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KPMG report: Section 846 and revised discount factors and guidance on accounting method change

The IRS yesterday released two revenue procedures to implement various changes required under section 846 (as amended by the 2017 U.S. tax law (Pub. L. No. 115-97)—the legislation that is commonly referred to as the "Tax Cuts and Jobs Act" (TCJA)) and pursuant to final regulations released in June 2019.

- **Rev. Proc. 2019-30** [PDF 103 KB] provides simplified procedures for an insurance company to obtain automatic consent of the Commissioner of Internal Revenue to change its methods of accounting to comply with section 846.

- **Rev. Proc. 2019-31** [PDF 368 KB] contains revised unpaid loss discount factors for the 2018 accident year and earlier accident years for use by insurance companies in computing discounted unpaid losses under section 846. In addition, Rev. Proc. 2019-31 prescribes the discount factors under section 846 for the 2019 accident year.

This report provides initial impressions about these revenue procedures.

Background

Insurance companies are required to account for certain unpaid losses when calculating taxable income. For non-life insurance companies, section 832 reduces underwriting income by the amount of discounted unpaid losses (as defined in section 846) and increases underwriting income by the amount of estimated salvage recoverable for the tax year. Under section 832(b)(6), unpaid loss adjustment expenses shown on the annual statement are included in unpaid losses and are discounted under section 846. Under section 832(b)(5), estimated salvage recoverable is determined on a discounted basis in accordance with procedures established by the U.S. Treasury Secretary and are generally discounted by using discount factors published by the IRS Commissioner. Additionally, underwriting income is reduced by discounted unearned premiums attributable to title insurance, which are also determined under section 846. Additionally, life insurance companies must also consider unpaid losses (as defined by section 846) when calculating income.

Section 846 provides that discounted unpaid losses must be separately determined for each accident year of each line of business by applying the annual rate determined under section 846(c) and the appropriate loss payment pattern to the amount of unpaid losses as measured at the end of the tax year. Section 846(d) directs the Treasury Secretary to use the most recent aggregate loss payment data of property and casualty insurance companies to determine and publish a loss payment pattern for each line of business every five years. This loss payment pattern is used to discount unpaid losses for the accident year ending with a determination year and for each of the four succeeding accident years. Discount factors are determined for each line of business for each accident year using the applicable loss payment pattern and annual rate.

The TCJA amended section 846 for tax years beginning after December 31, 2017. In particular, the TCJA modified the definition of annual rate under section 846(c) and the computational rules for loss payment patterns under 846(d). Additionally, the TCJA repealed the election that was previously set forth in section 846(e) to use the insurance company's own historical loss payment pattern instead of the pattern published by the Treasury Secretary.

In light of these changes, the TCJA provides for a transition rule with respect to unpaid losses and expenses unpaid (as defined in section 832(b)(5) and (6)) or unpaid losses (as defined in section 805(a)(1) and 807(c)(2)). Specifically, for the first tax year beginning after December 31, 2017 (First TCJA Year), the discounted unpaid losses at the end of the preceding tax year are determined as if the amendments made by the TCJA had applied to such unpaid losses in the preceding tax year and by using the annual rate and loss payment patterns applicable to accident years ending with calendar year 2018. The resulting adjustment, if any, is included in the insurance company's gross income ratably over an eight-year period, beginning with the First TCJA Year and continuing through the seven succeeding tax years. The TCJA also provides that, for subsequent tax years, the amendments made by the TCJA are applied with respect to such unpaid losses by using the annual rate and loss payment patterns applicable to accident years ending with calendar year 2018.

The Treasury and IRS in November 2018 issued proposed regulations under section 846. Under these proposed regulations, the annual rate determined under section 846 was based on a specific range of maturities (from one-half year to seventeen and one-half (17½ years)) from the corporate bond yield curve. The IRS in January 2019 released Rev. Proc. 2019-06 that prescribed unpaid loss discount factors for the 2018 accident year and earlier accident years consistent with the proposed regulations.
The Treasury and IRS in June 2019 issued final regulations under section 846, which apply to tax years beginning after December 31, 2017. Under the final regulations, the annual rate determined under section 846(c) is based on a specific range of maturities (from four and one-half years to 10 years) from the corporate bond yield curve. This is a modification from the proposed regulations, which calculated the annual rate using a range of maturities from one-half year to seventeen and one-half years from the corporate bond yield curve. Read ***TaxNewsFlash***

Rev. Proc. 2019-30

In general, taxpayers generally must secure the consent of the IRS Commissioner before changing a method of accounting pursuant to section 446(e) and Reg. section 1.446-1. Because section 846 (as amended by the TCJA) changes the proper time for the inclusion of the item in income or the taking of the item as a deduction, the IRS concludes that the TCJA resulted in a change in method of accounting.

