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## THE TAX CUTS AND JOBS ACT OF 2017— EFFECTS ON LIFE INSURERS

American Academy of Actuaries  
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# The Tax Cuts and Jobs Act of 2017— Effects on Life Insurers

## Introduction

The purpose of this paper is to outline the most significant changes in the taxation of life insurance companies that were made by the *Tax Cuts and Jobs Act of 2017* (TCJA). The focus of this paper is on the many changes that directly impact the work of actuaries, and some are related to the financial reporting impact of the TCJA on the life insurance industry. TCJA is effective for tax years beginning in 2018.

TCJA made significant changes to provisions specific to the taxation of life insurance companies. These include:

- A general simplification of the calculation of tax-deductible life and annuity reserves to more closely follow National Association of Insurance Commissioners (NAIC) regulations.
- Changes in the treatment of tax reserve basis changes.
- An increase in the Deferred Acquisition Cost (DAC) tax.
- Elimination of the small life insurance company deduction.
- Changes to the operations loss rules.
- Replacement of the formulas used to calculate the company's share of the Dividends Received Deduction (DRD) and of tax-exempt interest with a set rate of 70%.

TCJA also made major changes to the general corporate taxation rules that will also affect life insurance companies. These include but are not limited to:

- The reduction in the corporate tax rate from 35% to 21%.
- The reduction in the DRD to 50% (for life insurance companies, this is applied to the company's share of 70%, resulting in life insurance companies being able to deduct 35% of dividends received).
- Elimination of the corporate Alternative Minimum Tax (AMT).
- Changes to the taxation of foreign life insurance companies that are affiliates or subsidiaries of U.S life insurance companies, as well as foreign insurance companies that have U.S. shareholders.

TCJA lowered the corporate tax rate for all corporations from 35% to 21%, but for the life insurance industry, this reduction in taxes will be offset, in part, by changes that broadened the life insurance industry tax base such as the tax reserve changes, the increase in the DAC tax, and the reduction in the DRD.

In recognition of the lower corporate tax rate, which reduces the tax offset for losses, the NAIC increased life risk-based capital (RBC) requirements.

The net impact of TCJA, including the increase in RBC, will vary by many factors, including company, market, and product; will affect product profitability; and may lead to changes in product design or pricing or both.

In this paper, the term “noncancellable and guaranteed renewable accident and health insurance” means those products as defined under the Internal Revenue Code (IRC).

## General Reserve Rules

As of 1/1/2018, tax reserves used for the tax return must be calculated based on the same NAIC-prescribed method that is used in calculating the statutory reserves held in the Annual Statement. If the statutory method is not an NAIC-prescribed method, the company must separately compute the tax reserves (as further described in this paper) based on an NAIC-prescribed method.

The NAIC-prescribed method is the method applicable to the contract on the valuation date.

In addition, as under prior law, the same NAIC-prescribed Annual Statement for that calendar year must be used for all of the tax calculations discussed in this paper.

## I. Calculation of Tax Reserves for Non-Variable Products

### a. IRC Section 807(c)(1) Life Insurance Reserves

For non-variable life insurance, non-variable annuities with life contingencies, and noncancellable and guaranteed renewable accident and health insurance, the tax reserve is equal to 92.81% of the reserve computed using the NAIC-prescribed method applicable to the contract on the valuation date, which is then subject to the statutory cap and net surrender value floor as prescribed and required in Section 807. These caps and floors were prescribed and required under the prior law as well. If an assumption is specifically prescribed in the NAIC method, that assumption must be used to calculate the reserve to which the 92.81% factor is applied. Otherwise, the 92.81% factor is applied to the reserve computed using the NAIC method and the same assumptions as those in the statutory reserve. The statutory reserve used excludes deficiency reserves, reserves attributable to deferred and uncollected premiums and unpaid premiums, and reserves attributable to excess interest. Additional asset adequacy reserves and voluntary reserves remain nondeductible for tax purposes. An example of this calculation is provided in Appendix 1.

