Insurance alert

US tax reform: Understanding the impact on financial reporting of insurance companies – January 8, 2018

Background

On December 22, 2017, President Trump signed tax reform legislation (the 2017 Act), which includes a broad range of tax reforms affecting business, including corporate tax rates, business deductions, and international tax provisions. Many of these provisions significantly differ from prior US tax law, resulting in pervasive financial reporting implications.

The enactment of US tax reform represents a fundamental and dramatic shift in US taxation, which will have pervasive financial reporting implications for all companies with US operations. Companies will undoubtedly face challenges in accounting for the impact of tax reform.

This *Insurance alert* includes an overview of the accounting for tax law changes, key provisions of the 2017 Act, and details regarding how it will impact the financial statements.

When to account for tax law changes

Under US GAAP, changes in tax rates and tax law are accounted for in the period of enactment. For US federal purposes, the enactment date for US GAAP is the date the President signed the bill into law.

Under IFRS, changes in tax rates and tax law are reflected when enacted or substantively enacted. While in some jurisdictions this could result in differences in the enactment date, there is not a difference for changes in US federal law.

On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 (SAB 118) to address the application of US GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting in its 2017 annual and 2018 quarterly financial statements for certain income tax effects of the 2017 Act. The SEC staff also indicated it would not object to SAB 118 being applied by Foreign Private Issuers reporting under IFRS solely for purposes of accounting for the impact of the 2017 Act under IAS 12.

SAB 118 provides guidance for registrants under three scenarios.

- Registrants must reflect the tax effects of the 2017 Act for which the accounting is complete.
- Registrants must report provisional amounts for those specific income tax effects of the 2017 Act for which the accounting is incomplete but a reasonable estimate can be determined. Provisional amounts or adjustments to provisional amounts identified in the measurement period should be included as an adjustment to tax expense or benefit from continuing operations in the period the amounts are determined.
- Registrants are not required to report provisional amounts for any specific income tax effects of the 2017 Act for which a reasonable estimate cannot be determined, and would continue to apply ASC 740 based on the provisions of the tax laws that were in effect immediately prior to the enactment of the 2017 Act. Registrants would report the provisional amounts of the tax effects of the 2017 Act in the first reporting period in which a reasonable estimate can be determined.

The SEC staff expects that entities will act in good faith to complete the accounting under ASC 740. SAB 118 provides that the measurement period is complete when a company's accounting is complete and in no circumstances should the measurement period extend beyond one year from the enactment date. A registrant may be able to complete the accounting for some provisions earlier than others. As a result it may need to apply all three scenarios in determining the accounting for the 2017 Act based on the information that is available.

In accordance with SAB 118, the following disclosures should be provided when accounting under ASC 740 is not complete.

- Qualitative disclosure of income tax effects of the 2017 Act for which the accounting is incomplete;
- Disclosure of items reported as provisional amounts;
- Disclosure of existing current or deferred tax amounts for which the income tax effects of the 2017 Act have not been completed;
- The reason why the initial accounting is incomplete;
- The additional information that is needed to be obtained, prepared, or analyzed to complete the accounting requirements under ASC 740;
- The nature and amount of any measurement period adjustments recognized during the reporting period;
- The effect of measurement period adjustments on the effective tax rate; and
- When the accounting for the income tax effects of the 2017 Act has been completed.

The SEC staff also issued interpretive guidance (Compliance and Disclosure Interpretation 110.02) indicating that the re-measurement of deferred tax assets to reflect a change in a tax rate or tax laws is not an impairment under ASC 740 and that disclosure under Item 2.06 of Form 8-K would therefore not be required. However, the SEC staff noted that the enactment of new tax rates or tax laws could have implications for a registrant's conclusions about whether it is more likely than not that its deferred tax assets will be realized. Registrants employing the measurement period contemplated by SAB 118 that conclude that an impairment has occurred due to changes resulting from the enactment of the 2017 Act may rely on the Instruction to Item 2.06 and disclose the impairment, or a provisional amount with respect to that possible impairment, in its next periodic report.

At its January 10, 2018 board meeting, the FASB also plans to consider whether private companies may follow the SEC guidance.

How to account for tax law changes

Under US GAAP, the effect of a change in tax law is recorded discretely as a component of the income tax provision related to continuing operations in the period of enactment. This is true even if the deferred taxes being remeasured were established through a financial statement component other than continuing operations (e.g., other comprehensive income (OCI) or acquisition accounting). Adjusting temporary differences originally recorded to OCI (e.g., unrealized gains and losses on available-for-sale securities and "shadow DAC,") through continuing operations may result in a disproportionate effect of deferred taxes lodged in accumulated OCI. In other words, the original deferred tax amount recorded through OCI at the old rate will remain in accumulated OCI despite the fact that its related deferred tax asset/liability will be reduced through continuing operations to reflect the new rate. We believe that the disproportionate effect that remains in accumulated OCI should be eliminated when the circumstances upon which it is premised cease to exist (see PwC's *Income taxes* guide, Section 12.3.3.3). At its January 10, 2018 board meeting, the FASB will decide whether to add a narrow-scope project on the reclassification of certain tax effects stranded in accumulated other comprehensive income. If they do add the project, any guidance will be subject to public comment and further consideration by the board.

