



Treasury and IRS release additional corporate AMT guidance focused on the insurance industry

Tax Alert

Overview

The Inflation Reduction Act, [P.L. 117-169](#), signed into law by President Biden on August 16, 2022, included a 15-percent corporate alternative minimum tax (CAMT) on "adjusted financial statement income" (AFSI) of applicable corporations. The CAMT is effective for taxable years beginning after December 31, 2022.

On December 27, 2022, the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released [Notice 2023-7](#), which announced their intention (i) to issue proposed regulations that will address the application of the CAMT consistent with that notice and (ii) to provide additional interim guidance intended to help avoid substantial unintended adverse consequences to the insurance industry from the application of the CAMT. (Our prior Tax Alert discussing Notice 2023-7 can be found [here](#).) On February 17, 2023, Treasury and the IRS released that additional interim guidance in the form of [Notice 2023-20](#) (the "Notice").

In brief, the Notice addresses certain issues related to the treatment under the CAMT of life insurance company separate account assets that are marked to market for financial statement purposes, the treatment of certain items reported in other comprehensive income (OCI), and the treatment of embedded derivatives arising from certain reinsurance contracts. Specifically, sections 3 through 5 of the Notice provide interim guidance that covers time-sensitive issues concerning application of the CAMT as follows:

- Section 3 of the Notice describes rules that address certain CAMT issues regarding variable contracts and "similar contracts."
- Section 4 of the Notice describes rules that address certain CAMT issues regarding funds withheld reinsurance and modified coinsurance agreements.
- Section 5 of the Notice describes rules that address certain issues that arise under the CAMT for certain formerly tax-exempt entities whose exemption from U.S. federal income taxation was repealed by statute and as to which Congress provided special rules for determining the U.S. federal income tax basis in their assets held when the repeal of their exemption became effective.

Taxpayers may rely on the interim guidance provided in the Notice prior to the issuance of the proposed regulations, which are anticipated to include rules consistent with those provided in sections 3 through 5 of the Notice and to be applicable for tax years beginning after December 31, 2022. The Notice invites comments to be submitted by April 3, 2023, on questions arising from the interim guidance.

Section 3: AFSI Adjustments for Covered Variable Contracts

General Rule. Section 3.02(1) of the Notice provides a rule addressing the AFSI adjustments for Covered Variable Contracts. Specifically, for purposes of determining AFSI of a Covered Insurance Company issuing Covered Variable Contracts, to the extent (i) a change in the value of the Covered Investment Pool for such Covered Variable Contract(s) results in a change to the amount of the Covered Insurance Company's obligations to the holders of such Covered Variable Contract(s) by reason of law, regulation, or the terms of one or more such Covered Variable Contracts, and (ii) such change in the amount of the obligation is reflected in the Covered Obligations, then such change in the amount of the Covered Obligations for a taxable year is disregarded to the extent of the "[section 56A\(c\)\(2\)](#) exclusion amount" for that taxable year. For purposes of this rule, the following definitions apply:

- The **section 56A(c)(2) exclusion amount** for Covered Obligations for a taxable year is equal to the amount of financial accounting gains and losses in the Covered Investment Pool for the Covered Variable Contract(s) to which the Covered Obligations relate that is (i) taken into account in Net Income of the Covered Insurance Company for the taxable year and (ii) disregarded under section 56A(c)(2)(C) or section 56A(c)(2)(D)(i) for purposes of determining AFSI of the Covered Insurance Company for that taxable year.
- A **Covered Variable Contract** is one of the following types of contracts:
 - A variable contract, as defined in [section 817\(d\)](#). In general, variable contracts are life insurance and annuity contracts under which the amount of the insurance company's obligation depends, at least in part, on the value of the assets held in a separate account that is segregated from the general asset accounts of the insurance company.
 - A closed block contract, which the Notice describes as resulting from the demutualization of a mutual insurance company. As described in the Notice, a mutual insurance company may create a "closed block" for the benefit of holders of certain insurance contracts issued by the company in connection with the demutualization process. Generally, when a closed block is created, the company allocates assets to the closed block in an amount such that the assets, together with future revenue from the closed block, are expected to provide sufficient cash flow for future policy benefits, certain expenses, and policyholder dividends determined in a manner consistent with the manner in which they were determined prior to the demutualization. The closed block assets and the revenue from the closed block benefit only holders of the policies in the closed block.
 - A contract issued by a foreign insurance company that is regulated as a life insurance or annuity contract in the jurisdiction in which it is issued and for which the insurance company's obligations to the contract holder (and the company's corresponding reserves) must reflect (in whole or in part) the change in the value of a designated pool of investments supporting the contract.
- A **Covered Insurance Company** is (i) a company subject to tax under Subchapter L of the Internal Revenue Code of 1986, as amended (the Code), or (ii) a foreign company that is subject to regulation as an insurance (or reinsurance) company by its home country and is licensed, authorized, or

regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts.

