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KPMG report: Proposed regulations on computing and reporting life insurance reserves for insurance companies

Proposed regulations from the U.S. Treasury Department and IRS, published in today's Federal Register, provide guidance for the computation and reporting of life insurance reserves to account for the changes to section 807, as amended by Pub. L. No. 115-97 (enacted on December 22, 2017, and referred to as the "Tax Cuts and Jobs Act" (TCJA)).

Read the [proposed regulations](#) [PDF 330 KB] as published in the Federal Register on April 2, 2020.

Background

Section 801(a) imposes a tax on the life insurance company taxable income of every life insurance company.

Section 801(b) defines life insurance company taxable income to mean life insurance gross income, reduced by life insurance deductions.

Under section 803(a)(2), life insurance gross income includes a net decrease in items described in section 807(c) as required by section 807(a). Under sections 804 and 805(a)(2), life insurance deductions include a deduction for a net increase in items as required by section 807(b).

The items described in section 807(c) are: (1) life insurance reserves (as defined in section 816(b)); (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at the appropriate rate of interest to satisfy obligations under insurance and annuity contracts that do not involve life, accident or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both.

Additionally, section 831(a) generally imposes a tax on the taxable income of every insurance company other than a life insurance company (a nonlife insurance company). Section 832 defines taxable income for this purpose to be gross income (as defined in section 832(b)(1)) less allowed deductions. Section 832(b)(1) provides that gross income includes underwriting income, and section 832(b)(3) provides that underwriting income means premiums earned on insurance contracts during the tax year less losses incurred and expenses incurred.

Under sections 832(b)(4) and 832(b)(7)(A), premiums earned on insurance contracts during the tax year are reduced by life insurance reserves at the end of the tax year and increased by life insurance reserves at the end of the preceding tax year. For this purpose, life insurance reserves are defined in section 816(b) but determined under section 807(d).

Method of computing life insurance reserves for purposes of determining income

Historically, section 807(d)(1) provided that the amount of the life insurance reserves for any contract was the greater of the net surrender value of the contract (determined under section 807(e)(1)) or the federally prescribed reserve determined under section 807(d)(2). This amount, however, could not exceed the amount that would have been taken into account with respect to the contract in determining statutory reserves (as defined in prior section 807(d)(6)).

Prior section 807(d)(2) provided that the federally prescribed reserve for a contract was computed using the following method (generally based on the date the contract was issued):

- The tax reserve method applicable to the contract, for example the Commissioners' Reserve Valuation Method (generally for life insurance contracts) or the Commissioners' Annuity Reserve Valuation Method (generally for annuity contracts) prescribed by the National Association of Insurance Commissioners (NAIC);
- The greater of the applicable federal interest rate or the prevailing state assumed interest rate; and
- The prevailing Commissioners' standard tables for mortality and morbidity, adjusted as appropriate to reflect the risks (such as substandard risks) incurred under the contract that were not otherwise taken into account.

In recent years, principle-based reserving methods have been adopted to better reflect the economics of more complex life insurance and annuity products. These principle-based reserves (PBRs) were intended to replace a more formulaic approach to determining policy reserves with an approach that takes into account a range of future economic conditions and more closely reflects the risks of complex insurance products. However, federal income tax issues arose when applying prior section 807(d) to PBR methods. For example, a PBR method may require reserves to be computed based on many different scenarios in which many different interest rate assumptions are made, but prior section 807(d) required the use of a single interest rate when computing the reserve for a contract.

In 2010, the IRS issued Notice 2010-29, 2010-15 I.R.B. 547, to provide interim guidance to issuers of variable annuity contracts as a result of the adoption by the NAIC of Actuarial Guideline 43 (AG 43), which describes a PBR method, with respect to the appropriate treatment under section 807.

Enacted in 2017, the TCJA made several amendments to section 807 to update the calculation of life insurance reserves.

- First, section 807(d)(1) was amended to provide generally that the amount of the life insurance reserves for any contract (other than variable contracts) is the greater of the net surrender value of such contract or 92.81% of the reserve determined under section 807(d)(2). The amount of the life insurance reserve for a variable contract is the sum of (1) the greater of the net surrender value of

such contract or the portion of the reserve that is separately accounted for under section 817 and (2) 92.81% of the excess (if any) of the reserve determined under section 807(d)(2) over the amount in clause (1).

- Second, section 807(d)(2) was amended to provide that the amount of the reserve under section 807(d)(2) is determined using the tax reserve method applicable to such contract.
- Third, section 807(d)(3) was amended to provide generally that the tax reserve method applicable to a contract is the method prescribed by the NAIC that applies to the contract as of the date the reserve is determined, not the date the contract was issued, as was required prior to the TCJA.

