TaxNewsFlash

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Proposed regulations: Modification of discounting rules for insurance companies

The U.S. Treasury Department and IRS on November 5, 2018, released to the Federal Register proposed regulations (REG-103163-18) to provide guidance on new rules, as enacted by section 13523 of the new U.S. tax law (Pub. L. No. 115-97 enacted December 22, 2017) for discounting insurance companies' unpaid losses and estimated salvage recoverable for federal income tax purposes.

Read the **proposed regulations** (PDF 211 KB)

Modification of discounting rules for insurance companies

Background

Section 846 of the Code requires property and casualty (P&C) insurance companies to discount their unpaid losses and estimated salvage recoverable. This section also provides rules for discounting the unearned premiums of title insurance companies under section 832 and the unpaid losses of life insurance companies under sections 805(a)(1) and 807(c)(2).

[The following discussion refers to the unpaid losses of P&C insurance companies for the sake of brevity.]

The new U.S. tax law (Pub. L. No. 115-97, also referred to at times as the "TCJA"):

- Modified section 846 to change the definition of the applicable interest rate to be used

- Amended the computational rules for determining loss payment patterns under section 846(d)

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- Repealed the election under former section 846(e) to use the taxpayer's own historical loss payment pattern rather than the pattern published by the IRS for purposes of discounting its reserves

These changes are effective for tax years beginning after December 31, 2017.

Proposed regulations

The proposed regulations released on November 5, 2018, implement the recent legislative changes to the Code and make other technical improvements to the derivation and use of discount factors.

Modification of applicable rate of interest used to discount unpaid losses

Prior to the TCJA's enactment, section 846 required taxpayers to use an "annual rate" based on the applicable mid-term federal rate, as defined in section 1274(d). For years beginning after 2017, the annual rate for any calendar year will be determined by the IRS based on the corporate bond yield curve, as defined by section 430(h)(2)(D)(i) but by substituting "60-month period" for "24-month period" therein. The corporate bond yield curve is published on a monthly basis by the Treasury Department and consists of spot interest rates for each stated time to maturity.

The preamble to the proposed regulations notes that the revised section 846(c)(2) does not specify how the Treasury Secretary is to determine the annual rate for any calendar year based on the corporate bond yield curve. Consequently, to implement the changes imposed by the TCJA, the proposed regulations adopt an annual discount rate equal to the average of the corporate bond yield curve's monthly spot rates with times to maturity of not more than 17.5 years, computed using the most recent 60-month period ending before the beginning of the calendar year for which the determination is made. The preamble notes that the 17.5-year maturity range was selected to compute the annual rate in order to minimize the differences in aggregate taxable income that inherently result from applying a single discount rate for a given accident year versus the direct application of the corporate bond yield curve separately to each accident year.

This maturity range determination was made after an analysis of aggregate data reported on annual statements filed for 2015—the most recent year for which published aggregate data was available. Since section 846(c)(2) does not specify how the annual rate for a given calendar year is to be determined based on the corporate bond yield curve, the Treasury Department and the IRS considered multiple alternatives in an effort to match as closely as possible the yield curve from insurance companies' investments in bonds used to fund the undiscounted losses to be incurred in the future. As part of this process, the Treasury Department and the IRS also considered other methods, including using a variable maturity range, applying two rates (one for short-tail lines, and one for long-tail), applying a different annual rate for each line of business, or directly applying the corporate bond yield curve.

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Given the variety of options, the Treasury Department and IRS have invited commentators to suggest alternative methods, along with the legal basis for the suggested methods and explanations of how the suggested methods more clearly reflect income.

Modification of computational rules for loss payment patterns

Under section 846(d)(1), the Treasury Secretary determines a loss payment pattern for each line of business by reference to the historical aggregate loss payment data applicable to that line of business for each determination year (i.e., the calendar year 1987 and each fifth calendar year thereafter). These loss payment patterns are determined using the most recently published aggregate data reported on insurance companies' annual statements, as filed with the National Association of Insurance Commissioners (NAIC).

Prior to the TCJA's enactment, for short-tail lines of business, losses unpaid at the end of the first year following the accident year were treated as paid equally in the second and third years following the accident year. For long-tail lines of business, unpaid losses remaining after 10 years were treated as paid in the 10th year following the accident year, with an available extension provided certain conditions were met.