- A **Covered Investment Pool** is a pool of investment assets designated to support one or more Covered Variable Contracts.
- **Covered Obligations** are the financial accounting liabilities, including contract reserves and claims or benefits payable, that reflect a Covered Insurance Company's obligations under one or more Covered Variable Contracts and are taken into account in determining Net Income.
- **Net Income** is the net income or loss as set forth on the AFS (that is, the applicable financial statement, as defined in [section 451\(b\)\(3\)](#) or as specified by Treasury in regulations or other guidance) that covers that taxable year.

Example. The following example from section 3.02(2) of the Notice illustrates the rule and definitions described above:

Facts. A is a life insurance company subject to tax under Subchapter L of the Code and has a taxable year and accounting period that is based on the calendar year. A uses U.S. GAAP to prepare its AFS. On January 1 of Year 1, A issues a variable life insurance contract (as described in section 817) to an individual, X. A owns assets that support A's contractual obligation to X and holds those assets in a separate account that is segregated from the general asset accounts of A. A accounts for its contractual obligations to X in its Net Income. The separate account assets are stock in unrelated corporations. At the end of Year 1, no assets that support X's variable contract have been sold, and the fair market value of such assets has increased by \$10x. Pursuant to the terms of the variable life insurance contract, the increase in the value of the assets supporting X's variable contract caused A's contractual obligation to X to increase by \$10x. On A's AFS, the \$10x increase in the value of the assets supporting the variable contract is included in Net Income and offsets the \$10x increase in A's contractual obligation to X (which reduces A's Net Income).

Analysis. A is a Covered Insurance Company, and the variable life insurance contract that A issued to X is a Covered Variable Contract. The assets in the separate account that A holds to support its contractual obligations to X constitute a Covered Investment Pool, and A's contractual obligation to X is reflected in A's Covered Obligations. Pursuant to section 56A(c)(2)(C), although the \$10x unrealized gain in the Covered Investment Pool is taken into account in Net Income on A's AFS, it is not included in A's AFSI because it is not a dividend from another corporation and is not includible in the gross income of A under Chapter 1 of the Code. The \$10x increase in the Covered Obligations is taken into account in Net Income on A's AFS. Pursuant to section 3.02(1) of the Notice, for purposes of determining A's AFSI, the change in the amount of the Covered Obligations for the taxable year is disregarded to the extent of the section 56A(c)(2) exclusion amount for the taxable year. The relevant section 56A(c)(2) exclusion amount for the taxable year is equal to the \$10x unrealized gain in the Covered Investment Pool because such \$10x unrealized gain is taken into account in A's Net Income for the taxable year and is disregarded under section 56A(c)(2)(C) for purposes of determining A's AFSI for that taxable year. Accordingly, the \$10x increase in the Covered Obligations is also disregarded in determining A's AFSI for the taxable year. Thus, both the unrealized gain and offsetting change in the Covered Obligations are disregarded for purposes of determining A's AFSI, which eliminates what would otherwise be a difference between A's AFSI and A's life insurance company taxable income.

Observations. In crafting the rule of section 3.02(1) of the Notice, it appears that Treasury and the IRS addressed a chief concern of the life insurance industry; namely, that, absent guidance, section 56A(c)(2)(C) and section 56A(c)(2)(D) could generate significant differences between AFSI and Net Income of a Covered Insurance Company issuing Covered Variable Contracts. For example, under an AFS prepared according to either U.S. GAAP or IFRS

for a Covered Insurance Company issuing Covered Variable Contracts, unrealized gain or loss on the assets supporting such contracts (that is, the Covered Investment Pool) is included in the net income or loss set forth on the AFS, and there is an offsetting adjustment to certain liabilities to reflect the resulting change in the company's contractual obligations to contract holders, which also is included in the net income or loss set forth on the AFS. However, unrealized gain or loss on some categories of the supporting assets, but not the offsetting adjustment to liabilities, may be required to be disregarded under section 56A(c)(2)(C) or section 56A(c)(2)(D)(i) for purposes of determining AFSI, resulting in a mismatch that could significantly overstate or understate AFSI relative to taxable income. Overall, the Notice reflects an intent on the part of Treasury and the IRS to not double-count, omit, or impute income in connection with Covered Variable Contracts, but the Notice does not go so far as to suggest that section 56A(c)(2)(C) and section 56A(c)(2)(D) do not apply in that context.

As for the definition of Covered Insurance Company, that term's inclusion of "a foreign company that is subject to regulation as an insurance (or reinsurance) company by its home country and is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts" presumably is intended to cover certain controlled foreign corporations and U.S. branches of foreign insurance companies for purposes of determining the AFSI of such entities, at least to the extent that they issue Covered Variable Contracts (which term also is defined in a way that appears to contemplate this outcome).

Request for Comments. The Notice requests comments regarding, among other topics, whether the rule set forth in section 3.02 of the Notice should apply to other types of contracts in addition to the contracts described in the Notice, that is, in addition to variable contracts (as defined in section 817(d)), closed block contracts, and certain contracts issued by foreign insurance companies.