See Section V for a further discussion of what constitutes an NAIC-prescribed method, including discussion of what to use if the annual statement method is not an NAIC-prescribed method or where there is more than one NAIC-prescribed method.

### b. IRC Section 807(c)(2) Unearned Premiums and Unpaid Losses

There are no changes to the rules for

- unearned premiums and unpaid losses on life insurance and noncancellable and guaranteed renewable A&H, which are not required to be discounted; or
- unearned premiums on cancellable A&H insurance, which continue to be reduced by 20% (these contracts are not subject to DAC tax).

Tax reserves for cancellable disability income unpaid losses, both accrued and unaccrued, are equal to 92.81% of the statutory reserve computed using the NAIC-prescribed reserve method as of the date of valuation. The prior law provision that this reserve must be based on the company's actual experience for mortality and morbidity was not revised. The statutory cap remains based on the year of incurral in aggregate for the line of business (rather than determined on a seriatim basis).

Tax reserves for credit disability unpaid losses continue to be determined using property and casualty reserve methods. There were changes to the property and casualty tax reserving rules that may affect tax reserves for credit disability. In addition, the calculation of the discount rate has been revised. Under TCJA, the mid-year discount rate was changed from the Applicable Federal Interest Rate (AFIR) to a rate determined and published by the Treasury Department on the basis of a corporate bond yield curve.

Tax reserves for cancellable health insurance claims (whether identified or incurred but not reported [IBNR]) on other than cancellable disability income and credit disability coverage continue to be based on the assumption that unpaid losses are paid in the middle of the year following the accident year. The only change made by TCJA is that the mid-year discount rate was changed from the AFIR to a rate determined and published by the Treasury Department on the basis of a corporate bond yield curve.

**c. IRC Section 807(c)(3) Amounts Discounted at Interest Only**

The only changes to the calculation of these reserves for the tax return are that 1) the discount rate is determined as of the valuation date and 2) the discount rate must be the highest rate or rates permitted by the NAIC to discount the obligation. Under prior law, the tax rate to discount the obligation was determined as of the issue date and was the greatest of the AFIR, the prevailing state assumed rate (PSAR), and the rate of interest assumed by the company in determining the guaranteed benefits.

**Observations**

As of 12/31/18, under the Standard Valuation Law (SVL), the statutory valuation rates for amounts discounted at interest only are determined by date of issue. If the SVL were to be revised to determine the statutory valuation rates as of the date of valuation, TCJA would be able to accommodate such a change. For example, if the SVL were revised to annually update the rate(s) for both inforce and new business, then the rate(s) defined as of any valuation date would be used in the tax reserve calculation on that valuation date.

**d. IRC Section 807(c)(4) Dividend Accumulations and Other Amounts Held at Interest**

There are no changes to the calculation of these reserves.

**e. IRC Section 807(c)(5) Premiums Paid in Advance and Premium Deposit Funds**

There are no changes to the calculation of these reserves.

**f. IRC Section 807(c)(6) Premium Stabilization and Retired Lives Reserves**

There are no changes to the calculation of these reserves.

## **II. Calculation of Tax Reserves for Variable Life and Variable Annuity Contracts**

Reserves for variable life insurance and variable annuity contracts with life contingencies follow the general reserve rules described in the introduction with some modifications to reflect the variable nature of these contracts.

The tax reserve for a variable contract is the sum of (A) plus (B) where:

(A) is the maximum of the total contract net surrender value and the contract reserve separately accounted for under IRC Section 817, and

(B) is 92.81% times the excess, if any, of the total contract reserve calculated using an NAIC-prescribed method applicable to the contract on the valuation date over the value in (A).

The “total contract reserve” includes the reserves held in the general account and the reserves held in the separate account, both calculated using an NAIC-prescribed method applicable to the contract on the valuation date.

