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KPMG report: Final regulations on computing and reporting life insurance reserves (initial impressions)

The IRS on September 9, 2020, posted on its website final regulations (T.D. 9911) concerning the computation of life insurance reserves. The regulations also issued guidance on computing the change in basis of life insurance reserves for life insurance and nonlife insurance companies.

These regulations finalize regulations that were proposed in April 2020 with amendments. Read a KPMG report providing initial impressions about the proposed regulations: [TaxNewsFlash](#)

The version of the [final regulations](#) [PDF 235 KB] released September 9, 2020, includes this statement:

This document is in the process of being submitted to the Office of the Federal Register (OFR) for publication and will be pending placement on public display at the OFR and publication in the Federal Register. The version of the proposed rule [sic] released today may vary slightly from the published document if minor editorial changes are made during the OFR review process. The document published in the Federal Register will be the official document.

The following report of initial impressions about the final regulations is based on the version posted by the IRS on its website on September 9, 2020.

Background

The final regulations follow the April 2020 release of the proposed regulations, which provide guidance for the computation and reporting of life insurance reserves to account for the changes to section 807.

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.

Method of computing life insurance reserves for purposes of determining income

Enacted in 2017, the “Tax Cuts and Jobs Act” (TCJA) (Pub. L. No. 115-97) 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 National Association of Insurance Commissioners (NAIC) that applies to the contract as of the date the reserve is determined. Prior to the TCJA, the tax reserve was determined based on the reserve methodology as of the date the contract was issued.

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.

Final regulations

The preamble to the final regulations responds to several comment letters concerning the proposed regulations.

Deficiency reserves and asset adequacy reserves are not included in deductible tax reserves under sections 807(d) and 816(h). Prop. Reg. section 1.807-1(a) describes an asset adequacy reserve as “includ[ing] 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.” Further Prop. Reg. section 1.807-1(a) provides that an asset adequacy reserve is “any reserve or portion of a reserve that would have been established pursuant to an asset adequacy analysis required by the National Association of Insurance Commissioners (NAIC) Valuation Manual 30 as it existed on December 22, 2017, the date of enactment of Public Law 115-97” [TCJA].

In response to comments, the final regulations provide that an asset adequacy reserve is: (1) any reserve that is established as an additional reserve based upon an analysis of the adequacy of reserve that would otherwise be established in accordance with the requirements set forth in the NAIC Valuation Manual, such as Commissioners' Reserve Valuation Method (CRVM) or Commissioners' Annuity Reserve Valuation Method (CARVM) as applicable; or (2) any similar reserve. In addition, the final regulations provide that in determining whether a reserve is a life insurance reserve, the label placed on such reserve is not determinative, provided, however, any reserve or portion of a reserve that would have been established pursuant to an asset adequacy analysis required by the NAIC's Valuation Manual 30 as it existed on the date of enactment of the TCJA, is an asset adequacy reserve. Treasury rejected the comment requesting that the regulations replace the fixed date of enactment of TCJA with a reference to the date that the reserve is determined.

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.

The TCJA amended section 807(f) 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 taken into account under section 481 as adjustments 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 an insurance company other than a life insurance company (a nonlife insurance company). Under Prop. Reg. section 1.807-4(a), a change in basis of computing an item referred to in section 807(c) is a change in method of accounting for purposes of Reg. section 1.446-1(e), unless Reg. section 1.446-1(e) provides otherwise. Under Prop. Reg. section 1.807-4(a), both a life insurance company changing the basis of computing an item referred to in section 807(c) and a nonlife insurance company changing the basis of computing life insurance reserves must follow the administrative procedures prescribed by the IRS to obtain the IRS's consent to such a change.

Several commentators either disagreed with or asked for clarification of the interaction between section 807(f) and section 446. In response, the IRS detailed why it concluded that: (1) the computation of reserves is a method of accounting; and (2) in light of the amendments to section 807(f) by the TCJA, changes in basis of computing an item referred to in section 807(c) must follow the same administrative procedures as other changes in method of accounting. In addition, the preamble states that:

Except in extraordinary circumstance, section 446(b) does not affect the requirement that a life insurance company compute its reserves for Federal income tax purposes as required by subchapter L. Similarly, subchapter L does not affect the requirement under section 446(e) that an insurance company secure the consent of the Commissioner before changing its basis of computing reserves.

Section 1.807-4 of the final 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 final regulations requires an insurance company to follow administrative procedures prescribed by the Commissioner of Internal Revenue to change the basis of computing reserves. The company must follow the administrative procedures prescribed by the Commissioner of Internal Revenue or the Commissioner's delegate to obtain the consent of the Commissioner to such a change.

Section 1.807-4(b) of the final 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 company must obtain the consent of the Commissioner to such a change.

Section 1.807-4(c) of the final 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.

The IRS and Treasury rejected one commenter's request that accounting method changes to the computation of unearned premiums reserves and unpaid loss reserves also be eligible for automatic consent procedures. The IRS noted that the procedures were extended to life reserves in response to specific changes under the TCJA and declined to extend the automatic change procedures to these items.

