# Proposed Regulations Update Landscape for Life Insurance Tax Reserve Deductions

**April 8, 2020**

Treasury and the IRS have issued Proposed Regulations on the calculation of tax deductions for life insurance reserves and the timing for taking into account income and deductions from changes in the basis of determining life insurance reserves. The Proposed Regulations provide guidance on changes introduced by the Tax Cuts and Jobs Act of 2017 (the "TCJA"). The Proposed Regulations include some helpful clarifications but will not resolve all ambiguities taxpayers face in calculating their reserve deductions.

Our summary below highlights important aspects of the Proposed Regulations. The regulations will not be effective until issued in final form, although taxpayers may elect to rely on certain changes for taxable years beginning after December 31, 2017.

## Proposed Regulations

### Rules for Tax Reserve Deductions

- 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 (the "NAIC"). These rules apply to life insurance companies and for purposes of computing premiums earned by nonlife insurance companies.

- The Proposed Regulations follow the TCJA formula for tax reserve deductions, but also formalize legislative history that, as under prior law, asset adequacy reserves are not deductible.

- The Proposed Regulations say that asset adequacy reserves include 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. The regulations call out reserves that would have been established pursuant to an asset adequacy analysis under the NAIC's Valuation Manual as of the date of enactment of the TCJA.

**Comment**: The NAIC's asset adequacy analysis generally looks at the ability of a block of assets of an insurance company to support a corresponding block of liabilities, taking into account general business risks such as changes in interest rates. Asset adequacy reserves may be based on gross premium testing, cash flow testing or similar methods.

While the nondeductibility of asset adequacy reserves was expected, the catch-all exclusion of reserves not held with respect to a particular contract may create uncertainty as to whether a reserve includes a nondeductible component.

### Principle-Based Reserves

- Traditional life insurance reserve calculations used prescribed formulas to determine a single expected value for the cost of future benefits of a particular insurance contract. However, the NAIC has adopted principle-based reserving ("PBR") methods for life insurance, which use modeling to compute a reserve based on a range of potential future outcomes and may take into account the specific experience of the insurer in setting assumptions.

- The legislative history to the TCJA indicates that the revised tax reserve deduction was intended to accommodate PBR methods.

- The Proposed Regulations confirm that the TCJA changes resolved prior law uncertainty regarding the use of PBR methods and make technical changes to the definition of "life insurance reserves" to clarify that insurance companies may take into account PBR methods prescribed by the NAIC. As discussed above, asset adequacy reserves may not be taken into account.

**Comment**: The broadening of the life insurance reserve definition to permit use of PBR methods is a welcome clarification.

Although determining a PBR reserve requires running multiple scenarios of aggregate insurance contract performance, it ultimately yields a reserve that is allocated to a specific contract, unlike an asset adequacy reserve. According to the NAIC, PBR should take into account risks associated with the policies or contracts being valued, or their supporting assets, and not general risks of a business nature or of the insurance company.

### Timing of Deduction for Reserve Strengthening

- The TCJA made significant changes to the timing rules for taking into account income and deductions from changes in the basis of determining life insurance reserves.

- Under prior law, an insurance company would take into account income and deductions from changes in the basis of determining tax reserves over a 10-year period. The TCJA provides that changes in the basis of determining tax reserves are taken into account under the general rules for changes for method of accounting.

**Comment**: This change generally will be helpful, as taxpayers may take into account deductions attributable to changes in the basis of determining tax reserves immediately, rather than over the prior law 10-year period. However, income from a change in basis also is taken into account more rapidly, over a four-year period.

- The Proposed Regulations say that, as a result of the TCJA changes, changes in the basis of determining tax reserves require IRS consent.

**Comment**: The IRS consent requirement is different from prior-law standards applicable to changes in the basis for calculating tax reserves. The IRS has set out conditions under which it will automatically consent to a change in basis in Revenue Procedure 2019-43.

### Section 338 Elections

- The Proposed Regulations make clear that in bargain purchase deals treated as asset acquisitions as a result of a section 338(h)(10) election, subsequent reserve strengthening is treated as additional purchase price to be allocated among the target's investment assets.

**Comment**: Under this rule, post-closing reserve strengthening will not give rise to a current deduction and will instead offset tax only as the investment portfolio turns over, which is in line with the result of a pre-closing strengthening. Sellers and Buyers should therefore not have a tax incentive to postpone a reserve strengthening where a 338 transaction is contemplated.

### Foreign Life Insurance and Annuity Contracts

- The IRS is evaluating whether certain 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 U.S. tax qualification requirements. The proposal, on which the IRS invites comments, is that the contracts would need to be regulated as life insurance or annuity contracts by a foreign regulator and not be for the benefit of any U.S. person.

**Comment**: The IRS's interest in relief is welcome, as some requirements of U.S. rules for insurance and annuity contracts are unlikely to be satisfied by policies issued by foreign issuers unless a product has been designed to qualify for them, with potentially harsh results for U.S. reinsurers.

### Tax Reporting for Reserves

- As contemplated by the TCJA, the Proposed Regulations give the IRS discretion to require insurance companies to report opening and closing balances of life insurance reserves and other items that are taken into account in determining income or deductions. The reporting may include special rules regarding separate accounts.

**Comment**: Depending on their scope, the expanded reporting rules could increase the level of detail that insurance companies must report. The IRS has requested comments as to whether collecting this additional information is necessary and estimates of compliance costs.

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Please do not hesitate to contact us with any questions.

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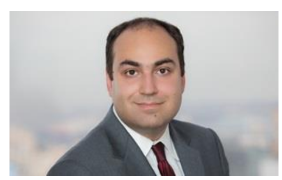

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