The reserve separately accounted for under IRC Section 817 is the portion of the total contract reserve allocable to non-guaranteed benefits, but not larger than the amount reported in the statutory blank for the separate account. Under both statutory and tax requirements, companies must hold in their general account at least the reserves supporting guaranteed benefits on a variable contract. In making this determination, the allocation to the separate account must be required, permitted, or consistent with the NAIC-prescribed method used to determine the total contract reserve.

There are no changes to the computation of the reserve increases and decreases in IRC Section 805(a) and (b) pursuant to IRC Section 817 adjustments for appreciation and depreciation of the assets. An example of this calculation is provided in Appendix 1. Please note that the example was created prior to the publication of the 2020 changes to VM-21.

### **III. Supplemental Benefits**

TCJA made no changes to the definition of supplemental benefits, to the requirements for a supplemental benefit to be qualified, or to the treatment in the cash value comparison of qualified supplemental benefits.

Under prior law, the tax reserves for supplemental benefits were equal to the statutory reserve for such benefits.

Under TCJA, the tax reserve for a supplemental benefit must be computed using the NAIC-prescribed method in effect on the date of valuation. That reserve must be multiplied by 92.81%.

If the supplemental benefit is a qualified supplemental benefit (QSB), that reduced reserve is subject to any Cash Surrender Value Floor attributable to the QSB (usually none) and cannot exceed the Statutory Reserve actually held for the QSB on a per contract basis.

### **IV. Reserves for Non-Standard Business**

Under TCJA, there is no longer a requirement for prevailing commissioners' standard tables for mortality and morbidity to be used in the calculation of tax reserves. As described in Section I. a., if mortality assumptions are specifically prescribed in the NAIC method, those assumptions must be used to calculate the reserve to which the 92.81% factor is applied. Otherwise, the 92.81% factor should be applied to the reserve computed using the NAIC method and the same mortality assumptions as in the statutory reserve.

Elimination of the requirement for prevailing commissioners' standard tables for mortality and morbidity for tax reserves means the rule concerning adjustments to the prevailing commissioners' standard tables for mortality and morbidity to reflect risks that were not otherwise taken into account in the development of the standard table, such as substandard risks, simplified underwriting, preferred risks, etc., has also been eliminated.

In addition, the special rule for tax reserves for qualified substandard policies has been eliminated.

To the extent that substandard reserves are required or permitted by the NAIC method, they are included in the tax reserve and are subject to the 7.19% haircut. For example, if a substandard reserve is being held as required by Commissioners' Reserve Valuation Method (CRVM) as defined prior to principle-based reserving (PBR), that substandard reserve is included in the tax reserve and is subject to the haircut.

## V. NAIC-prescribed Method

As of 1/1/2018, tax reserves are based on the NAIC-prescribed method applicable to the contract on the valuation date, which is used in calculating the statutory reserves held in the Annual Statement used for the tax return. This assumes that an NAIC-prescribed method is being used in the Annual Statement. The tax reserve method is no longer based on the NAIC-prescribed method in effect when the contract was issued.

Under TCJA, IRC Section 807(d)(3)(A) defines the "tax reserve method" as

1. Life insurance contract: CRVM in the case of a contract covered by CRVM, using the definition of CRVM in effect for the contract as of the date the reserve is determined.
2. Annuity contract: Commissioners' Annuity Reserve Valuation Method (CARVM) in the case of a contract covered by CARVM, using the definition of CARVM in effect for the contract as of the date the reserve is determined.
3. Noncancellable and guaranteed renewable A&H contract: The reserve method prescribed by the NAIC that covers such contract as of the date the reserve is determined.
4. Other contracts not covered above:
  - a. The reserve method prescribed by the NAIC that covers such contract as of the date the reserve is determined.
  - b. If the NAIC has not prescribed a method for a particular contract, a reserve method which is consistent with one of the reserve methods listed in (1), (2), (3) or (4)(a) (whichever is most appropriate) as of the date the reserve is determined.