The IRS also indicated that it intends to revise Rev. Proc. 2020-19, section 26.04(2)(b) to require netting of the section 481(a) adjustments at the level of each item referred to in section 807(c) so that there is a single section 481(a) adjustment for each of the items referred to in section 807(c).

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 final regulations allows the IRS to require information necessary for the proper reporting of items described in section 807(c), including separate account items.

In response to comments, the IRS indicated that it understands the importance of obtaining the life insurance industry's input before changing the reporting requirements. The IRS stated it expects to consult with the life insurance industry before making any changes to reporting requirements. In addition, any changes would be subject to the burden analysis and public notice and comment under the Paperwork Reduction Act.

Electronic filing of annual statements

Reg. section 1.6012-2(c)(4) provides that electronic filers must file their annual statement or a portion thereof in accordance with the applicable rules in the forms or instructions. The IRS and Treasury Department anticipate that once the IRS has the capacity to accept the electronic filing of annual statements, the tax return forms and instructions will require electronic filing of all or portions of the annual statement.

Removal or revision of regulations with no future application

The final regulations also 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 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.
- **Reg. section 1.817A-1**—The final regulations retain the provision (and related definitions) that waives section 811(d) for non-equity indexed modified guaranteed contracts (MGCs) during the temporary guarantee period, because these rules continue to remain relevant.
- **Reg. section 1.338-11**—The final regulations 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)(2)(ii) no longer exists. Accordingly, this exception is removed from the code.

Proposed applicability dates

The rules apply to tax years beginning after December 31, 2017, or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.

Rev. Rul. 2020-19

The IRS also on September 9, 2020, issued Rev. Rul. 2020-19 to illustrate the application of section 807(f) to 10 common factual situations to determine when the Commissioner's approval is required to change the company's tax reserve methodology. Method changes covered by section 807(f) are treated as automatic method changes (see Rev. Proc. 2019-43). Thus, in order to effectuate a method change, the life insurance company must attach a Form 3115 to the tax return for the year of change.

In some of the examined situations, the IRS ruled that an accounting method change occurs when the NAIC imposes a new computational requirement as a component of CARVM reserves. The IRS's conclusion is the same even if the NAIC change only applies to contracts issued after a prospective effective date. (See Situations 1 through 5 of Rev. Rul. 2020-19.) As a result, the life insurance company must obtain the Commissioner's approval before changing its tax reserve methodology.

In other situations, the IRS concluded that a change in reserve computation due to the operation of an existing requirement of the Valuation Manual or Actuarial Guideline (e.g., VM-20) is not a change in basis which requires the Commissioner's approval. For example, when the life insurer's deterministic reserves exceed both the stochastic reserve and the sum of the policy net premium reserves, the life insurer must use the deterministic reserves for the statutory reserves for that year. If the same life insurer finds in the next year that the net policy reserves were the statutory reserves because they exceeded both the deterministic reserves and the stochastic reserves, this would not be a change in basis that requires the Commissioner's approval. A similar result occurs when a company has a reserve difference when it periodically updates its mortality experience under the deterministic method. Other examples of reserve changes that are not deemed method changes include moving from a contracts net surrender value in one year to CRVM in the next, mathematical and posting errors that occur for a single tax year, and reserve changes due to providing new benefits on existing contracts. (See Situation 6 through 10.)

KPMG observation

- According to tax professionals, the changes to the rules for asset adequacy reserves in the final regulations reflect a substantial improvement from the proposed regulations by tying the definition of asset adequacy reserves more closely to the NAIC Valuation Manual. Although the inclusion of "any similar reserve" creates some ambiguity, the focus of the definition provides consistency with the Valuation Manual as it existed when the TCJA was enacted.
- The clarification in the preamble that, except in extraordinary circumstances, section 446(e) does not affect the requirement that a life insurance company compute its tax reserves under subchapter L indicates that the government's final determination is that the change made to section 807(f) by the TCJA was not limited to the timing of the recognition of the change (i.e., from 10 years to one year or four years). Thus, when a change in the method for determining life insurance reserves occurs, an insurance company must complete a Form 3115 and follow the automatic method change rules pursuant to Rev. Proc. 2019-43.
- The IRS also indicated that it intends to revise Rev. Proc. 2019-43 (the listing of automatic accounting method changes). As revised, section 26.04(2)(b) of Rev. Proc. 2019-43 will require netting of the section 481(a) adjustments at the level of each item referred to in section 807(c) so that there is a single section 481(a) adjustment for each of the items referred to in section 807(c). This is a welcome clarification and simplification of the automatic change procedures.
- At some future date, the IRS may require disclosure on Form 1120-L of the opening and closing balances of the items described in section 807(c) and with respect to the method of computing such items for the purposes of determining income to the extent it is useful to the government. However, the IRS indicated that it plans to consult with the life insurance industry before any such additional reporting requirements are implemented.

- The date when the regulations will be published in the Federal Register is not yet known.

For more information contact a KPMG tax professional:

Sheryl Flum | +1 (202) 533-3394 | sflum@kpmg.com

Fred Campbell-Mohn | +1 (212) 954-8316 | fcampbellmohn@kpmg.com

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