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Final Regulations Clarify State of Play for Life Insurance Tax Reserve Deductions

September 23, 2020

Treasury and the IRS have issued Final Regulations on the rules for computing the tax deduction for life insurance reserves and a Revenue Ruling governing changes in the basis of determining a life insurance company's reserves. The guidance brings helpful clarifications to the Proposed Regulations issued in April 2020 and continues to harmonize the tax rules with modern reserving developments such as the adoption of principle-based reserves. Our summary below highlights important aspects of the Final Regulations and the Revenue Ruling.

FINAL REGULATIONS

Asset Adequacy Reserves

- The Tax Cuts and Jobs Act of 2017 (the "TCJA") introduced new rules for measuring the deduction for life insurance reserves. Under these rules, the tax reserve for a contract generally equals the greater of (i) the surrender value of the contract and (ii) 92.81% of the reserve determined under the methodology prescribed by the National Association of Insurance Commissioners ("NAIC"). These rules apply to life insurance companies and for purposes of the deduction for unearned premiums of nonlife insurance companies.

- The Proposed Regulations formalized legislative history providing that, as under prior law, asset adequacy reserves are not deductible. The Proposed Regulations described asset adequacy reserves as including any reserve that is established as an additional reserve based upon an analysis of the adequacy of reserves that would otherwise be established or any reserve that is not held with respect to a particular contract. This definition could be read broadly to encompass items beyond the traditional understanding of asset adequacy reserves.

- The Final Regulations provide helpful clarification by providing a more precise definition of asset adequacy reserves. Under the Final Regulations, asset adequacy reserves are additional reserves based upon an analysis of the adequacy of reserves otherwise established in accordance with the NAIC Valuation Manual, or any similar reserve.

- The preamble to the Final Regulations also reconfirms that, consistent with the legislative history to the TCJA, principle-based reserving ("PBR") methods for life contracts do not contain any asset adequacy reserve component.

Comment: While the inclusion of "any similar reserve" in the Final Regulations provides the IRS with some flexibility, the removal of the reference to reserves not held with respect to a particular contract and the PBR discussion clarify that the Final Regulations are not seeking to expand the concept of asset adequacy reserves.

Future Guidance

- The IRS declined to provide guidance on whether insurance contracts issued by a non-U.S. insurance company and reinsured by a U.S. insurance company should be treated as life insurance or annuity contracts for purposes of the insurance company tax rules even if they do not meet all of the technical U.S. tax qualification requirements for insurance contracts. The treatment of these contracts is relevant to the U.S. reinsurer's own tax position even if the policyholders are not U.S. taxpayers. The IRS indicated that it is continuing to study this area.

REVENUE RULING 2020-19

- The TJCA modified the Internal Revenue Code to provide that any change in the basis for determining reserves is treated as a change of accounting method. As a result of this change, income and deduction from a change in basis is no longer spread over 10 years, but rather the shorter periods applicable to accounting method changes (presently, deductions from a change in basis are taken into account immediately, but income is taken into account over four years). Moreover, changes in accounting methods require the government's consent.

- To provide guidance on the new rules, the IRS issued Revenue Ruling 2020-19, which includes 10 examples to determine whether the fact patterns constitute a change in basis requiring government approval under the new rules.

- Under the Revenue Ruling, a change in the NAIC methodology for determining a reserve (or erroneous application of reserving methodology) that affects the current and prior years and thus alters the reserve deduction is treated as a change of accounting method that requires consent. Unlike the prior rules, the taxpayer can only change its method of calculating reserves on a going-forward basis and may not amend past open-year tax returns.

- However, if a change in the reserve calculation is driven by terms of the NAIC reserving method or tax reserve formula, there is no change of accounting method, and therefore consent is not required. For example, if the reserve is calculated as the greater of two items, a shift in which item is larger is not a method change, nor is an update to experience data used in the reserve formula, if the reserving method contemplates ongoing updates.

- Purely computational errors (e.g., a computer programming error) also are not a change of accounting method. However, the Revenue Ruling's example on this point is drafted narrowly, as the computational error described is limited to a single tax year, and the case of a formula error that is not spotted in the following year is unaddressed.

Comment: While the approach to computational errors in the Revenue Ruling seems unduly narrow, the ability to follow built-in changes to a reserving methodology continues the trend toward updating traditional tax rules to synchronize with modern statutory reserving developments favoring dynamic calculations.

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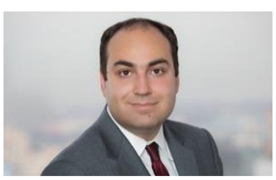

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