In addition, changes in the valuation allowance assessment due to tax reform would also be recorded to continuing operations in the tax provision.

The tax guidance requires the impact of the tax legislation to be recorded on its enactment date December 22, 2017. For AFS and cash flow hedges, subject to materiality, this would require:

1. Updating the fair values of the instruments to December 22, 2017.
2. Updating the deferred tax and OCI amounts based on those December 22, 2017 values at the original tax rate.
3. Reflecting the impact on deferred taxes through continuing operations.
4. Updating the fair values of the instruments to December 31, 2017 with updated tax rates to establish OCI and deferred taxes.

Key Provisions

Corporate rate reduction

The 2017 Act reduces the corporate tax rate from 35% to 21% for tax years beginning after December 31, 2017.

ASC 740, *Income Taxes*, requires deferred tax assets and liabilities to be measured at the enacted tax rate expected to apply when temporary differences are to be realized or settled. Thus, at the date of enactment, a calendar year-end company will need to remeasure deferred tax balances based upon the new 21% tax rate.

Typically, when the statutory tax rate is constant between periods, so-called "return-to-provision" adjustments for temporary differences do not generally impact the overall effective tax rate. This may change with tax reform. For example, calendar year return-to-provision adjustments would impact the current provision at a 35% rate but impact the deferred provision at 21%.

Alternative minimum tax (AMT)

The 2017 Act repeals the AMT regime for tax years beginning after December 31, 2017. For tax years beginning in 2018, 2019, and 2020, the AMT credit carryforward can be utilized to offset regular tax with any remaining AMT carryforwards eligible for a refund of 50% of the outstanding balance. Any remaining AMT credit carryforwards will become fully refundable beginning in the 2021 tax year.

Any existing valuation allowances on AMT credit carryforwards should be released as part of accounting for tax reform since the asset will be fully refundable. At its January 10, 2018 board meeting, the FASB will consider whether any AMT credit carryforwards should be reclassified as a receivable at the time of enactment (and if so, whether it should be discounted) or whether it should remain classified as a deferred tax asset.

Net operating losses (NOLs)

For life insurance companies with net operating losses (NOLs) arising after December 31, 2017, the 2017 Act limits a taxpayer's ability to utilize NOL carryforwards to 80% of taxable income. In addition for life insurance companies, NOLs arising after 2017 can be carried forward indefinitely, but carryback is prohibited. NOLs generated in tax years that began before January 1, 2018 will not be subject to the taxable income limitation and will continue to have a three year carryback and 15 year carryforward period.

The 2017 Act preserves the existing tax law for NOLs of property and casualty insurance companies in which those NOLs are carried back 2 years and carried forward 20 years to offset taxable income in such years without application of the 80% offset limitation.

Deferred tax assets for NOLs will need to be measured at the applicable tax rate in effect when the NOL is expected to be utilized. The changes in the carryforward/carryback periods as well as the new limitation on use of NOLs may significantly impact valuation allowance assessments for NOLs generated after December 31, 2017 for life insurance companies.

ASC 740 identifies four sources of taxable income to support realization of deferred tax assets. The changes in US tax law for life insurance companies will limit two of those sources in future periods with regard to NOLs. One source, taxable income in prior carryback years, is eliminated for NOLs arising after 2017. Another source, tax-planning strategies, is limited. This is because tax-planning strategies, as defined in ASC 740, are actions an entity ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused. Since NOLs generated after December 31, 2017 will not expire, a tax-planning strategy, by definition, would not provide a source of future taxable income.

However, tax actions that management has already implemented, are in the process of implementing, or committed to implementing in the near term may be reflected in estimates of future taxable income if they are supported by objectively verifiable evidence (see PwC's *Income taxes* guide, Section 5.6).

As companies schedule deferred taxes at the new rate and also consider the realizability of deferred tax assets, they should consider how deferred tax assets other than NOLs will reverse. If the reversal is expected to generate an indefinite carryforward NOL, this may impact the valuation allowance assessment. Some deferred tax assets, such as those relating to capital losses, may be subject to other limitations. The indefinite carryforward period for NOLs may also mean that deferred tax liabilities related to indefinite-lived intangibles, commonly referred to as "naked credits," can be considered as support for realization. As the naked credits may provide an income source for the existing temporary differences that will reverse to generate indefinite lived NOLs, companies with a full valuation allowance on such temporary differences could have a valuation allowance release upon enactment.