This means if a company is not using an NAIC-prescribed method in its Annual Statement, then that company must use an NAIC-prescribed method for calculating its tax reserves. For example, in its Annual Statement, a company might be:

- Following a state-specific reserve requirement;
- Using a permitted practice that changed the methodology to allow different reserves; or
- Holding U.S. GAAP or IFRS reserves.

In these cases, the company would have to recompute its reserves using an NAIC-prescribed method in order to determine its tax reserves.

Similar to the situation under prior law, there is the question as to what is “the NAIC-prescribed method in effect on the date of valuation” if there are multiple NAIC-prescribed methods that are permitted on the date of valuation.

The final answer to this question will likely depend on guidance issued by the Department of the Treasury and the IRS. Many tax experts consider the correct answer to be that if the NAIC specifies more than one permissible method of computing statutory reserves, then the method elected for statutory reserves for a specific contract should govern for tax reserves.

Note that if one of the NAIC-prescribed methods is CRVM or CARVM and the other NAIC-prescribed methods are not CRVM or CARVM, then the NAIC-prescribed method defined as CRVM or CARVM would prevail.

If a company files more than one annual statement, it is unclear which jurisdiction’s assumptions (e.g., valuation interest rate, mortality table, etc.) should be used to compute the reserves to which the 92.81% factor is applied. This issue is discussed in detail in Section VI.

## VI. Statutory Cap

As under the prior law, tax reserves continue to be capped by statutory reserves on a seriatim basis, except for cancellable disability income. Tax reserves for cancellable disability income continue to be capped based on the year of incurral in aggregate for the line of business (rather than determined on a seriatim basis).

When does the statutory cap come into play under TCJA? Consider a company that has a permitted practice to hold lower reserves due to a methodology different from the NAIC-prescribed methodology. In this case, the company's tax reserve would still be capped by the lower statutory reserves held by the company. For example, if the NAIC methodology total statutory reserve is \$100, but the company is holding \$90 because of such a permitted practice, the company would calculate its tax reserve as the lesser of \$92.81 (92.81% times \$100) and the statutory reserve of \$90.00.

If a company files more than one annual statement for state regulatory purposes, there is a question as to which one should be used for determining the statutory cap. This question might occur if a company does business in different states with different minimum reserve requirements, and the company reports to each state at least the minimum reserves of that particular state. Revenue Ruling 2008-37, issued under the prior tax law, addressed this issue and defined the statutory reserve for statutory cap purposes as “the highest aggregate amount set forth on an annual statement pursuant to the minimum reserve requirements of any state in which the company does business” and “that the minimum requirements of some states in which [a company] does business would have permitted [a company] to hold and report a lower aggregate minimum amount of reserves has no effect on the determination of [a company's] statutory reserves.”

There are three things that should be noted about Revenue Ruling 2008-37:

- A company must use the same annual statement to determine all of its tax reserves and statutory caps.
- The ruling did not address the situation where a company may be holding a reserve higher than the minimum required.
- When this revenue ruling was issued, the methodology to be used for determining tax reserves was significantly more prescribed (e.g., interest rates and mortality tables) than the structure is under TCJA.

## **VII. Treatment of the Difference Between Tax Reserves as of 12/31/2017 and 1/1/2018**

There is a transition rule in TCJA for how to treat the change in certain reserves due to TCJA. This transition rule applies to the following:

- 807(c)(1) life insurance reserves;
- 807(c)(2) unaccrued unpaid loss reserves; and
- 805(a)(1) accrued unpaid losses that are subject to discounting under 846.

Specifically, the difference between:

- A. the tax-deductible amount of these reserves as of 12/31/2017 under the prior tax act and after 2017 basis changes

and

- B. the tax-deductible amount of these reserves as of 1/1/2018 calculated as required under TCJA

is to be included in or deducted from taxable income in equal amounts over the next eight tax years, that is, beginning in 2018.

