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# TaxNewsFlash

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# KPMG report: Modification of discounting rules for insurance companies (initial impressions about final regulations)

Final regulations from the U.S. Treasury Department and IRS provide guidance with regard to discounting insurance companies' unpaid losses and estimated salvage recoverable for federal income tax purposes.

The final regulations (T.D. 9863) reflect measures that were enacted by the 2017 U.S. tax law (Pub. L. No. 115-97 that is often referred to as the "Tax Cuts and Jobs Act" (TCJA)). The **final regulations** [PDF 211 KB] were published in the Federal Register on June 17, 2019.

The following discussion provides initial impressions and observations about the final regulations.

## Modification of discounting rules for insurance companies

### Background and proposed regulations

Treasury and the IRS in November 2018 released proposed regulations (REG-103163-18) to address the TCJA's modifications to section 846. Read ***TaxNewsFlash***

The IRS subsequently issued Rev. Proc. 2019-06 to provide the unpaid loss discount factors and salvage discount factors for the 2018 accident year and the transitional amount required under the TCJA. Read ***TaxNewsFlash***

The discount factors presented in Rev. Proc. 2019-06 were calculated based on the 2018 proposed regulations.

### Final regulations

The final regulations generally adopt the proposed regulations with one notable change to the determination of the applicable interest rate, discussed below.

In general, the final regulations retain the effective date included in the proposed regulations (i.e., for tax years beginning after December 31, 2017).

**Determination of applicable interest rate**

Section 846(c)(2) provides that the annual rate for any calendar year will be determined by the Treasury Secretary based on the corporate bond yield curve (as defined in section 430(h)(2)(D)(i), determined by substituting "60-month period" for "24-month period" therein).

The corporate bond yield curve—commonly referred to as the high quality market (HQM) corporate bond yield curve—is published on a monthly basis by the Treasury Department and IRS. It reflects the average of monthly yields on investment grade corporate bonds with varying maturities that are in the top three quality levels available, and it consists of spot interest rates for each stated time to maturity. The spot rate for a given time to maturity represents the yield on a bond that gives a single payment at that maturity. For the stated yield curve, times to maturity are specified at half-year intervals from one-half year through 100 years. Section 846(c)(2) does not specify how the Secretary is to determine the annual rate for any calendar year based on the corporate bond yield curve.

The proposed regulations provided for the use of a single annual rate applicable to all lines of business. The maturity range in the proposed regulations (that is, times to maturity from 0.5 to 17.5 years) was selected to produce a single discount rate that would provide approximately the same present value of taxable income, in the aggregate, as would be obtained by applying the 60-month average corporate bond yield curve (forecast through 2028) directly to the future loss payments expected for each line of business (determined using the loss payment patterns applicable to the 2018 accident year).

Several commenters expressed concern with the selection of the maturity range used to determine the singe rate applicable to all unpaid losses for all lines of business under the proposed regulations. The final regulations reflect a change from the proposed regulations, and determine a single annual rate based on a narrower range of maturities—that is the average of the corporate bond yield curve's monthly spot rates with times to maturity from 4.5 to 10 years, computed using the most recent 60-month period ending before the beginning of the calendar year for which the determination is made. The selected maturity range has an average maturity of 7.5 years, which is closer to the average maturity of the industry's bond investments than the 9-year average maturity of the maturity range in the proposed regulations.

The Treasury Department and IRS intend to publish guidance that will provide revised unpaid loss discount factors based on the final regulations for each property and casualty line of business for all accident years ending with or before calendar year 2018, which were previously published in Rev. Proc. 2019-06. The future guidance will also provide that taxpayers may use either the revised discount factors or the discount factors published in Rev. Proc. 2019-06 for tax years beginning after December 31, 2017, and ending before June 17, 2019. The guidance will describe the adjustment to be taken into account by any taxpayer that uses the discount factors prescribed in Rev. Proc. 2019-06 in a tax year. Taxpayers must use the revised discount factors in tax years ending on or after June 17, 2019.