The mere existence of deferred tax liabilities, however, does not make them a dollar-for-dollar source of taxable income. The limitation on NOL usage to 80% of taxable income for future NOLs may shift loss utilization into later years or suggest that deferred tax liabilities in future periods are insufficient to support realization. For example, consider a company with a $100 NOL and a $100 deferred tax liability. The $100 deferred tax liability would provide an income source to utilize $80 of the NOL. Thus, due to the limitations on NOL usage, and in the absence of other sources of taxable income, a valuation allowance of $20 would be necessary.

New International tax system

Territorial regime

The 2017 Act introduces international tax provisions that fundamentally change the US approach to the taxation of foreign earnings, including the implementation of a territorial system (or partial territorial system in some instances) by providing a 100% dividend received deduction (DRD) on certain qualified dividends from foreign subsidiaries. Domestic corporations will continue to apply existing subpart F rules.

This provision, coupled with other international provisions discussed below, significantly impacts the accounting for outside basis differences. The change to a territorial system may reduce the significance of evaluating outside basis differences and the indefinite reinvestment assertion as the US tax cost of dividend remittances will generally be reduced. However, the outside basis accounting model has not changed. Companies will need to continue to assess and evaluate their intentions with respect to outside basis differences. Companies can continue to assert that some or all of their undistributed earnings are indefinitely reinvested provided they have the ability and intent to do so, along with specific plans for reinvestment of those earnings. Those that do not assert indefinite reinvestment need to account for any potential costs, such as any future foreign taxes that would be withheld on distributions.

It may be more difficult to overcome the presumption that undistributed earnings will be transferred to a US parent entity. This is because, as a result of the DRD, the incremental tax on remittance may be relatively minimal (i.e., it will consist of only foreign withholding taxes, state tax, and foreign currency translation effects). It may also be difficult to overcome the presumption if overseas cash is needed to fund significant liabilities in the US, such as the toll charge liability discussed below. However, the ability to assert indefinite reinvestment remains. For example, it may not be appropriate to remove an assertion in jurisdictions where an entity is prevented from remitting earnings, has reserve requirements, or has projected working capital and other capital needs in the country where the earnings were generated.

New judgments on the indefinite reversal criteria are required as of each balance sheet date at each level of an organization. Companies still need to declare their intentions with respect to their outside basis differences. Companies that do not assert indefinite reinvestment may need to record deferred tax liabilities for the potential tax consequences of recovering the outside basis difference at the date of enactment of the new law, and reassess their assertion on an ongoing basis. Enactment of a territorial system along with the deemed repatriation provision discussed below could result in changes in management's intentions. To the extent a company changes its indefinite reinvestment assertion, the impact is reflected in tax expense in the period of change and appropriate financial statement disclosure should be made.

To calculate or measure the tax effect of an outside basis difference, a realistic and reasonable expectation as to the time and manner of the expected recovery must be determined. Taxes provided should reflect the expected form of recovery (e.g., dividend, sale, liquidation) and the character of taxable income that the repatriation will generate (e.g., ordinary versus capital gain). Outside basis differences will need to continue to be considered at every level of an entity's legal structure.

The deemed repatriation provisions of the 2017 Act result in an increase in the tax basis of foreign subsidiaries. This could result in excess tax over book basis for certain subsidiaries. Recognition of a deferred tax asset on an outside basis difference is prohibited unless it is apparent that the basis difference will reverse in the foreseeable future.

Repatriation "toll-charge"

The 2017 Act requires a mandatory deemed repatriation of post-1986 undistributed foreign earnings and profits (E&P). The rate applied varies depending on whether the E&P is held in liquid (as defined in the 2017 Act) or non-liquid assets. A proportional deduction on the deemed repatriation will result in a repatriation toll charge of 15.5% for cash and liquid assets and 8% for non-liquid assets. The toll charge will be assessed regardless of whether the company has cash in its foreign subsidiaries and regardless of whether the company brings back the earnings. The toll charge is determined on the greater of E&P as of two measurement dates (November 2, 2017 or December 31, 2017). The amount of cash and liquid assets is determined based on the greater of the amounts calculated using two alternative measurement periods. At the election of the taxpayer, the toll charge can be paid in installments over eight years.

Companies can utilize existing foreign tax credit (FTC) and NOL carryforwards to settle the toll charge. Alternatively, companies can elect to not apply NOL carryforwards if they wish to utilize existing FTCs. Companies can claim a credit for foreign taxes deemed paid on foreign earnings subject to the mandatory inclusion, however these credits are subject to a "haircut."

In the period of enactment, companies will need to record a tax payable for the toll tax irrespective of any actual remittances or their historical financial statement assertions.

The financial statement impact of recording the toll tax liability may be significant and will vary depending on a number of factors, including previous assertions. Historically, many companies have not recorded (or disclosed) a liability amount for their outside basis differences. In other cases, liabilities may have been recorded or disclosed, but enactment of the reform provisions may drastically change that amount.