Asset adequacy reserves and similar reserves that address solvency concerns of state regulators but do not meet technical actuarial requirements continue to be excluded from life insurance reserves for federal income tax purposes, as was the case before the TCJA.

Proposed regulations

Section 1.807-1(a) of the proposed regulations provides that no asset adequacy reserve may be included in the determination of the amount of life insurance reserves under section 807(d). This proposed regulation is consistent with the law both before and after the TCJA.

The substantive rules in current Reg. section 1.807-1 have no application for tax years beginning after December 31, 2017, and therefore, are not included in section 1.807-1 of the proposed regulations.

Change in basis of computing reserves

Prior to amendment by the TCJA, section 807(f)(1) provided that if the basis for determining any item described in section 807(c) (for example, life insurance reserves) as of the close of any tax year differed from the basis for that determination as of the close of the preceding tax year, then so much of the difference between the amount of the items at the close of the tax year computed on the new basis and the amount of the item at the close of the tax year computed on the old basis, as is attributable to contracts issued before the tax year, was taken into account ratably for each of the succeeding ten tax years.

If a company ceases to qualify as a life insurance company, section 807(f)(2) (which was not amended by the TCJA) requires, except as provided in section 381(c)(22), that the balance of any adjustment under section 807(f) be taken into account in the tax year preceding the tax year in which the taxpayer no longer qualifies as a life insurance company.

Section 807(f) was amended by the TCJA to provide that any difference in an amount of an item referred to in section 807(c) at the close of the tax year computed on a new basis versus on the old basis is attributable to a change in a method of accounting. Section 1.807-4 of the proposed regulations provides guidance relating to both the change in basis of computing reserves of a life insurance company and the change in basis of computing life insurance reserves of a nonlife insurance company. Section 1.807-4(a) of the proposed regulations requires an insurance company to follow administrative procedures prescribed by the Commissioner of Internal Revenue to change the basis of computing reserves.

Section 1.807-4(b) of the proposed regulations provides that, to avoid the double counting of income or a deduction, a taxpayer that changes its basis of computing reserves is required to take into account under section 481(a) an adjustment attributable to the change in basis. The proposed regulations provide that if a taxpayer loses its insurance company status, then any remaining balance of a section 481(a) adjustment must be taken into account in the last tax year the taxpayer was an insurance company. This proposed rule, however, would not require an insurance company to accelerate the accounting for such adjustment if it changes from a life insurance company to a nonlife insurance company or vice versa.

Section 1.807-4(c) of the proposed regulations provides that, for purposes of determining any increase or decrease in items described in section 807(c) (for a life insurance company) or the amount of life insurance reserves (for a nonlife insurance company), the determination is to be made for the year of change using the old basis of computing reserves and is to be made in the following tax year using the new basis of computing reserves.

Section 26.04 of Rev. Proc. 2019-43 provides the current procedures for an insurance company to obtain automatic consent of the IRS Commissioner to change its method of accounting to comply with section 807(f). In response to comments, the Treasury Department and IRS intend to revise section 26.04 of Rev. Proc. 2019-43 in the following ways.

- First, section 26.04(2)(b)(ii) of Rev. Proc. 2019-43 provides that multiple changes during the same tax year for the same type of contract are considered a single change in basis and the effects of such changes are netted and treated as a single section 481(a) adjustment. Section 807(f)(1), however, provides that the section 481(a) adjustment is the difference between the amount of any item referred to in section 807(c) computed on the new basis and the amount of such item computed on the old basis. Accordingly, the Treasury Department and IRS intend to revise section 26.04 of Rev. Proc. 2019-43 to require netting of the section 481(a) adjustments at the level of each item referred to in section 807(c) so there is a single section 481(a) adjustment for each of the items referred to in section 807(c).
- Second, section 26.04(1) of Rev. Proc. 2019-43 provides that the automatic change procedures apply to a nonlife insurance company. The Treasury Department and IRS intend to revise section 26.04 of Rev. Proc. 2019-43 to clarify the manner in which nonlife insurance companies implement changes to the basis of computing life insurance reserves (as defined in section 816(b)) during a tax year (year of change). Specifically, the clarification would provide that, if a nonlife insurance company changes the basis of computing its life insurance reserves, then for purposes of applying section 832(b)(4), (1) for the year of change, life insurance reserves at the end of the year of change with respect to contracts issued before the year of change are determined on the old basis, and (2) for the year following the year of change, life insurance reserves at the end of the preceding tax year with respect to contracts issued before the year of change are determined on the new basis. Life insurance reserves attributable to contracts issued during the year of change and thereafter must be computed on the new basis.

Additionally, certain revenue rulings are proposed to be obsoleted for tax years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations to the extent they are inconsistent with section 807(f).

