio	DAC Tax	RBC	20-Year Level Term		Whole Life	
					Profit Margin	*IRR*	*Profit Margin*	*IRR*
Before	21%	93%	Pre-TCJA	Pre-TCJA	8.9%	16.9%	6.4%	15.4%
After	21%	93%	Post-TCJA	Pre-TCJA	8.5%	16.6%	6.0%	15.0%
Impact	✓	✓	✓	-	-0.3%	-0.3%	-0.3%	-0.4%

Table 5
Increase RBC Components

	FIT Corporate Rate	Tax to Stat Reserve Ratio	DAC Tax	RBC	20-Year Level Term		Whole Life	
					Profit Margin	*IRR*	*Profit Margin*	*IRR*
Before	21%	93%	Post-TCJA	Pre-TCJA	8.5%	16.6%	6.0%	15.0%
After	21%	93%	Post-TCJA	Post-TCJA	7.6%	15.2%	5.7%	14.5%
Impact	✓	✓	✓	✓	-1.0%	-1.4%	-0.3%	-0.5%

Another significant update is the change to Tax DAC. For those unfamiliar with this concept, let's start with some basics. Tax DAC is the tax accounting treatment of deferred acquisition costs, similar in concept to the treatment of GAAP DAC but simplified. The IRS prescribes a level percentage of capitalization, based on product type, which is intended to be a proxy estimate of first year commissions. Like GAAP DAC, the capitalized amount is then amortized and expensed over time, but unlike GAAP DAC, the amortization is in a straight-line manner over a defined period. The result is that a company generally pays more tax to the IRS upfront (due to costs being capitalized) but pays less tax in future periods due to amortization of the acquisition costs. This mechanism may be thought of as an interest-free loan to the IRS.

TCJA increases the capitalization percentage for each of our products from 7.7 percent to 9.2 percent and increases the amortization period from 10 years to 15 years. Both items result in a decrease to profitability, as the higher capitalization percentage results in more capitalization (or in terms of a loan, a larger loan) and the amortization is extended five years, which increases the time period for capitalized costs to be expensed (or in terms of a loan, extends the time to repayment). The profitability results are displayed in Table 4.

MORE BAD NEWS … CAPITAL

The corporate tax rate reduction has tangential impacts and reduces profitability through decreased tax effects on required capital. Required capital is a key consideration of product profitability. In the United States, required capital is often referred to as risk-based capital and it is the minimum amount of capital required by the company. To obtain and maintain a high financial strength rating, companies generally need to hold more capital than the minimum, and this target capital is often a multiple of RBC. The RBC calculation is mostly formulaic and the components of the calculation, sometimes referred to as risk factors C0 through C4, are reduced for taxes. Depending on which part of RBC is being calculated, the post-tax C-values are roughly equal to pre-tax C-values multiplied by (1-Tax Rate Percentage). So, if the tax rates decrease from 35 percent to 21 percent and all else is equal, a smaller tax effect is applied to risk-based capital and the formula indicates that more capital is needed, which hurts profitability. Table 5 contains the results on profitability, which show this change has a higher impact on the 20-year level term contract compared to whole life.

TAX RESERVE EFFICIENCY

As noted, maximizing tax reserves is beneficial for insurance companies and that generally means having tax reserves as close as possible to statutory reserves. We were curious if there were certain contracts where the new tax reserve methodology might shrink a gap between tax and statutory reserves. The question we wanted to answer ended up being simple: Are there situations where the tax reserves are currently less than 92.81 percent of the statutory reserve? In these situations, we would expect the new tax reserve methodology to increase efficiency and profitability. One of the main drivers of differences in statutory and tax reserves under the old tax law is where the applicable federal interest rate (AFIR)—which is the discount rate used to compute tax reserves—is greater than the prescribed statutory discount rate. This is the situation that we examined to answer our question (however, we think there are other situations, so email us your examples to play along).

