

# Tax reform impact on LTC insurance and other long-tailed health business: An actuarial perspective

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Although tax reform was frequently discussed throughout 2017, the final provisions of the law materialized quickly toward the end of the year, leaving many actuaries scrambling to absorb the provisions of the new law and discern how they could impact year-end financial reporting. This article gives an overview of the key provisions in the new law, and provides an actuarial perspective on the effect the new law could have on long-term care (LTC) insurance and long-tailed health business generally. We focus on the immediate implications of the law, but also offer some longer-term perspective on how the new law could alter the LTC marketplace broadly over the coming years.

## Overview of key provisions

The recently passed federal legislation (H.R. 1, 115th Congress) impacts many important aspects of life and health insurance taxation. The new law, effective with the first tax year beginning after December 31, 2017, changes the corporate tax rate, the methods for calculating tax reserves for life insurance companies, and rules related to the proxy deferred acquisition cost (DAC) tax. Following is a brief summary of the key changes:

- The corporate tax rate is set at 21% of taxable income.
- Tax reserves are changed such that they may not exceed 92.81% of the amount determined using the tax reserve method otherwise applicable to the contract, following an eight-year phase-in period. The tax-to-stat reserve ratio amount required to be phased in over eight years is calculated as the difference between the tax reserve at December 31, 2017, under prior law, and the tax reserve at December 31, 2017, under the new law. The difference is ratably taken into account in taxable income over the next eight years.
- Proxy DAC tax rules are changed as follows:
  - The capitalization percentage for non-group contracts is now 9.20% (previously 7.70%). The new rates are 2.45% for group contracts (previously 2.05%) and 2.09% for annuities (previously 1.75%).
  - The amortization period is extended from 10 years (prior law) to 15 years (new law). The amortization of the existing proxy DAC asset at December 31, 2017, is unchanged.

- Small company rules are generally eliminated, except that the special five-year DAC amortization for small companies is retained.

Although these changes are not effective until after December 31, 2017, and therefore do not directly impact reserves calculated at December 31, 2017, the provisions will affect projections used by many companies for cash flow testing projections. Although exact requirements of actuaries during this transition period remain uncertain, at least one state (New York) has clarified that the impact of the new tax legislation must be considered for year-end 2017 reserve testing. It is likely that other states will expect the impact of tax reform to be considered by the Appointed Actuary in some capacity—either in the baseline results or as a sensitivity test to previously completed work.

The remainder of this article offers an actuarial perspective on the important aspects of the legislation, focusing specifically on LTC insurance and other long-tailed health lines of business. Milliman does not provide tax advice, and the commentary provided in this article should not be construed as such. Companies are encouraged to seek tax or legal counsel before pursuing any particular tax strategy.

## Implications for LTC blocks

Despite the lower federal income tax rate, the new tax law has an unfavorable impact on the tax position of some LTC insurers. The reduced federal income tax rate has little impact when profit margins, and therefore generally taxable income, are small. When profit margins are negative, the lower tax rate is, itself, unfavorable. The lower tax rate reduces the tax credit generated by a loss on a block of LTC business that can be used to offset positive taxable income elsewhere within a tax reporting entity. In some cases, the small, if any, reduction in cash tax payments caused by the lower tax rate is more than offset by the changes to the proxy DAC rules and the limitations on future tax-to-stat reserve ratios.

Changes to the proxy DAC rules both increase the amount that is capitalized to the proxy DAC asset and extend the period over which the insurer recovers this “interest-free loan” to the federal government. Our early modeling of this provision

suggests that, for a “typical” LTC block, the change to the proxy DAC rules could increase the present value effective tax rate by approximately 1%, e.g., from 21% to 22%. The present value effective tax rate refers to the present value of federal income taxes divided by the present value of future statutory gains, calculated at a 4% discount rate.

The new limitation on the tax-to-stat reserve ratio can have a much larger impact on many LTC blocks, which generally carry large reserves relative to the amount of statutory profits and taxable income. Here, our early modeling suggests that the change in the limitation on tax reserves could increase the present value effective tax rate, perhaps even above the level that would have been projected under the prior law—e.g., as high as 35% to 40% at the upper end of the range—and therefore may make tax reform unfavorable overall to some LTC companies. Because the new law describes the phase-in of the tax reserve step-down as an annual increment to taxable income calculated under the old law, this conclusion, and the effective tax rate that companies will realize, is materially dependent upon the tax-to-stat ratio under prior law. Indeed, some companies may see a favorable outcome from the new law. Ultimately, the tax-to-stat reserve differential is only temporary and is reversed as the block runs off. However, the tax reserve “step down” due to the new law is heavily weighted toward the early years and only slowly reverses for long-tailed business. The impact on a present value basis can be therefore quite material.

It is logical to expect that this situation could improve with higher profit margins and, for some blocks, this may be true. However, higher profit margins generally arise from higher statutory reserves, which, under the new law, come with a proportionately larger increment to taxable income over the next eight years, as the tax reserve phases down to the new 92.81% limit. Each company will want to separately consider the impact the tax law will have on its individual tax position.