Measurement of the toll tax liability may require extensive effort. E&P is determined on a cumulative basis and historical practices in calculating and tracking both E&P and tax pools should be revisited. Adding to the complexity is the need to compute E&P as of two separate measurement dates and the determination of the amount of earnings that are held in cash/liquid assets or other assets using two measurement periods. Furthermore, the determination of E&P balances, foreign tax pools, and the amount of cash and liquid assets may be impacted by the existence of uncertain tax positions.

Some have inquired as to whether the toll tax payable should be discounted given that it can be paid over an extended period of time. We expect the FASB to offer perspective on this question in late January.

Companies should also consider what impact the one-time toll charge and enactment of a territorial system will have on their valuation allowance assessments. Additional taxable income from the toll charge could support realization of existing deferred tax assets. Alternatively, existing deferred tax assets, such as FTCs, may have been supported by future repatriations and any remaining FTCs post toll charge would need to be assessed for realizability. Future realization of deferred tax assets is dependent on availability of an income source, which could be impacted by tax reform. A holistic evaluation of how tax reform impacts the valuation allowance assessment will be needed. Additionally, similar to other aspects of tax reform, the toll charge will need to be assessed from a state income tax perspective, with the impact depending on existing rules and enacted state law changes in response to federal changes.

On a prospective basis, unremitted earnings of foreign subsidiaries will include both earnings that have previously been taxed through the deemed repatriation provisions (but not distributed) as well as future earnings that generally would not be taxed in the US as a result of the 100% DRD. Understanding these amounts will be important as the resulting tax effects of repatriation, including potential FTCs, foreign currency gains or losses, and future basis adjustments, vary. For example, companies may expect the repatriation of foreign earnings that have been subjected to the toll tax to be free of additional US tax consequences; however, foreign withholding taxes as well as taxes on foreign currency gains and losses that arise from exchange rate movement between the deemed and actual distribution dates should not be overlooked.

Anti-base erosion - Minimum tax on certain related party payments

The 2017 Act introduces a new minimum tax on international payments as a means to reduce the ability of multi-national companies to erode the US tax base through deductible related-party payments. The minimum tax, known as the base erosion and anti-abuse tax (BEAT), is imposed when the tax calculated under BEAT exceeds the corporation's regular tax liability determined after the application of certain credits allowed against the regular tax. BEAT is measured based on modified taxable income (i.e., taxable income after adding back base erosion payments). With certain exceptions, base erosion payments are payments to related foreign persons that result in a US tax deduction generally excluding payments for cost of goods sold.

A 5% BEAT rate applies for the tax year that began after December 31, 2017. After that, the BEAT rate increases to 10%, and for years ending after December 31, 2025 the rate increases to 12.5%. Different rates apply to banks and securities dealers.

The BEAT applies to corporate taxpayers with average annual gross receipts over the preceding three years of at least $500 million and that have base erosion payments of more than 3% of the corporation's deductible expenses (2% for banks and securities dealers). The minimum tax paid does not reduce future regular income tax liabilities (i.e., unlike AMT, the BEAT is not creditable).

We believe the BEAT should be accounted for as an income tax under ASC 740 as it is a tax assessed on a net income amount. A question exists as to whether companies should account for BEAT in the period in which it occurs, or whether companies that anticipate being subject to BEAT should factor that into the rate used for measuring their deferred taxes. We expect the FASB to offer perspective on this question in late January.

The application of the BEAT to affiliated reinsurance programs with foreign affiliates may significantly impact multi-national insurance companies. As the BEAT would apply to reinsurance payments paid or accrued after January 1, 2018, companies should consider the impact of the BEAT on their affiliated reinsurance programs and explore alternatives, which generally have a regulatory component to them in addition to business and capital considerations. The BEAT will result in an increase in tax payments for the 2018 tax year going forward and will need to be considered in projections of taxable income.

Insurance-specific provisions

Life insurance companies - Reserves

Under the 2017 Act, the tax-deductible life insurance reserve for a contract (other than certain variable contracts) would generally be the greater of the net surrender value of the contract (if any), or 92.81% of the amount determined using the tax reserve method otherwise applicable to the contract. For variable contracts, the separate account reserves with regard to the contract would not be multiplied by the 92.81 percent factor. A statutory reserves cap would apply, as under prior tax law.

This provision applies to taxable years beginning after December 31, 2017. Implementation of this provision is similar to a change in accounting method. For the first taxable year beginning after December 31, 2017, the difference in the amount of the tax basis reserve with respect to any contract at the end of the preceding taxable year and the amount of such tax basis reserve determined as if the new tax law had applied for that year is treated as a transition adjustment. This transition adjustment amount is brought into taxable income on a straight-line basis over each of the eight taxable years following that preceding year (2018 - 2025).

As the enactment date of this provision is in 2017, calendar-year entities should report the impact in the 2017 financial statements. In general, the provision is expected to lower the tax basis associated with life insurance reserves; accordingly, the existing deductible temporary difference is expected to increase. Consequently, an additional deferred tax asset should be recognized as of December 31, 2017. The increase in deductible temporary differences also represents the transition adjustment amount, described above. As this taxable income is not recognized immediately, a deferred tax liability is recognized.