The difference between tax-deductible IRC Section 807(c)(3) amounts discounted at interest-only reserves as of 12/31/2017 under the prior tax act and as of 1/1/2018 under the new tax act is not described as an element of the transition rule of TCJA. Hence, this difference is expected to be subject to the treatment of reserve basis changes under new IRC Section 807(f) Change in Basis Accounting described in the next section.

## **VIII. Future Section 807(f) Changes in Basis of Calculating Tax Reserves**

Two issues arise when considering basis changes in the basis of calculating tax reserves—that is, how to account for a change in the basis of calculating tax reserves when determining taxable income, and how to determine what constitutes a change in basis for tax reserve purposes.

Under prior law, changes in the basis of calculating tax reserves were spread over the following 10 tax years, starting in the tax year after the change. This rule has been revised under TCJA for new changes in basis.

However, there have not been any changes to two rules:

- That tax reserves attributable to contracts issued in the year of change must be computed on the new basis.
- That the amount of the adjustment for the tax reserve basis change is determined at the end of the year of change while the statutory reserve basis change is at the beginning of the year of change.

Under TCJA, changes in the calculation of tax reserves starting with tax reserves reported at the end of 2018 are to be spread following rules similar to the automatic accounting method change rules. Under the automatic accounting method change rules, a decrease in income is taken in the year of change and an increase in income is spread over four tax years (that is, the year of change and the next three tax years). These rules have been clarified in Rev. Proc. 2019-10, Rev. Proc. 2019-43, Revenue Ruling 2020-19 and Regulation 1.807-4.

Rev. Proc. 2019-10 also includes the addition of a new section 26.04 to Rev. Proc. 2018-31. Specifically, a taxpayer that changes its basis of computing reserves is subject to the procedures that apply to obtain the automatic consent of the commissioner to change a method of accounting. Under these procedures, the taxpayer must file Form 3115.

TCJA does not address the treatment of pre-2018 basis change amounts. The Rev. Proc. 2019-10 clarifies that for changes that arose under section 807(f) in a year beginning prior to January 1, 2018, a taxpayer must continue the 10-year spread under prior law by taking such amounts into account as described in section 807(f)(1) before its amendment by the TCJA. Further, the determination of the end-of-year 2017 tax reserve used in the calculation of the transition amount described in Section VII of this paper is to be the amount determined after considering any change in basis that is taken into account as required by section 807(f).

The Rev. Proc. 2019-10 was modified in Rev. Proc. 2019-43. Together, they provide guidance on how to treat multiple tax reserve basis changes occurring in the same tax year. Tax reserve basis changes are to be netted by 807(c) category. This will result in a single net negative adjustment or a single positive adjustment for each 807(c) category.

The automatic accounting method change rules for tax are reviewed and updated annually by the IRS and Treasury. Actuaries should monitor the changes to such rules and guidance as they relate to reserve basis changes.

The second issue when considering changes in the basis of calculating tax reserves is the definition of what constitutes a change in reserve basis for tax purposes. Questions currently exist and pre-date TCJA concerning what constitutes a tax reserve basis change, and the introduction of PBR has complicated this issue. Many tax experts agree that a change in valuation basis for statutory accounting (stat basis change) should be considered a tax reserve basis change. Thus, the rest of this discussion will focus on what constitutes a change in valuation basis for statutory.

For statutory purposes, there have not been any changes in the principles of what constitutes a statutory reserve basis change for life business not subject to PBR.

The NAIC Accounting Practices and Procedures Manual (APPM) details how to apply these principles to changes in life PBR reserves. It is expected that the net premium reserve (NPR) calculations within life PBR will follow the rules applicable to life business not subject to PBR. The APPM states: A change in valuation basis for principle-based reserves shall include cases where the required reserve methodology has changed or the insurer makes a voluntary decision to choose one allowable reserving method over another. This means that for the deterministic and stochastic reserve components of life PBR reserves, a material change in method resulting from a change to the Valuation Manual would be treated as a statutory reserve basis change. It also means that assumptions that are expected to change on a regular basis in these components of life PBR reserves will not result in statutory basis changes.