Reporting of reserves

The TCJA added section 807(e)(6) to the Code, which provides that the Secretary shall require reporting (at such time and in such manner as the Secretary shall prescribe) with respect to the opening and closing balance of reserves and with respect to the method of computing reserves for purposes of determining income.

Consistent with section 807(e)(6), section 1.807-3 of the proposed regulations allows the IRS to require information necessary for the proper reporting of items described in section 807(c), including separate account items.

Electronic filing of annual statements

Section 6012(a)(2) generally requires that returns with respect to income taxes must be made by every corporation subject to taxation under subtitle A of the Code. Reg. section 1.6012-2(c)(1) provides that a life insurance company must make a return on Form 1120-L, *U.S. Life Insurance Company Income Tax*

Return, and generally file a copy of its annual statement with the return. Similarly, Reg. section 1.6012-2(c)(2) requires every domestic insurance company other than a life insurance company to make a return on Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*, and generally file a copy of its annual statement with its return. For these purposes, an annual statement means the annual statement, the form of which is approved by the NAIC, that is filed by an insurance company for the year with the applicable state regulators or, if the insurance company is not required to file the NAIC annual statement, a pro forma annual statement. Reg. section 1.6012-2(c)(3) generally provides that the requirements of Reg. section 1.6012-2(c)(1) and (2) concerning returns and annual statements also apply to foreign insurance companies subject to tax under section 801 or section 831.

Reg. section 1.6012-2(c)(4) provides that if an insurance company described in Reg. section 1.6012-2(c)(1), (2), or (3) files its return electronically, it is not to include its annual statement with such return but that such statement (or pro forma annual statement) must be available at all times to the IRS.

The Conference Report to the TCJA contemplates requiring the electronic filing of annual statements to improve reporting of insurance reserves, as necessary to carry out and enforce section 807. Accordingly, Reg. section 1.6012-2(c) is proposed to be amended to remove the rule that prohibits an insurance company that files its Form 1120-L or Form 1120-PC electronically from filing its annual statement (or pro forma annual statement) electronically.

Proposed removal or revision of regulations with no future application.

The notice of proposed rulemaking also proposes to remove several regulations that provide guidance under law that has been repealed or substantially changed and will have no application after the adoption of the proposed regulations as final. Several specific regulations are noted below.

Reg. section 1.381(c)(22)-1

Reg. section 1.381(c)(22)-1(b)(6) is proposed to be removed because its requirement that an acquiring corporation take into account any net increases or net decreases in reserves of the distributor or transferor corporation under section 810(d)(1) is no longer applicable.

The principle in Reg. section 1.381(c)(22)-1(b)(6), however, applies to transactions in which the distributor or transferor corporation has any remaining portion of an adjustment that was required to be taken into account over 10 years under prior section 807(f). See section 2.08 of Rev. Proc. 2019-10.

After the amendment of section 807(f) by the TCJA, an acquiring corporation must take into account any remaining section 481(a) adjustment of the transferor or distributor corporation pursuant to the IRS's administrative procedures. See section 7.03 of Rev. Proc. 2015-13.

Reg. section 1.817A-1

A revision to Reg. section 1.817A-1 is proposed to remove the requirement that the current market rate of interest prescribed in Reg. section 1.817A-1(a)(5) be used to determine both the life insurance reserve and the required interest (as provided in prior section 812(b)(2)(A)) during the temporary guarantee period of a non-equity indexed modified guaranteed contract (MGC). Section 807(d), as amended, does not prescribe a particular interest rate to be used in determining life insurance reserves. Thus, the requirement in Reg. section 1.817A-1(b)(2) that the applicable interest rate to be used under section 807(d)(2)(B) to compute life insurance reserves for an MGC is a prescribed current market interest rate is now inapplicable.

Additionally, the need for Reg. section 1.817A-1(b)(1) to prescribe a current market interest rate to determine life insurance reserves for MGCs (as opposed to an interest rate applicable when the contract was issued) is no longer present because section 807(d), as amended, requires the use of a method in effect as of the date the reserve is determined. Reg. section 1.817A-1 also requires that the current

market rate of interest prescribed in Reg. section 1.817A-1(a)(5) be used to determine reserves under section 807(c)(3) for an MGC during any temporary guarantee period.

Reg. section 1.338-11

The notice of proposed rulemaking proposes to revise Reg. section 1.338-11(d)(2) to reflect the change in section 807(f) made by the TCJA.

Reg. section 1.338-11(d) generally provides that when a section 338 election is made for an insurance company, new target must effectively capitalize its subsequent increase in reserves for any acquired contracts in the deemed asset sale to the extent the fair market value of certain assets acquired by new target in the deemed asset sale exceeds the adjusted grossed-up basis (AGUB) allocated to those assets—that is, to the extent of a “bargain purchase.” In the absence of this rule, a new target could obtain a better tax result if it acquired understated reserves and subsequently increased them rather than acquiring adequately stated reserves.