Life insurance companies - Deferred acquisition costs (DAC)

As under prior tax law, acquisition costs with regard to life insurance and annuity contracts would be capitalized and amortized, based on a proxy percentage multiplied by net premiums received. The 2017 Act extends the amortization period for DAC from 120 months to 180 months and increases the capitalization percentages by approximately 20%, when compared to existing law: 2.09% for annuity contracts, 2.45% for group life insurance contracts, and 9.20% for all other specified life insurance contracts.

This provision applies to taxable years beginning after December 31, 2017 with no recomputation of existing unamortized DAC balances required as of the enactment date. Instead the new capitalization percentages and amortization period apply to net premiums received in 2018 and after.

These new provisions should be considered in the assessment of future taxable income for both valuation allowance (US GAAP and statutory) and deferred tax asset admissibility (statutory) assessments, as necessary.

Life insurance companies - Proration

Under prior tax law, a life insurance company's dividends received deduction (DRD) with regard to corporate stock that it owns is based on the "company's share" of dividends received. The benefit a life insurer receives from tax-exempt interest likewise is limited to the "policyholders' share" of such interest. The 2017 Act replaces the complex prior tax law computation of the "company's share" and "policyholders' share" with fixed percentages of 70% and 30%, respectively.

This provision applies to taxable years beginning after December 31, 2017 and will impact the effective tax rate reconciliation in future years but will not have an enactment date change.

Life insurance companies - Special rule for distributions to shareholders from pre-1984 policyholders surplus account

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under US tax law. The 2017 Act repeals the special rules imposing income tax on distributions to shareholders from the policyholders surplus account of a stock life insurance company.

This provision applies to taxable years beginning after December 31, 2017. For stock life insurance companies with an existing policyholders surplus account, a tax would be imposed on the balance of the account at the end of the preceding taxable year. Accordingly, the ability of an entity to delay recognition of taxation is eliminated.

Under the applicable transition provision, the tax associated with the remaining policyholder surplus balance is included over an eight year period. Importantly, the tax on the 1/8th of the policyholder surplus balance is in addition to any tax on other life insurance company taxable income, and may not be offset by other future deductions.

Accordingly, in the period of enactment, a tax payable for the policyholder surplus tax should be established through the income statement.

Property and casualty insurance companies - Reserves

The computation of tax basis discounted unpaid loss reserves is modified to incorporate a significantly higher discount rate based on a 60-month average, investment grade, corporate bond yield curve as published by the Treasury Department, and extended loss payment patterns for long tail lines of business - up to 24 years. No change in the length of the payment pattern for short tail lines was enacted - it remains at 3 years. Additionally, the 2017 Act repeals the election permitting a taxpayer to use its own historical loss payment patterns for determination of discount factors. This provision was beneficial for taxpayers that paid claims more quickly than the industry average.

These provisions apply to taxable years beginning after December 31, 2017. Implementation of this provision is similar to a change in accounting method. For the first taxable year beginning after December 31, 2017, the difference in the amount of the tax basis unpaid losses at the end of the preceding taxable year and the amount of such tax basis unpaid losses determined as if the new tax law had applied for that year is treated as a transition adjustment. This transition adjustment amount is brought into taxable income on a straight-line basis over each of the eight taxable years following that preceding year (2018 - 2025).

As the enactment date of this provision is in 2017, calendar-year entities should report the impact in the 2017 financial statements. In general, the provision is expected to lower the tax basis associated with unpaid loss reserves; accordingly, the existing deductible temporary difference is expected to increase. Consequently, an additional deferred tax asset should be recognized as of December 31, 2017. The increase in deductible temporary differences also represents the transition adjustment amount, described above. As this taxable income is not recognized immediately, a deferred tax liability should be recognized.

Property and casualty insurance companies - Salvage and subrogation

The 2017 Act does not specifically modify the guidance applicable to the requirement to accrue salvage and subrogation recoveries or related discounting. However, pre-2017 Act law required that discounting of salvage and subrogation generally follow the rules applicable to unpaid loss reserves. Although payment patterns were determined using different data and there was no election to use company payment patterns, the interest rate was identical to the rate used for unpaid loss reserves. Given the change in the interest rate applicable to unpaid loss reserves, it is likely that the Internal Revenue Service will issue guidance modifying the determination of discounted salvage and subrogation on terms similar to unpaid loss reserves.

Property and casualty insurance companies - Proration

Under prior law, the computation of the tax-deductible amount of reserves for losses incurred for property and casualty insurance companies is reduced by 15% of tax-exempt interest and DRD (proration percentage). The 2017 Act increases the proration percentage to 25%, which attempts to mirror the existing law after-tax impact.

This provision applies to taxable years beginning after December 31, 2017 and will impact the effective tax rate reconciliation in future years but will not have an enactment date change.