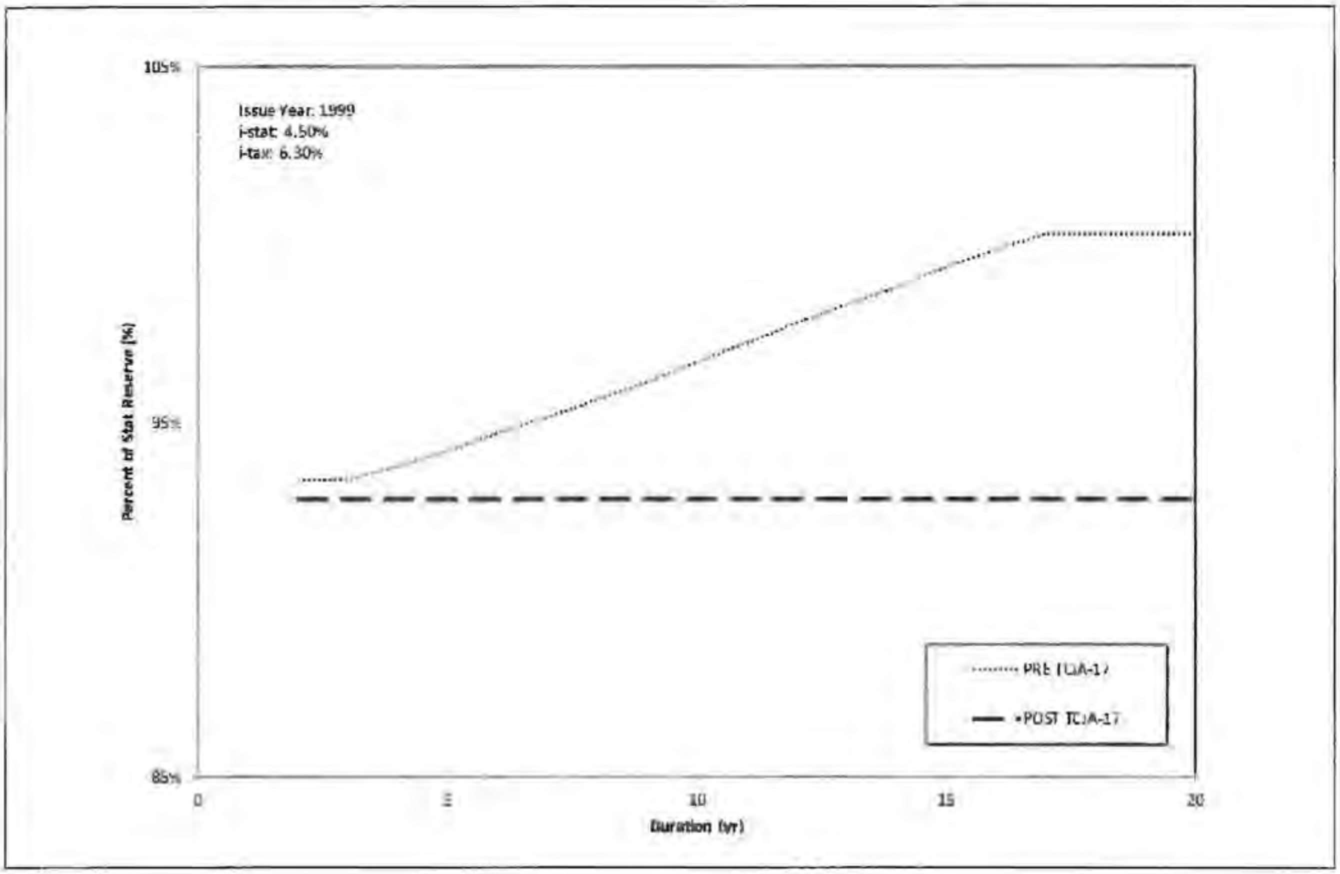
Table 6 contains the AFIR, the prescribed statutory discount rate from years 1992–2004. There are large differences between the appropriate discount rates across accounting bases, and tax discount rates are higher, leading to lower reserves on a tax basis, all else being equal.

Table 6
Comparison of Discount Rates

YEAR	AFIR	STAT	AFIR - STAT
1988	7.77%	5.50%	2.27%
1989	8.16%	5.50%	2.66%
1990	8.37%	5.50%	2.87%
1991	8.42%	5.50%	2.92%
1992	8.40%	5.50%	2.90%
1993	8.10%	5.00%	3.10%
1994	7.45%	5.00%	2.45%
1995	6.99%	4.50%	2.49%
1996	6.63%	4.50%	2.13%
1997	6.33%	4.50%	1.83%
1998	6.31%	4.50%	1.81%
1999	6.30%	4.50%	1.80%
2000	6.09%	4.50%	1.59%
2001	6.00%	4.50%	1.50%
2002	5.71%	4.50%	1.21%
2003	5.27%	4.50%	0.77%
2004	4.82%	4.50%	0.32%