Additionally, as the reported reserve is based on several calculations, a change in which of the several calculations produces the “winning reserve” is not a change in basis. However, any change in method such as the formula being used and any change in how experience factors are calculated for statutory accounting would be a statutory reserve basis change. For statutory, a “change in basis” could have a value of zero. For example, the situation where the deterministic reserve is the highest value and a change is made to the NPR that does not change that the deterministic reserve prevails might be considered a change in basis, but the value of the change would be zero.

The APPM description of stat basis change was written before the adoption of the new VA Framework in the revised VM-21, and therefore, has no additional elaboration as to which changes to variable annuity PBR reserves should flow through statutory operating income and which should flow through statutory surplus changes. However, because the stochastic calculations of variable annuity and life PBR are based on the same principles, and are identical except for product specific issues, it seems reasonable to assume they should be treated the same for change in basis determination.

Furthermore, the Additional Standard Projection Amount calculation in VA CARVM involves:

- Scenarios that are a company choice of one of two approaches:
  - Replicate the stochastic scenarios and calculations, but using prescribed assumptions, or
  - Determine a single scenario from a deterministic set of 40 market paths that are variations of the current environment that most closely matches the company's stochastic calculation, then use that scenario along with the prescribed assumptions, and
- The use of prescribed policyholder behavior assumptions that are determined as industry average values and are anticipated to be updated regularly.

Consistent with the guidance for life PBR, it would be reasonable to assume for statutory accounting that:

- Because the scenarios are dynamic, any change should fall in the category of an experience update;
- Because the prescribed assumptions are based on industry average experience, are expected to be updated every three years or so, and are not issue-date-dependent, they fall in the category of an experience update.

In September, 2020, shortly before the publication of this paper, Treasury/IRS released Rev. Ruling 2020-19, which provides several examples of what constitutes a tax basis change. The reader should refer to the ruling when determining whether their specific facts constitute a change in basis.

## **IX. Implications of the Requirement That Tax Reserves Continue to Be Determined on a Seriatim Basis**

Life and variable annuity PBR require an allocation of the modeled reserve, which is calculated in the aggregate, to individual contracts. Thus, these methods provide the required contract-by-contract determination of reserves for statutory cap purposes. For companies that are using these methods for tax reserves, these methods also provide the required contract-by-contract determination for the determination of tax reserves.

When a method of allocation of a modeled reserve that is calculated in the aggregate is not provided by regulatory guidance, the allocation to individual contracts should be based on an actuarially appropriate method.

The 92.81% factor should be applied after the determination of the individual contract-level reserves—that is, after the allocation of any aggregate reserve.

As noted above, additional asset adequacy reserves and voluntary reserves remain nondeductible.

## **X. Reasonable Mortality Charge Requirements—Definition of Life Insurance & Modified Endowment Contract Calculations—IRC Sections 7702 & 7702A**

Under TCJA, changes were made in section 7702 relating to the definition of the “prevailing commissioners standard table.” The definition is now found completely in section 7702 (specifically in section 7702(f)(10)) instead of the former reference in section 7702 to the previous section 807(d)(5). Reasonable mortality charges must meet the requirements prescribed in regulations or must not exceed the mortality charges specified in the prevailing commissioners’ standard mortality tables, as of the date of issue of the contract.

“Prevailing commissioners’ standard tables” are defined as the most recent commissioners’ standard tables prescribed by the NAIC that are permitted to be used in computing reserves for that type of contract under the insurance laws of at least 26 states when the contract was issued. Under IRS safe harbor rules with respect to the 2001 CSO and the 2017 CSO, which are the currently required statutory mortality bases for the net premium reserve, the mortality charges by duration to be used in the development of section 7702 and 7702A factors must be the lesser of the mortality charges guaranteed in the contract and those in the prevailing commissioners’ standard mortality table.