**Continuance of composite method**

The Treasury Department and IRS proposed, as noted in the preamble to the proposed regulations, to discontinue the use of the "composite method" described in section 3.01 of Rev. Proc. 2002-74, 2002–2 C.B. 980, and section V of Notice 88-100, 1988-2 C.B. 439.

In response to comments, however, the Treasury Department and IRS will continue to permit the use of the composite method and to continue to publish composite discount factors annually.

**Smoothing adjustments**

Section 1.846-1(d)(1) of the proposed regulations provided that the loss payment pattern determined by the Secretary for each line of business generally is determined by reference to the historical loss payment pattern applicable to such line of business. However, under section 1.846-1(d)(1) and (2) of the proposed regulations, the Secretary may adjust the loss payment pattern for any line of business using a methodology described by the Secretary in other published guidance if necessary to avoid negative payment amounts and otherwise produce a stable pattern of positive discount factors less than one.

The final regulations adopt Reg. section 1.846-1(d) as proposed.

**Determination of estimated discounted salvage recoverable**

Reg. section 1.832-4(c) provides that (except as otherwise provided in guidance published by the Commissioner of Internal Revenue in the Internal Revenue Bulletin) estimated salvage recoverable must be discounted either: (1) by using the applicable discount factors published by the Commissioner for estimated salvage recoverable; or (2) by using the loss payment pattern for a line of business as the salvage recovery pattern for that line of business and by using the applicable interest rate for calculating unpaid losses under section 846(c).

The Treasury Department and IRS proposed, again as noted in the preamble to the proposed regulations, that estimated salvage recoverable be discounted by using the published discount factors applicable to unpaid losses. Section 4.02 of Rev. Proc. 2019-06 provides that the unpaid loss discount factors set forth therein also serve as salvage discount factors for the 2018 accident year and all prior accident years for use in computing discounted estimated salvage recoverable under section 832.

Commenters expressed support for the proposed use of discount factors applicable to unpaid losses as the discount factors for salvage. Consequently, future guidance published in the Internal Revenue Bulletin will continue to provide that estimated salvage recoverable is to be discounted using the published discount factors applicable to unpaid losses. Additionally, the Treasury Department and IRS will continue to use payment data unreduced by salvage recovered and losses incurred data unreduced by salvage recoverable to compute loss discount factors.

**Reinsurance and international lines of business**

As described in the preamble to the proposed regulations, because of the repeal of former section 846(d)(3)(E) and (F) by section 13523 of the TCJA, section 846 no longer explicitly provides for the determination of loss payment patterns for nonproportional reinsurance and international lines of business extending beyond three calendar years following the accident year. Consistent with the proposed regulations, Reg. section 1.846-1(b)(3)(iv) and (b)(4) are removed in the final regulations.

**Other changes**

In addition, the final regulations adopt several other conforming changes to the regulations as proposed.

**Change in method of accounting**

The Treasury Department and IRS plan to publish guidance in the Internal Revenue Bulletin that provides simplified procedures under section 446 and Reg. section 1.446-1(e) for an insurance company to obtain automatic consent of the Commissioner to change its method of accounting to comply with section 846, as amended by the TCJA, for the first tax year beginning after December 31, 2017.

**KPMG observation**

The final regulations largely adopt the regulations as proposed in 2018. Tax professionals have observed that the biggest difference is the change to the determination of the applicable annual rate based average of the corporate bond yield curve's monthly spot rates with times to maturity from 4.5 to 10 years. This change will likely affect the transitional amount and the year-end 2018 reserves. However, the preamble to the final regulations provides that taxpayer may use either the revised discount factors or the discount factors published in Rev. Proc. 2019-06 for tax years beginning after December 31, 2017, and ending before June 17, 2019.

Additionally, the IRS's intent to issue accounting method guidance with respect to section 846 suggests that Form 3115 may be required as part of the 2018 tax return.

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