The TCJA did not modify the loss payment pattern for short-tail lines of business, but it provided for an extension of the 10-year long-tail payment period for a maximum of 14 additional years if the amount of losses that would have been treated as paid in the 10th year after the accident year exceeds the average of the loss payments treated as paid in the seventh, eighth, and ninth years after the accident year.

The TCJA also repealed sections 846(d)(3)(E) through (G) of the Code, which provided rules for situations in which annual statement data was available for longer periods after the accident year than the periods otherwise assumed under section 846; special rules for determining payment patterns for the international and reinsurance lines of business; and guidance for addressing negative loss payment patterns.

The preamble to the proposed regulations attempts to fill the void left by the repeal of the rules designed to address negative loss payment patterns by proposing a "smoothing" mechanism, and the proposed regulations themselves grant the Treasury Department and IRS the authority to adopt such an approach. The preamble details this proposed approach, which provides steps to include payment amounts from adjacent years and calculate an average if the payment amount for a given year is negative, and compares the proposed mechanisms to other approaches suggested by previous commenters.

The preamble also recognizes that the TCJA's repeal of section 846(d)(3)(E) leaves no specific rules for determining the loss payment patterns for non-proportional reinsurance and international lines of business extending beyond three calendar years

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beyond the accident year, since these lines are not included in the list of long-tail lines set forth in section 846(d)(3)(A)(ii). The Treasury Department and IRS have requested comments regarding the length of the loss payment patterns for these lines, and the legal basis for limiting the payment patterns for these lines to three calendar years following the accident year versus extending the payment patterns beyond those years.

Repeal of historical loss payment pattern election

Prior to the TCJA's enactment, taxpayers were permitted to elect under section 846(e) to use their own historical loss payment patterns with respect to all lines of business rather than the industry-wide pattern determined by the IRS, providing certain requirements were met. The TCJA repealed this election, and the proposed regulations do not provide any mechanism to replace it. The final tax year available for companies to elect to use their own historical company payment pattern was 2017.

Transition rule

The transition rule set forth in TCJA section 13523(e) provides that, for the first tax year beginning after December 31, 2017, the unpaid losses and expenses unpaid (as defined in section 832(b)(5) and (6)) at the end of the preceding tax year, and the unpaid losses (as defined in sections 805(a)(1) and 807(c)(2)) at the end of the preceding tax year, are determined as if the amendments made by section 13523 of the TCJA had applied to such unpaid losses and expenses unpaid in the preceding tax year and by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018. Any adjustment resulting from this transition rule is taken into account ratably in such first tax year and the seven succeeding tax years.

For subsequent tax years, such amendments are applied with respect to unpaid losses and expenses unpaid for accident years ending with or before calendar year 2018 by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018. The preamble describes this transition rule, but neither the preamble nor the proposed regulations modify or provide new information regarding the transition rule.

Other considerations

Below is a summary of other notable items within the preamble and the proposed regulations:

- The preamble explains the proposal to discontinue the "composite method" for discounting unpaid losses relating to accident years not separately reported on the NAIC annual statement by requiring taxpayers to compute discounted unpaid losses with respect to that year using the discount factor published by the IRS for that year for the appropriate line of business.

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- The preamble notes that the Treasury Department and IRS anticipate providing in future guidance that estimated salvage recoverable is to be discounted using the published discount factors applicable to unpaid losses. This would eliminate the need to publish separate discount factors for estimated salvage and subrogation. The Treasury Department and IRS also request comments regarding whether net payment data and net losses incurred data should be used to compute loss discount factors.

- These proposed regulations were not subject to review by the Office of Management and Budget (pursuant to Executive Order 12866). However, the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

KPMG observation

The public hearing for these proposed regulations has been scheduled for December 20, 2018. The regulations will not be finalized until after that date, and the IRS is unlikely to issue 2018 discount factors until final regulations are issued. As such, it is expected that 2018 discount factors will not be published until 2019. As a result, companies need to consider how to approach their year-end processes absent specific guidance.

The preamble's extended discussion on the appropriate discount rate and the requests for comments on alternative discount rates and the application of section 846 to reinsurance and international lines of business appear to support the view that Treasury and the IRS are open to alternative approaches and mechanism to address the TCJA changes to section 846.

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