Interestingly, although the tax law describes an eight-year phase-in to the 92.81% limitation, the prescribed mechanism for implementing the phase-in would appear to cause companies to reach the limit either before or after the eight-year period has expired. The law requires that “the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of such reserve determined as if the proposal had applied for that year *is taken into account for each of the eight taxable years following that preceding year, one-eighth per year.*” A strict reading of the provision is that the dollar amount of the difference is reflected in taxable income each year for the next eight years. For a mature block of business that has reached the point where tax reserves decrease each year, the prescribed method will result in a tax-to-stat ratio that reaches 92.81% before the eight-year period has expired. For a block of business that is still building reserves, the opposite is true. In the former case, the impact of tax reform may be greater than initially envisioned.

It is unclear whether the limitation on the tax-to-stat reserve ratio applies to the disabled life reserve, or only the active life reserve. A conservative reading of the law would suggest that the limitation applies to both. The new law repeals the reference to the federally prescribed interest rate, which defined the difference between statutory and tax reserves under the prior law. In the absence of any formally prescribed method for calculating a disabled life tax reserve, the conservative approach would be to assume that the limitation applies to all reserves, including the disabled life reserve. Others have argued that disabled life reserves do not fit the definition of a “life insurance reserve” as that term is used in the law, and therefore requires special treatment (presumably that the tax-to-stat limitation does not apply). We expect that formal guidance will be forthcoming on this issue. In the meantime, our experience is that many companies are planning for the conservative approach, i.e., assuming that the limitation will apply to the disabled life reserve.

## Transaction pricing, capital issues, and other considerations

The new law has the potential to shift the landscape for LTC mergers and acquisitions (M&A) activity or for reinsurance deals. Arguably, transaction tax benefits have motivated much of the activity in this area over the last several years. The only general statement one can make is that things have changed—the dollar amount of the transaction tax benefit and the party to which it accrues may have changed as a result of the new law. This statement applies equally to statutory and GAAP results—while statutory value may drive transaction activity, GAAP reserves and value of business acquired (VOBA) will be significantly impacted by tax reform as well. Early indications are that companies are thinking holistically about how tax reform reflects both accounting frameworks and economic values of deals. Additionally, given the meaningful consequences discussed in the preceding section, it seems that the new law could spur a strategic review of options for offshore reinsurance options. Offshore arrangements are often motivated by factors including tax and capital considerations. With a potential change in both of them, companies may take this opportunity to examine strategic reinsurance options.

Another potential opportunity exists with respect to combining different types of business. In large part, the unfavorable nature of the tax law for many LTC companies arises from the reserve-intensive nature of the business. Less reserve-intensive products—e.g., term life insurance or short-tailed health business—may have a markedly different tax profile. It may be possible, either within an existing corporate structure or through transactions, to pursue combinations of different blocks of business that maximize tax efficiency.

Because it becomes effective with the first taxable year beginning after December 31, 2017, the new law has no immediate consequence on required capital as of year-end 2017. Looking forward, it is possible that the new law could impact

the tax effect included in the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) calculation. This seems to be an area that would require the attention of, or at least clarification from, the NAIC within the next year. In the meantime, some companies are considering what capital requirements and RBC ratios would look like under the 21% federal tax rate. This could have a nontrivial impact on transaction pricing.

There may be opportunities for strategic tax planning to create value (or at least mitigate losses) from the change in the law. The new law does provide some opportunity in this respect. As with the prior law, the new law does not permit deduction of asset adequacy or deficiency reserves for federal income tax purposes. However, the law does change the phase-in period for a change in method of accounting—for example, a strengthening of the valuation basis. Prior law allowed for such a strengthening to be phased in ratably over a 10-year period. The new law makes the treatment of a change in accounting method for life insurance companies consistent with the general provisions of Section 481(a), allowing a four-year phase-in of a reserve strengthening. This is potentially good news for LTC blocks with asset adequacy or premium deficiency reserves. The four-year phase-in allows for quicker recognition of the tax benefit than allowed under prior law, and may also offset some or all of the impact of the new limitation on tax-to-stat reserves.

Care is necessary, however, to distinguish between asset adequacy and premium deficiency reserves that are expected to be permanent (and therefore likely candidates for taking advantage of the tax deduction) versus those expected to be temporary. In the latter case, the tax benefit may not be large enough to compensate for locking in reserves on a more conservative basis than is used currently.

If the company has an existing asset adequacy or premium deficiency reserve, of which at least a portion is expected to be permanent, the adverse implications of the new law can be more than fully offset. We say “more than fully” because the reserve strengthening could be phased in more quickly (four years) than the new limitation on tax reserves (eight years).

Overall, we expect that the next several months will be interesting times for actuaries as we deal with financial reporting during this transition period. Although there are certainly some provisions of the new law that will be viewed unfavorably by life and health insurers, we also see emerging opportunities for those who think strategically and proactively plan for the new tax landscape.



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