Property and casualty insurance companies - Special estimated tax payments

Prior to the 2017 Act, property and casualty insurance companies were allowed an election to offset the impact of loss reserve discounting by claiming an additional special deduction and making "special estimated tax payments." The election did not impact the cash paid to the government, only the calculation of taxable income. Payment of special estimated tax payments were generally treated as a current payment of tax.

The 2017 Act repeals this special rule, effective for taxable years beginning after December 31, 2017. For the first taxable year beginning after December 31, 2017, the existing balance in the special deduction account at the end of the preceding taxable year is included in taxable income with the remaining special estimated tax payments applied against the amount of additional tax attributable to this inclusion. Generally, any tax produced by reversing special deductions should be offset by special estimated tax payments applied. For various reasons this is not always the case and likely may not be the case because the special estimated tax payments were created at 35%, and the reversing special deduction balance will produce tax at a 21% rate.

The 2017 Act provides that any special estimated tax payments in excess of the additional tax created by the reversal of the special deduction balance are treated as estimated tax payments under section 6655. Such amounts would be used to satisfy the 2018 tax liability, and could produce a tax refund.

As of December 31, 2017, companies will need to estimate the amount, if any, of special estimated tax payments that will be treated as an estimated tax payment for the 2018 tax year. A current tax recoverable should be recognized for this amount.

Other financial reporting considerations

Such significant changes in US tax law may have financial reporting consequences beyond the typical tax line items in the financial statements. For example, accounting for the effects of tax reform may impact financial statement reporting and ratios such as liquidity, cash flow needs, working capital, earnings per share, etc. Changes in financial ratios may impact existing debt covenants and dividend distributions that require certain ratios. Additionally, some of these effects may have pre-tax implications. Several are discussed below, but this is not an exhaustive list.

Long-lived asset and goodwill impairment considerations

A company tests its asset groups for recoverability whenever events occur or circumstances change that indicate its long-lived assets may not be recoverable. The company forecasts future cash flows directly associated with an asset group to determine if the net cash flows of the group exceed its carrying amount. While the cash flows are usually forecasted on a pre-tax basis, the company should consider whether the 2017 Act will affect expected cash inflows (e.g., revenues) and outflows (e.g., cost of revenues) of its asset groups at a level that would constitute a triggering event to test for recoverability.

Goodwill is tested annually for impairment and in the interim if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Depending on how the 2017 Act affects the fair value and carrying amount of a reporting unit, it may result in a triggering event to test goodwill for impairment.

The fair value of a reporting unit is the price the selling entity would receive in an orderly transaction with a market participant at the impairment test date. If an entity is testing a reporting unit for impairment at December 31, 2017, we would expect the effects of the 2017 Act to be considered by market participants and reflected in the determination of fair value.

The carrying amount of a reporting unit should be based on the carrying amounts of the assets and liabilities comprising the reporting unit as reflected in the company's balance sheet on the impairment test date. Deferred taxes originating from temporary differences related to the reporting unit's assets and liabilities should be included in the carrying amount of the reporting unit. Deferred tax assets generated from net operating loss carryforwards and tax credits may be included in the reporting unit depending on facts and circumstances. The impact of the 2017 Act on a company's deferred tax balances should not be adjusted for the purpose of conducting a goodwill impairment test unless the entity has recorded such changes as of the impairment testing date.

Hedging

Companies may designate forecasted transactions as the hedged item in a cash flow hedge. This may include things like forecasted sales, forecasted purchases, or forecasted interest payments. To qualify for hedge accounting, the forecasted transactions must be probable of occurring. Companies should assess whether aspects of tax reform may change the probability of forecasted transactions occurring. If a hedged forecasted transaction is no longer probable of occurring, than hedge accounting must be discontinued and amounts reported in accumulated other comprehensive income must be immediately reclassified into current earnings.

In addition, companies that employ after-tax hedging strategies should also consider the impact of the legislation on their hedging relationships. A change in the tax rate used to determine the tax effect of gains and losses on the hedging instrument can impact the hedging relationship and may require a company to change the hedge ratio through a dedesignation and redesignation of the hedging relationship. Companies that engage in after-tax net investment hedging should evaluate the impact of the change in tax rate in determining: (1) whether there is sufficient net investment in the hedged foreign operation after consideration of the tax effects, (2) whether the hedge is highly effective after consideration of the tax effects, and (3) if the company has not yet adopted the new hedging guidance (ASU 2017-12), the amount of ineffectiveness in the hedging relationship.

Companies that engage in after-tax net investment hedging should also consider the impact of the tax law change on the balance of their net investment (the hedged item). Companies designate the opening net investment balance in a net investment hedge. The impacts of the tax legislation on the hedged investment should be considered for any hedging relationships designated after enactment, including both new hedges and any cases when the hedging instrument is dedesignated and redesignated. Companies also need to evaluate the impact in determining the opening net investment balances (e.g., as of January 1, 2018 for a calendar year company) in hedged foreign subsidiaries for all net investment hedges.