We first tested our question for the same 20-year level term plan from our profitability analysis but assuming an issue date of 1999. In 1999, the difference in the discount rate between the two reserve methodologies was 1.80 percent. In Figure 1, we examined the ratio of the pre-TCJA tax reserves to statutory reserves and the ratio of post-TCJA tax reserves to statutory reserves.[3] The pre-TCJA tax to statutory ratio is always higher, with the ratio grading to 100 percent near the end of the term, while the TCJA-2017 to statutory reserves is a level percentage (92.81 percent) of statutory reserves. So even if we hopped in our DeLorean and turned back time to 1999, the pre-TCJA method was still more tax efficient from the insurance company's perspective. This contract would be in the 18th duration when TCJA became effective, so we did not find our post-TCJA winner in this term contract. In general, it appears that there might be some opportunity for increased efficiency in years preceding 1999; however, that would also likely imply a level term period of longer than 20 years. Even if a 30-year level term product was issued in the early 90s, where the difference between tax and statutory discount rates are largest, the contract would be near the end of its level term period, and we can see from Figure 1 that the tax to statutory ratio is increasing to 100 percent in later durations of the contract.

Figure 1
Tax to Statutory Ratio (20yr Term)



We then examined a whole life plan with an issue date of 1993. The contract was issued to a 40-year old, making them 65 in 2018, with the contract being in the 25th duration. In Figure 2, we display the ratio of both pre- and post-TCJA tax reserves, as well as the ratio of net surrender value to statutory reserves. Under both pre- and post-TCJA, the floor to the reserve is the net surrender value, and under post-TCJA, the comparison to the net surrender value is done after the haircut percentage is applied. We can see that the tax to statutory ratio of pre-TCJA and the net surrender value is lower than the post-TCJA until about the 35th duration. At the 35th duration, under both methodologies, the tax reserve is floored at the net surrender value.

So, we found an answer to our question, at least for an individual product type. The cash value ratio is less than the post-TCJA ratio at the current duration and for the next 10 durations, and in this case the new tax reserve methodology increases tax reserve efficiency and profitability compared to the old methodology. One caveat is that part of TCJA instructs companies that differences in tax reserves between the old and new methods are to be recognized evenly over eight years. So, while this situation increases profitability overall, the increased profit is spread over time.

Figure 2
Tax to Stat Ratio (Whole Life)

