Back To The Future: The Insurance Industry And Tax Reform

By Kristan Rizzolo and Susan Seabrook (May 16, 2018, 4:35 PM EDT)

Over the years, Congress has repeatedly overhauled the insurance-specific provisions of the Internal Revenue Code, which are found in Subchapter L.[1] For example, under the Revenue Act of 1918, both investment income and underwriting income were included in the taxable income of all insurance companies.[2] By 1921, Congress had been persuaded that this treatment did not accurately reflect the nature of the life insurance enterprise.[3] For the first time, life insurance companies were taxed on investment income only, while all other insurance companies continued to be taxed on both investment and underwriting income.[4] The Life Insurance Company Income Tax Act of 1959 flipped the treatment again, such that life insurance companies were taxed on both their investment income and their underwriting income under a new three-phase system.[5] This three-phase system was then supplanted by the Deficit Reduction Act of 1984.[6]

With the passage of P.L. 115-97,[7] commonly referred to as the Tax Cuts and Jobs Act, Congress made significant changes throughout the code, and Subchapter L did not escape the congressional pen. This article discusses some of the key changes to Subchapter L and how those changes may impact insurance companies. In addition, we identify some areas where further guidance may be necessary to clarify application of the new law.

Reserve Changes

"Wait a minute, Doc. Ah... Are you telling me that you built a time machine... out of a DeLorean?" — Marty McFly*

Both life insurance companies and property casualty insurance, or “P&C,” companies carry reserves to cover future obligations under the insurance policies they issue. The tax rules applicable to insurance companies’ reserve calculations were last overhauled in 1984 by the Deficit Reduction Act — relating to life insurance reserves — and the Tax Reform Act of 1986 — relating to P&C reserves.[8] The Deficit Reduction Act limited the amount of an insurer’s life insurance reserve for tax purposes to the greater of a contract’s net surrender value or an amount determined by applying a complicated formula, capped at the contract reserve reported on the insurer’s regulatory annual statement. In the case of P&C companies, since 1986, the code has required a discount on their annual statement reserves for future loss payments to take into account the time value of money. The TCJA, while not exactly a legislative
DeLorean, does seem to be looking both backward and forward with respect to the significant changes made to the calculation of life insurance reserves and the discounting of P&C company loss reserves.

**Changes to Life Insurance Reserve Rules**

The precise components of the formula used to calculate life insurance reserves under the 1984 Act have generated significant controversy over the years.[9] The TCJA amends section 807(d) of the code by discarding the complicated existing formula and providing that life insurance reserves for a contract are generally equal to the greater of: (1) the net surrender value of the contract; or (2) 92.81 percent of the reserve prescribed by the National Association of Insurance Commissioners with respect to that contract. 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). Life insurance reserves remain subject to the statutory reserve cap that applied before the TCJA.

Under the new 807(d) rules, a life insurance company is no longer required to use the prevailing state interest rate or the prevailing mortality table for purposes of calculating life insurance reserves. In addition, consistent with statutory accounting rules, life insurance reserves under the new rules are determined using methods and assumptions prescribed at the time the reserve is determined, not at the time the contract is issued. These changes appear to incorporate some long-needed flexibility into the calculation of tax-deductible reserves, which is generally necessary in order to accommodate new reserving methodologies. Specifically, the revisions hopefully will reduce administrative complexities associated with insurance companies’ implementation of principles-based reserves.

The TCJA also amends code section 807(f) to repeal the 10-year spread period for taking into account reserve adjustments arising out of changes to a life insurer’s basis for calculating reserves. Instead, the general income adjustment rules applicable to changes in methods of accounting will apply. As a result, a net negative adjustment arising out of a change in the basis for calculating reserves would generally be taken into account in the taxable year of the change, with a net positive adjustment generally taken into account over four taxable years, beginning with the taxable year in which the change occurs.

New section 807(f) treats any adjustment arising out of a change in basis for calculating reserves as an adjustment “attributable to a change in method of accounting initiated by the taxpayer and made with the consent of the Secretary.”[10] This language suggests that such changes in basis may be treated consistently with changes made under the rules for automatic method changes, but as of this writing, the Internal Revenue Service has not confirmed that treatment.[11]

The new reserve rules apply for taxable years beginning after Dec. 31, 2017. Under a transition rule, life insurance companies would take into account ratably over eight taxable years the effect of recalculating reserves for existing contracts under the new reserving rules.