Reg. section 1.338-11(d) was intended to minimize incentives for sellers to defer increases in reserves. An exception to Reg. section 1.338-11(d), however, is provided if new target is required by section 807(f) to spread the reserve increase over the 10 succeeding tax years. See section 1.338-11(d)(2)(ii). There was limited incentive for sellers to defer increases in reserves when new target was required to spread the deduction resulting from the reserve increase over 10 years, as was the case under section 807(f) prior to its amendment by the TCJA.

The amendment to section 807(f) by the TCJA together with the applicable administrative procedures require a deduction resulting from a reserve increase under section 807(f) to be taken into account in one year. As a result, there is greater incentive for a seller to defer increases in reserves if the new target would be allowed to take the deduction into account in one year, and the reason for providing the exception currently in Reg. section 1.338-11(d)(2)(ii) no longer exists. Accordingly, this exception is proposed to be removed.

A new section 1.338-11(d)(3)(iii) is also proposed to be added to the regulations so the standard used for determining when there is an additional premium under Reg. section 1.338-11(d)(3) for a change in items referenced in section 807(c) is the same as that used under section 807(f). Changes in PBRs that are contemplated by the applicable method, for example, may not constitute changes in the basis of computing reserves under section 807(f) and should not result in an amount of additional premium under Reg. section 1.338-11(d)(3).

Proposed applicability dates

The rules in today’s notice of proposed rulemaking are proposed to apply to tax years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

A taxpayer may choose to apply sections 1.807-4, 1.816-1, and 1.817A-1(b) of the final regulations to tax years beginning after December 31, 2017 (the effective date of the revision of section 807 made by the TCJA), and ending before the first tax year that begins on or after the date of publication of the Treasury decision adopting these rules as final in the Federal Register.

Alternatively, a taxpayer may rely on sections 1.807-4 and 1.816-1 of the proposed regulations for tax years beginning after December 31, 2017, and ending before the first tax year that begins on or after the date of publication of the Treasury decision adopting these rules as final in the Federal Register.

Under proposed section 1.6012-2(l), taxpayers may choose to apply section 1.6012-2(c) of the final regulations to any original federal income tax return (including any amended return filed on or before the

due date (including extensions) of such original return) timely filed on or after the date of publication of the Treasury decision adopting these rules as final in the Federal Register.

KPMG observation

Initial observations with regard to the proposed regulations include the following:

- These proposed regulations were included on the IRS Guidance Priority Plan, and so these changes clarifying the TCJA's amendments to section 807 were expected.
- Confirmation that asset adequacy reserves are not includable for tax purposes is consistent with the TCJA.
- The proposed regulations indicate that the IRS is not going to challenge PBR reserves even if they include some considerations that are not strictly related to mortality or morbidity. There has been a concern that reserves computed using principle-based methods may not meet the definition of life insurance reserves under section 816. The issue focused on various assumptions made in the PBR approach that are not strictly related to mortality or morbidity issues (and were more like asset adequacy issues).
- The IRS makes clear that the government's position on changes to the basis for determining reserves is a change in method of accounting. Tax professionals expect there may be comments to the extent this requirement is in conflict with the requirement that accounting methods used for life insurance companies be consistent with NAIC rules.
- The proposed regulations clarify the method for accounting for a change in the basis for computing reserves and eliminate previous guidance that is no longer applicable after TCJA. Importantly, the IRS proposes to have the section 481(a) adjustment be the net number for all section 807(f) adjustments for a single year. This improves on the position taken in Rev. Proc 2019-43, which required netting adjustments by type of insurance and which caused many questions on how to implement this treatment.
- Companies that switch from life insurance companies to nonlife insurance companies, and vice versa, will not need to accelerate the section 807(f) adjustments. Because the time for recognizing the adjustments is one to four years, there would be a minimal impact on these companies.
- Annual statements must be filed electronically with Forms 1120-L and 1120-PC. It is assumed the IRS will have the systemic ability to accept these files, although tax professionals have noted the IRS has requested comments regarding any potential technical issues with this new requirement.
- Regulations under section 817A are modified to remove the prescribed interest rate. Comments have been requested on whether the current market rate of interest prescribed by these regulations should continue to apply to reserves under section 807(c)(3) for an MGC during any temporary guarantee period.
- The proposed regulations eliminate the safe harbor provision under Reg. section 1.338-11 for post-transaction 807(f) reserve changes. As a result, certain reserve increases are incorporated into the buyer-adjusted grossed up basis calculations.
- The clean-up of the reserve regulations removes provisions that were made irrelevant by the TCJA and renumbers the regulations to correspond to current Code sections.

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