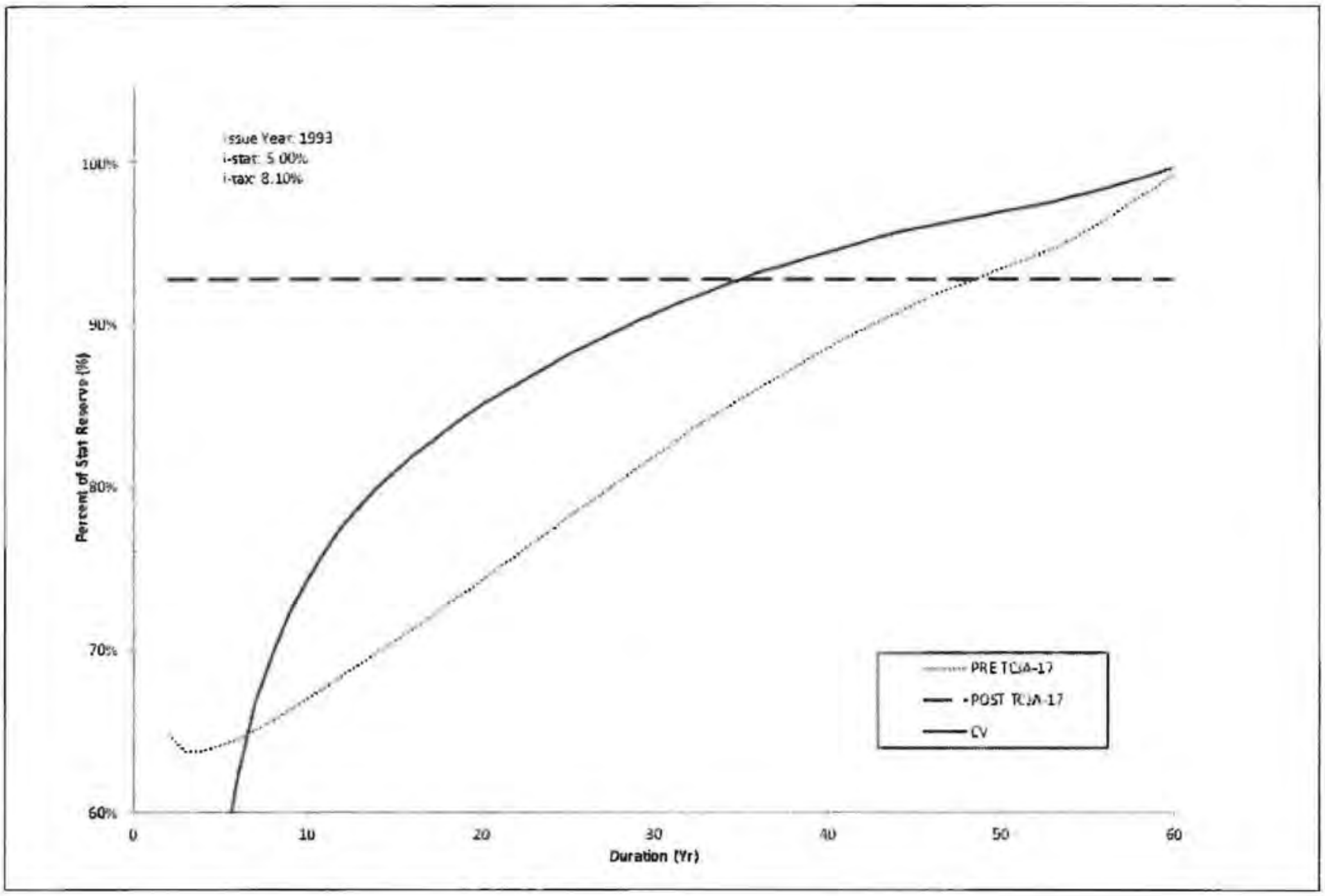


Table 7
Attribution of TCJA Net Impact

	20-Year Level Term		**Whole Life**	
	Profit Margin	*IRR*	*Profit Margin*	*IRR*
Baseline—**Pre-TCJA**	**5.7%**	**14.7%**	**5.2%**	**15.0%**
Corporate Tax Rate	9.1%	17.2%	7.5%	16.6%
Tax Reserve Method	8.9%	16.9%	6.4%	15.4%
Tax DAC	8.5%	16.6%	6.0%	15.0%
RBC Factors—**Post-TCJA**	**7.6%**	**15.2%**	**5.7%**	**14.5%**
Net Impact	1.9%	0.5%	0.5%	-0.5%

CONCLUSION

The various directional impacts of the components of TCJA to profitability are mostly intuitive and offset. While there appear to be situations where the impact of the tax reserve haircut methodology may not be directionally clear, the provisions contained in the insurance reform section and the resulting increase to capital amounts offset much of the increase to profitability realized by decreasing the corporate tax rate.

As can be seen by the attribution analysis shown in Table 7, the largest offset for the term plan was due to the impact on risk-based capital, while the largest offset for whole life was due to the haircut reserve methodology. The net impact of TCJA was close to neutral for both product types. The magnitude of the impact of TCJA on profitability may vary depending on the product design, reserve methodology and cash flow model assumptions, among many other things. ■

ENDNOTES

1 Our analysis is based on calculating capital with current RBC factors and updated tax adjustments using the new corporate tax rate. We note that the Academy of Actuaries and the NAIC Life Risk-Based Capital Working Group are analyzing how RBC factors should be updated due to the change in the corporate tax rate.

2 In this article, we assume the NAIC prescribed reserve method is equal to the statutory reserve, though this may not always be the case.

3 Please note that all graphs in this article reflect terminal reserves.

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Work Group Welcomes Input on PBA Projections for Future Practice Note

The American Academy of Actuaries' PBA Projections Practice Note Work Group is seeking input from practitioners on questions encountered when projecting future VM-20 reserve calculations. Issues may be related to inner/outer loops, simplification techniques, asset assumptions, VM-21/AG 43 and economic capital frameworks.

If you have questions relating to projecting future PBA (principle-based approach) calculations, the work group would like to hear from you. Please contact Academy life policy analyst Ian Trepanier (trepanier@actuary.org) to submit questions and comments, which will help in the development of a future practice note on PBA projections.

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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.

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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.