**Changes to Property Casualty Reserve Discounting Rules**

A P&C company’s loss reserves are determined with respect to the line of business and the accident year of the incurred loss. To compute its loss reserves, a P&C company requires two main assumptions: an interest rate and a payout pattern. The TCJA changed both.
With respect to the prescribed interest rate for discounting P&C loss reserves, the TCJA changed the rate from the mid-term applicable federal rate to an annual rate determined by the U.S. Treasury on the basis of the corporate bond yield curve. The corporate bond yield curve is defined as the yield curve reflecting average monthly yields for the preceding 60 month period on investment grade corporate bonds in the top three quality levels available, at varying maturities. The IRS has not yet announced the length of the bond maturities that will be used to determine the applicable interest rate for loss reserve discounting.

With respect to payout patterns, the TCJA extended the computational rules for long-tail business up to the 24th year after the accident year. For the 10th year after the accident year and each subsequent year, the amount of losses treated as paid is equal to the amount of the average of losses treated as paid in the seventh, eighth and ninth years after the accident year — or, if lesser, the portion of the unpaid losses not theretofore taken into account. Any losses not treated as paid before the 24th year after the accident year are treated as paid in the 24th year. Because the TCJA repealed section 846(e), which permitted a taxpayer to elect to use its own loss payment pattern, all P&C companies must now use the payment patterns prescribed by the IRS to compute their loss reserve discounts.

The new discounting rules are effective for taxable years beginning after 2017, with a transition rule under which the impact of applying the new rules relating to pre-effective date losses and expenses is taken into account over an eight-year period.

Changes to Amortization of Policy Acquisition Expenses and to Proration Rules

"Please excuse the crudity of this model. I didn’t have time to build it to scale or paint it." — Dr. Emmett Brown

Section 848 of the code provides rules for insurance companies to capitalize and amortize a portion of policy acquisition expenses on “specified insurance contracts.” The capitalized amount is referred to as DAC. Subject to certain exceptions, “the term ‘specified insurance contract’ means any life insurance, annuity, or non-cancelable accident and health insurance contract (or any combination thereof).”[12] Specified insurance contracts are divided into three categories — annuity contracts, group life insurance and all other specified insurance contracts — for purposes of setting the DAC percentage.

The TCJA increased the DAC rates for all three categories of specified insurance contracts. The rate for annuity contracts increased from 1.75 percent to 2.1 percent, the rate for group life insurance contracts increased from 2.05 percent to 2.46 percent, and for all other specified insurance contracts the rate increased from 7.7 percent to 9.24 percent. The TCJA also extended the amortization period for DAC from 10 years to 15 years. As a result, the DAC amortization period now matches the amortization period for IRC section 197 assets.


Changes to Life Insurance Proration Rules

In the case of a life insurance company, the dividends-received deduction is permitted only with respect to the “company’s share” of certain dividends received,[13] reflecting the fact that some portion of the company’s dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the
reserve items by the “policyholder’s share” of tax-exempt interest. The regime for computing the company’s share and the policyholder’s share of net investment income generally is referred to as “proration.”

Before the TCJA, section 812(a) of the code defined “company’s share” and “policyholder’s share” for purposes of proration through complicated formulas roughly designed to identify the portion of a life insurance company’s net investment income attributable to assets backing policyholder obligations. The TCJA amended section 812(a) to define the company’s share as 70 percent and the policyholder’s share as 30 percent. Given the complexity of prior law, the change to a flat company and policyholder share would seem a welcome simplification; however, the application of the new formula may disadvantage some insurance companies based on their mix of business and investment approach.

The new proration rule for life insurance companies is effective for taxable years beginning after Dec. 31, 2017.

Changes to P&C Insurance Proration Rules

Before the TCJA, section 832(b)(5)(B) of the code required a P&C company to reduce its losses incurred by 15 percent of certain income items that are not subject to tax, including tax-exempt interest and deductible dividends received. This proration rule was enacted to eliminate the double deduction that P&C companies could arguably otherwise obtain by funding deductible reserves with untaxed amounts.

The TCJA replaces the 15 percent proration percentage with a formula, i.e., 5.25 percent divided by the current maximum corporate tax rate. The current 21 percent corporate rate results in a 25 percent proration percentage. The conference committee report explains that the proposal keeps the reduction in the reserve deduction consistent with prior law by adjusting the rate proportionately to the decrease in the corporate tax rate. However, it appears that the changes to loss reserve discounting were not taken into account. Thus, it is possible that some P&C companies may experience a substantial decrease in their loss reserve deduction as a result of holding significant tax-exempt bond portfolios.