Section 7702 also provides that if the prevailing commissioners' standard mortality tables as of the beginning of any calendar year ("year of change") are different from the prevailing commissioners' standard mortality tables as of the beginning of the preceding calendar year, the issuer may use the prevailing commissioners' standard mortality tables as of the beginning of the preceding calendar year with respect to any contract issued after the change and before the close of the three-year period beginning on the first day of the year of change.

TCJA made no other changes to rules for calculating values for compliance with sections 7702 & 7702A, including for substandard contracts.

### **Observations**

This now automatically provides for a three-year transition period for a new standard mortality table for determining section 7702 (Definition of Life Insurance) and section 7702A (Modified Endowment Contract) factors.

## **XI. Section 848—DAC Tax**

There have been two significant changes to IRC section 848 dealing with the capitalization of certain policy acquisition expenses. First, the capitalized specified policy acquisition expenses (DAC) have increased because the DAC tax percentages of subsection (c) of section 848 have been increased. Second, the period to allow the deductions of the capitalized expenses under subsection (a) of section 848 has been increased from 120 months to 180 months.

The DAC tax percentages have been increased:

- For annuity contracts, from 1.75% to 2.09%;
- For group life insurance contracts, from 2.05% to 2.45%;
- For all other contracts (which include non-group life insurance, noncancellable and guaranteed renewable A&H), from 7.7% to 9.2%.

TCJA increases the general rule for the timing of the deduction of the capitalized acquisition expenses from a 120-month period to a 180-month period, but does not change the timing of deductions of the first \$5 million of capitalized acquisition expenses over 60 months or the phase-out procedure of a year's capitalized acquisition expenses from \$5 million up to \$15 million.

DAC tax amortization that started prior to 1/1/18 is to be continued using the appropriate 5-year or 10-year amortization periods in effect prior to TCJA.

## **XII. Changes to the Operations Loss Rules for Life Insurers**

TCJA repealed the special life insurance company operations loss rules. TCJA also amended the regular net operating loss (NOL) rules and made them applicable to life insurance companies.

The key elements of these rules are:

- No carryback of NOLs
- Unlimited carryforward of NOLs
- Use of loss carryforwards in any single taxable year is limited to 80% of taxable income.

These new rules apply to only loss carryforwards arising in taxable years beginning after 12/31/17.

## **XIII. Effect of TCJA on Statutory Accounting for i) Deferred Tax Assets/Liabilities (DTAs/DTLs), ii) Risk-Based Capital (RBC) Factors and iii) Total Adjusted Capital (TAC)**

The decrease in the corporate tax rate from 35% to 21% and the change in the operations loss rules will reduce the amount of the deferred tax asset (DTA). However, some of the other changes in the taxation of life insurers (e.g., the change in DAC) will result in an increase in the DTA. The net impact of these changes will most likely be a decrease in the net deferred tax asset.

The corporate tax rate change from 35% to 21% will generally increase the life RBC factors because they are after tax. It should be noted that when the tax rate changes, the RBC factor change is not an automatic adjustment.

Regulators have changed factors in the life RBC formula that will be effective beginning with the 2018 filing year.

There are a large number of factors in the life RBC formula. The adopted changes to life RBC increased many of the factors, net of tax, by 21.5%. However, some RBC factors were decreased as a result of the TCJA, while others remained unchanged. For example, C1 pre-tax RBC factors for bonds, preferred stocks, and similar instruments, and C2 RBC factors for individual and group life, were reduced by 3%, reflecting a higher post-tax discount rate, because these RBC factors are calculated assuming future losses. The net result is that the majority of post-tax RBC factors increased by less than 21.5%.

The total impact of TCJA on TAC will take some years to emerge and will differ by company.

An insurer's mix of assets and liabilities, business profile, and tax attributes will determine the impact of the TCJA on the life RBC calculations for that company.