Equity method investments for the benefit of tax credits

Companies may own equity method investments in flow-through entities to receive tax credit benefits earned by the investee. Common examples of these credits include qualified affordable housing credits, solar credits, and wind credits. Companies should consider whether aspects of tax reform may indicate that the value of their equity method investment could be impaired. This would generally be assessed under ASC 323, *Investments -- equity method and joint ventures*.

Equity method investments in qualified affordable housing projects that are accounted for using the proportional amortization method should be assessed for impairment under ASC 323-740. Because the investment balance in a qualified affordable housing projects essentially represents the collection of future tax benefits the company expects to receive (via credits and tax deductions associated with losses flowing through to the investor), companies electing the proportional amortization method under ASC 323-740 are required to amortize the investment balance each period. The amortization amount is determined by multiplying the investment balance by a ratio of the current year tax benefits divided by the total expected tax benefits over the life of the investment.

Tax reform will change the expected tax benefits due to the flow-through losses providing less of a benefit at a 21% tax rate than they would have at a 35% tax rate. We believe that it is appropriate for companies to adjust the proportional amortization calculation to reflect the expected tax benefits at the new rate, which will result in a “catch up” in amortization of the investment balance. Consistent with the annual amortization charge, we believe this “catch up” should be reflected in income tax expense. If there is any indicator that it is more likely than not that the new carrying value will not be realized (e.g., if the carrying value exceeds the remaining balance of tax credits and expected future deductions), companies should assess the investment for impairment using the guidance in ASC 323-740.

Statutory accounting implications

In addition to the impacts under US GAAP noted above, there will be corresponding impacts to statutory income tax balances. For example, the recognition of the remeasurement of deferred tax values is not subject to the normal SSAP 101 intraperiod allocation rules, which allocates change in deferred income tax between separate components of surplus, e.g., unrealized gains /losses. Consequently, absent relief from the NAIC or state regulatory agencies, statutory basis reporting entities must contend with disproportionate tax effects lodged in different components of surplus.

Admissibility of deferred tax assets

The 2017 Act will have a significant impact on the net admitted deferred tax asset, not only because of the 40% reduction in the applicable tax rate.

Under SSAP 101, paragraph 11.a., deferred tax assets are admitted to the extent that taxes paid in prior years can be recovered through (hypothetical) loss carrybacks for existing deductible temporary differences that are expected to reverse during the corresponding timeframe. With the elimination of the NOL carryback provision for life insurance companies, the admissibility provisions of SSAP 101, paragraph 11.a., will be less relevant as only capital character deductible temporary differences may support admitted deferred tax assets via 11.a. carryback.

Consequently, life insurance companies that have historically reported a substantial amount of net admitted deferred tax assets under SSAP 101, paragraph 11.a., will now have to rely more heavily on the provisions of SSAP 101, paragraph 11.b., which requires the use of complex and subjective calculations including forecasts of projected income.

Although non-life insurance companies did not lose NOL carryback, the application of the SSAP 101, paragraph 11.a. test is still impacted by the 2017 Act. For next two years, non-life insurance companies will face the prospect of tax rates in the carryback period that do not agree with the applicable tax rate used to measure deferred tax values as of the reporting date. Furthermore, any hypothetical loss carryback to pre-2018 tax years will need to consider the impact of AMT, despite its repeal for tax years after 2017. These circumstances may add additional complexity to the calculation in the near term.

Under SSAP 101, paragraph 11.b., deferred tax assets are admitted based upon the expected realization of deferred tax assets based upon deductible temporary differences estimated to reverse over the applicable period, but not to exceed the applicable percentage of modified surplus (realization test). The realization of deferred tax assets is determined by computing future tax “with and without” the estimated reversing temporary differences.

Tax reform impacts the computation of future taxable income through the change in or creation of book tax differences; and therefore, the results of the realization test. For example, the changes in the proration calculation, and underlying change to the dividends received deduction, will alter taxable income compared to a similar calculation made under prior law.

Depending upon facts and circumstances, the calculation of taxable income in the realization period will need to incorporate these tax law changes. Of course, one favorable change is the repeal of AMT, which may produce sufficient simplification to offset the burden of new provisions.

For life insurance companies, as noted above, the loss of NOL carryback places greater emphasis on the results of the 11.b. calculation. Fortunately, the reduced value of the gross DTA, measured at 21%, may relieve potential pressure from the percentage of surplus limitation. That is, the 40% reduction in the gross deferred tax asset value will likely allow more of the net deferred tax asset to be admitted under the realization test provided there is sufficient reversing deductible temporary differences and taxable income in the with and without calculations. Another impact of the loss of NOL carryback is that within the 11.b. test, life insurance companies will not be able to carry back to offset any losses from years two or three.

Under SSAP 101, paragraph 11.c., deferred tax assets not admitted via paragraphs 11.a. or 11.b. may be admitted if such deferred tax assets can be offset by existing gross deferred tax liabilities. In this regard, reporting entities are instructed to consider reversal patterns at a level consistent with the valuation allowance assessment, as well as any significant and relevant historical and / or currently available information regarding reversal patterns or the likelihood of offset.