Like the change to the life insurance company proration rules, the new proration percentage for P&C companies is effective for taxable years beginning after Dec. 31, 2017.

Changes to Net Operating Loss Rule

"Since when can weathermen predict the weather, let alone the future?" — Marty McFly

Before the enactment of the TCJA, net operating losses, or NOLs, could generally be used to offset 100 percent of taxable income. Any unused NOLs could be carried back for two years and carried forward for 20 years. P&C companies were subject to these rules. However, life insurance companies were not. Under pre-TCJA law, life insurance companies were allowed a deduction for operations loss carryovers and carrybacks in lieu of the NOL deduction. The operations loss could be carried back for three years and carried forward for 15 years. The differing loss rules as between life and nonlife insurance companies created complexity within the already complex tax rules applicable to life-nonlife consolidated returns. While the new rules eliminate the roots of the former complexity, they also introduce new complexity, which in turn generates new challenges.
Life Insurance Company NOL Rules

The TCJA repealed the special carryback (three years) and carryforward (15 years plus an additional three years for a new company) provisions applicable to life insurance company NOLs and conformed the treatment of life insurance companies’ NOLs to the general treatment of NOLs applicable to other companies. Thus, under the new NOL rules enacted in the TCJA, a life insurance company’s NOLs are limited to 80 percent of taxable income computed without regard to the NOL deduction. In addition, NOLs no longer can be carried back but they can be carried forward indefinitely.

While the changes are consistent with the overall changes to NOL rules (with the exception of the new rules applicable to P&C companies), existing life insurance company products were priced taking into account the ability to carry back NOLs. Companies will need to assess how to price contracts going forward and include any appropriate assumptions in pricing. In addition, this change may create statutory accounting issues that would need to be addressed.

The changes to the NOL rules for life insurance companies applies to losses arising in taxable years beginning after Dec. 31, 2017.

Property Casualty Insurance Company NOL Rules

Under the TCJA, the pre-2018 NOL rules continue to apply to P&C companies. As a result, NOLs still can be carried back two years and carried forward for 20 years. Moreover, the 80 percent of taxable income limitation does not apply to a P&C company’s NOLs. With the repeal of the alternative minimum tax — which limited NOLs to 80 percent — P&C companies will have 100 percent of their NOLs available to carry back or to carry forward.

The retention of existing NOL rules for P&C companies may create additional complexities for P&C companies that are in consolidated groups with non-insurance companies. Such groups need to address carrybacks of P&C losses to non-insurance company income, to determine the percentage of P&C NOLs that can be used against non-insurance company income and to establish how NOLs will be ordered. The existing consolidated return rules may be sufficient to address such issues but additional guidance may be needed to address specific aspects of the new NOL reality.

Conclusion

"See you in about 30 years." — Dr. Emmett Brown

Given Congress’ history of overhauling Subchapter L on a somewhat regular basis, we might expect that the TCJA’s Subchapter L provisions will themselves one day be dramatically revised. In the meantime, the technical — as well as practical — implications of implementing the provisions of the TCJA will continue to emerge. Given that guidance may be necessary to clarify certain provisions, continued dialogue between the industry and the government will be critical to ensure that issues are identified accurately and prioritized appropriately.

M. Kristan Rizzolo and Susan E. Seabrook are partners at Eversheds Sutherland LLP.

*All italicized quotes are attributable to the motion picture “Back to the Future” (1985); Universal Pictures (A Robert Zemeckis Film).
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[1] All references to the code herein are to the Internal Revenue Code of 1986, as amended.


[9] “While there are many who complain that the Internal Revenue Code is incomprehensible, there are some few who revel in the intricacies of its labyrinthine composition. But those who take delight in such pursuits and who also understand the mystic processes of establishing reserves in the life insurance industry are an even rarer specie of the ornithological world.” Mutual Benefit Life Insurance Company v. Commissioner, 488 F.2d 1101 (3rd Cir. 1973). See also, e.g., Rev. Rul. 94-74, Notice 2008-18, Notice 2010-29, TAM 200328006 (March 20, 2003), TAM 200448046 (Aug. 30, 2004), American Financial Group v. United States, 678 F.3d 422 (6th Cir. 2012), Cigna Corp v. Commissioner, T.C. Memo. 2012-266.


[11] In that connection, it is not clear whether the deemed consent language of the statute is intended to incorporate the audit protection that generally accompanies such consent.