When a taxpayer changes a method of accounting, an adjustment may be required under section 481(a). The section 481(a) adjustment is computed as of the beginning of the year of change and taken into account over the section 481(a) adjustment period provided in the applicable administrative guidance (generally one tax year for a negative section 481(a) adjustment or four years for a positive section 481(a) adjustment.

Given the timing of the proposed and final regulations, the IRS acknowledged that taxpayers face unique challenges to makes changes of methods of accounting to comply with section 846. The IRS, therefore, issued Rev. Proc. 2019-30 to provide simplified procedures for an insurance company that is a calendar year taxpayer to obtain consent of the Commissioner to change its methods of accounting consistent with section 846. **Specifically, a taxpayer making a change under this revenue procedure is not required to file a Form 3115 to obtain consent for the change**.

In general, taxpayers qualify under Rev. Proc. 2019-30 when they either: (1) use the revised discount factors in the first TCJA year; or (2) use the proposed discount factors in the First TCJA Year and the revised discount factors in the Section TCJA Year.

Section 481 adjustments related to discounted unpaid losses must be spread ratably over eight years, consistent with the transition rule of the TCJA.

- For taxpayers that use revised discount factors for the First TCJA Year, the total amount of the change under the transition rule represents the section 481 adjustment.

- For taxpayers that use proposed annual rates and discount factors in the First TCJA Year and revised numbers for the Second TCJA Year, the initial adjustment (i.e., from the previous method to the proposed numbers) is to be spread over eight years starting with the First TCJA Year and the remaining adjustment (i.e., from the proposed numbers to the final numbers) is to be spread over seven years starting with the Second TCJA Year. To the extent that any additional adjustment (Supplement Adjustment) is required to prevent the duplication or omission of income as a result of changing from the proposed to the final numbers, taxpayers may choose to make such adjustment in the Second TCJA Year or spread over seven years starting with the Second TCJA Year.

For section 481 adjustments related to estimated salvage recoverable, the standard 481(a) adjustment periods generally apply to the principles outlined above. That is, negative adjustments must be accounted for in one year and positive adjustments may be spread over four years. In other words, the eight year spread provided by the transitional rule does not apply to estimated salvage recoverable.

For changes related to title insurance, the change of method of accounting is made using a cutoff method in the First TCJA Year. Therefore, no adjustment is required or permitted under section 481. To the extent that proposed numbers were used in the First TCJA Year, changing to the revised numbers in the Second TCJA Year will require a section 481(a) adjustment using the standard section 481(a) adjustment periods.

The provisions of Rev. Proc. 2015-13 generally apply to taxpayers qualifying under Rev. Proc. 2019-30. However, the limitation under Rev. Proc. 2015-13 that prevents taxpayers from making a change in method of accounting when the requested year of change is the final year of the taxpayer's trade or business does not apply.

In general, the IRS will not require a taxpayer that makes a change in method of accounting for amounts covered by Rev. Proc. 2019-30 to make adjustments prior to the year of change provided the taxpayer complies with the provisions of the revenue procedure. The IRS may change a taxpayer's method of accounting for the same item that is the subject of a change in method of accounting made under this revenue procedure if the taxpayer's method of accounting for the same item is an issue under consideration on July 22, 2019.

Rev. Proc. 2019-30 is effective for tax years beginning after December 31, 2017, and ending on or before December 31, 2019.

Rev. Proc. 2019-31

As discussed above, the IRS previously released discount factors in Rev. Proc. 2019-06 consistent with the annual rate and loss payment patterns of the proposed regulations. Read ***TaxNewsFlash***

Rev. Proc. 2019-31 provides for updated discount factors to account for the change in annual rate set forth in the final regulations (i.e., determined using the range of maturities from four and one-half years to 10 years from the corporate bond yield curve).

Companies must use the annual rate and associated discount factors consistent with the final regulations for tax years ending on or after June 17, 2019. For companies with tax years ending after December 31, 2017, and before June 17, 2019, companies generally may choose to use either the proposed annual rate and discount factors or the final annual rate and discount factors.

KPMG observation

These revenue procedures provide necessary information that taxpayers will need to prepare their 2018 tax returns and to assist with the 2019 tax provision process. Additionally, Rev. Proc. 2019-30 provides helpful guidance regarding method changes required by the TCJA. Most taxpayers that used or will use revised discount factors in the First TCJA Year or used proposed discount factors in the First TCJA Year and intend to use revised discount factors in the Second TCJA Year may make the required adjustments to their returns without the need to formally request a method change. Further, clarification that salvage and subrogation adjustments are not subject to the 8-year transition was helpful.

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