#### **XIV. Effects on the Taxation of Foreign Life Insurance Companies That Are Affiliates or Subsidiaries of U.S Life Insurance Companies**

The TCJA will affect U.S. life insurers with foreign affiliates or subsidiaries with respect to, but not limited to, the following:

- There is a new participation exemption system for earnings of foreign subsidiaries. The participation exemption is 100% of foreign dividends received from specified foreign corporations (SFCs). The Dividends Received Deduction (DRD) is available to U.S. corporations that are U.S. shareholders with respect to the SFC (the shareholder owns at least 10% of stock, by vote or value, directly or indirectly). There is a one-time transition tax of 8% or 15.5% of the subpart F inclusion (prior to foreign tax credits) held by the SFC. The tax rate assessed depends on the amount of cash held by the SFC.
- The definition of U.S. shareholder was expanded under the TCJA to include persons who hold at least 10% of the value of the stock of the foreign company. Prior to TCJA, only persons who held at least 10% of the voting stock were included.
- Global Intangible Low-Taxed Income (GITLI) is a new category of income under the TCJA. While similar in treatment to subpart F income, GITLI includes the low-taxed income of a Controlled Foreign Corporation (CFC) that is not considered subpart F income and exceeds a routine return of 10% of the CFC's depreciable assets.
- Base Erosion and Anti-Abuse Tax (BEAT) imposes a tax on certain base erosion payments made by a U.S. taxpayer to a foreign affiliate. A minimum of 10% will be imposed when base erosion payments exceed a modified taxable income amount. Reinsurance payments are specifically mentioned as constituting base erosion payments. This will have an impact on the determination of certain reinsurance reserve credits as well as reinsurance arrangements between U.S. domiciled companies and foreign affiliates.
- A new eligibility requirement was added to the insurance company exception to Passive Foreign Investment Company (PFIC) status. The requirement is that a foreign insurance company's applicable insurance liabilities must exceed 25% of gross assets on an annual basis. Applicable insurance liabilities include (i) loss and loss adjustment expenses and (ii) life and health insurance reserves (except for deficiency, contingency, or unearned premium reserves).

## Appendix 1— Examples of Calculations

These examples assume the statutory reserve is computed using an NAIC-prescribed method on the date of valuation for the policy. If the computational method is not an NAIC-prescribed method, then the computation of the statutory reserve using an NAIC-prescribed method is a required first step.

These examples do not include a change in basis under 807(f).

### **Non-Variable Life Insurance Policy**

#### Statutory Data:

Statutory Mean Reserve*	1,500
Statutory Deficiency Reserve	200
Due/Deferred Premium Asset	75
Net Cash Surrender Value	1,250

#### Tax Calculations:

Adjusted statutory reserve, $1,500 - 75 =$	1,425
Apply 92.81%	1,323
Floor – Max [1,323 and 1,250]	1,323
Ceiling – Min [1,323 and $(1500 + 200 - 75)$ ]	1,323
EOY Tax Reserve	1,323

\*Figure shown does not include deficiency reserve nor asset adequacy reserve.

The following example was created prior to the publication of the 2020 changes to VM-21.

**Variable Annuity Policy**

Statutory Data:	Separate Account (SA)	General Account (GA)	Total
Account Value	800	200	1,000
Net Surrender Value NSV, using 8% charge	736	184	920
AG43 Basic Reserve (BR)	752	188	940
Statutory CARVM held, (GA – excess over BR)	752	218	970
Capital Gains during tax year	60	0	60
 Tax Reserve Calculations:			
Max [NSV and Separate Account Reserve], 920 and 752			920
Excess CARVM Reserve, 970 – 920			50
Apply 92.81%, .9281 x 50			46
Ceiling – Min [(920 + 46) and 970]			966
EOY Tax Reserve after 817(a) adjustment 966 – 60			906
Subsequent year BOY Tax Reserve			966

This example assumes a method for the allocation of the separate account reserve versus the general account reserve that is compliant with IRC §817(c). There are other allocations that are compliant with IRC §817(c) that may also be used.

The source for this variable annuity policy example is the article “Changes to the Computation of Tax Reserves under P.L. 115-97” as presented in the June 2018 issue of *Taxing Times*.



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