Certain elements of tax reform may impact reversal patterns or the ability of offset. For example, the loss of NOL carryback for life insurance companies would prevent the use of carryback to cure a timing mismatch - deferred tax liabilities reversing before deferred tax assets. This would be applicable to existing 807(f) deferred tax liabilities that reverse in the three year reversal period. As the deferred tax assets remaining after the 11.a. and 11.b. test are by definition likely reversing outside the three year reversal period, the portion of the 807(f) deferred tax liability reversing in three years would not be available to offset the remaining deferred tax assets. A fresh look at the potential for timing mismatches is recommended.

Life insurance companies - Interest maintenance reserve (IMR)

The annual layers of the IMR are recorded and built at the current tax rate; however, future years will be established at the reduced corporate tax rate. Thus, life insurance companies will need to ensure the IMR amortization schedules properly reflect the annual layers.

Risk based capital (RBC) and dividendable surplus

As a result of the above, deferred tax adjustments, risk-based capital and dividendable surplus may be significantly impacted.

Tax sharing agreements / Tax accounting policies

SSAP 101 is applied on a separate entity basis. In cases where the insurance company joins in the filing of a consolidated return, SSAP 101, paragraphs 16 and 17, provide that a written income tax allocation agreement is required. This agreement impacts the determination of admitted deferred tax assets under paragraph 11.a. and the admissibility of intercompany income tax receivables. Given the significance of tax reform, it is recommended that income tax allocation agreements be reviewed.

Disclosures

In addition to the requirements of ASC 740 and SAB 118, SEC registrants should consider disclosure in Management's Discussion & Analysis of known trends or uncertainties that are reasonably likely to have a material impact on their financial condition or results of operations. The discussion should generally address the potential effects of the 2017 Act on the variability of earnings, financial condition, and liquidity. For example, the toll charge liability could result in significant cash requirements, driving the need for enhanced liquidity disclosures. It is important that the disclosures are balanced between impacts of the 2017 Act that potentially result in a tax benefit and those impacts that potentially increase tax expense.

For SEC registrants, current guidance requires disclosure in the effective tax rate reconciliation footnote of individual reconciling items that are more than 5% of the amount computed by multiplying pre-tax income by the statutory tax rate. A US-based entity subject to a 35% statutory tax rate would disclose any item that increases or decreases the tax rate by 1.75% or more. This would decrease to approximately 1% with a 21% statutory rate. As a result, more items in the effective tax rate reconciliation may need to be separately disclosed, and companies may need to adjust the disclosure for prior periods presented in the financial statement for comparison purposes. For tax rate reconciliation purposes, a calendar

US-based entity will utilize a 35% statutory rate for 2017 and a 21% statutory rate in 2018.

Many companies today disclose that it is not practicable to determine the amount of unrecognized deferred tax liabilities related to investments in foreign subsidiaries and foreign corporate joint ventures. Tax reform may impact a company's continued usage of the 'impracticability' exception or may render it no longer applicable once a liability has been measured/recorded for the entire outside basis difference.

Systems, processes, and controls

Given the 2018 effective date for many of the provisions, it will be critical that companies work expeditiously to evaluate necessary changes to systems and processes to comply with the new US tax laws. Companies should assess necessary changes in their income tax accounting systems that will be impacted by tax reform legislation. Companies will need to consider changes in processes, controls, data needs, and systems. In addition, companies should ensure they have processes in place to monitor tax law and accounting developments in these areas.

The potential changes in systems and processes may result in changes in internal controls. Companies should revisit the controls they have in place to: identify tax law and accounting developments, assess the reliability of data used in the provision process, identify and monitor new deferred taxes, consider the realizability of deferred taxes, evaluate needed disclosures, and assess tax positions taken, among other items.

What's next

Enactment of US tax reform is one of the most comprehensive policy developments in many years and will bring with it complex, wide-ranging impacts to financial reporting. While the effect will vary significantly between companies, it is expected that implementing and accounting for reform will be a challenging exercise. Notwithstanding the difficulty involved, the accounting guidance requires recognition of the tax effects of tax law changes in the period in which the law is enacted. As a result, while many difficulties exist, companies will need to determine the potential implications in financial reporting to ensure they account for these changes in the period of enactment.

Additional information

To have a deeper discussion, contact:

Arthur Wightman
Territory & Insurance Leader
Email: Arthur.Wightman@bm.pwc.com
+1 441 299 7127

Colm Homan
Partner - Insurance
Email: Colm.Homan@bm.pwc.com
+1 441 299 7116

Matthew Britten
Partner - Insurance
Email: M.Britten@bm.pwc.com
+1 441 299 7265

Damian Cooper
Partner - Insurance
Email: Damian.Cooper@bm.pwc.com
+1 441 295 2000 ext. 7685