Section 4: AFSI Adjustments for Covered Reinsurance Agreements

General Rule. Section 4.02(1) of the Notice sets forth certain exclusions from AFSI where a Covered Insurance Company (as defined above) is a party to a Covered Reinsurance Agreement, that is, a funds withheld reinsurance or modified coinsurance agreement described in section 2.03(2) of the Notice and any retrocession of all or part of the risk under such an agreement. Specifically, for a Covered Insurance Company that is a party to a Covered Reinsurance Agreement, the following changes accounted for separately in the AFS with respect to each such agreement are excluded from AFSI:

- For the ceding company holding the Withheld Assets (as defined below), changes in Net Income (as defined above) as a result of changes in the amount of the Withheld Assets Payable (as defined below) to the reinsurer that correspond to the unrealized gains and losses in the Withheld Assets to the extent such unrealized gains and losses are not included in AFSI.
- For the reinsurer, changes in Net Income as a result of changes in the amount of the Withheld Assets Receivable (as defined below) from the ceding company that correspond to the unrealized gains and losses in the Withheld Assets; provided, however, that such exclusion will be reduced to the extent the reinsurer's Withheld Assets Receivable is offset and the changes in its Net Income are reduced as a result of accounting for a retrocession of the reinsured risk.

Observation. Query whether the Notice's differing language for each of the ceding company and the reinsurer is intended to have differing impacts. Specifically, for the ceding company, the Notice excludes from AFSI changes in Net Income as a result of changes in the amount of the Withheld Assets

Payable to the reinsurer that correspond to the unrealized gains and losses in the Withheld Assets "to the extent such unrealized gains and losses are not included in AFSI," whereas, for the reinsurer, the Notice excludes from AFSI changes in Net Income as a result of changes in the amount of the Withheld Assets Receivable from the ceding company that correspond to the unrealized gains and losses in the Withheld Assets.

As noted above, a **Covered Reinsurance Agreement** is a funds withheld reinsurance or modified coinsurance agreement described in section 2.03(2) of the Notice. As described in that section of the Notice:

- In funds withheld reinsurance and modified coinsurance agreements, from a legal title and financial accounting perspective, the ceding company retains the supporting assets (**Withheld Assets**) as security for the reinsurer's obligations under the reinsurance agreement.
- The ceding company records a liability (**Withheld Assets Payable**) to the reinsurer to reflect the assets it has retained. Under U.S. GAAP and IFRS, the unrealized gains and losses from certain of the Withheld Assets are generally accounted for as part of the ceding company's OCI. However, any related change in the Withheld Assets Payable, which is generally equal to the unrealized gains and losses included in OCI, is accounted for as part of the net income or loss of the ceding company, as set forth in the ceding company's AFS, and is not offset by the unrealized gains and losses that are included in OCI.
- The reinsurer has a corresponding asset (**Withheld Assets Receivable**) and the unrealized gains and losses on the Withheld Assets are generally accounted for as part of the net income or loss of the reinsurer that is set forth on the reinsurer's AFS.
- Financial accounting guidance states that the ceding company's Withheld Assets Payable and the reinsurer's Withheld Assets Receivable include an embedded derivative.

Example. The following example from section 4.02(3) of the Notice illustrates the rule and definitions described above:

Facts. Each of A and B is a life insurance company subject to tax under Subchapter L of the Code and has a taxable and accounting year that is based on the calendar year. Each of A and B uses U.S. GAAP for purposes of preparing its AFS. On January 1 of Year 1, A, the ceding company, enters into a funds withheld reinsurance agreement with B, the reinsurer. B does not retrocede any risk covered by the funds withheld reinsurance agreement. Pursuant to the terms of the agreement, from a legal title and financial accounting perspective, A retains the assets supporting the reinsured contracts (the Withheld Assets). A has a liability to B with respect to the Withheld Assets (the Withheld Assets Payable). A reflects all the unrealized gains and losses in the Withheld Assets in OCI on its AFS, and A accounts for the corresponding changes in the Withheld Assets Payable as part of its Net Income. B records an asset that corresponds to A's Withheld Assets Payable (the Withheld Assets Receivable), and B accounts for changes in the Withheld Assets Receivable as part of its Net Income.

At the end of Year 1, no Withheld Assets have been sold, and the fair market value of the Withheld Assets has increased by \$10x. On A's AFS, it includes the \$10x unrealized gain in OCI and records the effect of the \$10x increase in its Withheld Assets Payable in its Net Income. B records the effect of a corresponding \$10x increase in its Withheld Assets Receivable in its Net Income.

Analysis. Each of A and B is a Covered Insurance Company, and the funds withheld reinsurance contract is a Covered Reinsurance Agreement. The \$10x of unrealized gain in the Withheld Assets is included in OCI on A's AFS. Pursuant to section 4.02(1)(a) of the Notice, to the extent the \$10x of unrealized gain is not included in A's AFSI, the amount included in A's Net

Income as a result of the \$10x increase in A's Withheld Assets Payable is excluded from A's AFSI.

The amount included in B's Net Income as a result of the \$10x increase in B's Withheld Assets Receivable corresponds to the unrealized gain in the Withheld Assets. Pursuant to section 4.02(1)(b) of the Notice, this \$10x increase is excluded from B's AFSI.

Observation. Another issue of primary concern for the life insurance industry with respect to the computation of AFSI has been the potential distortions that may arise from the U.S. GAAP accounting treatment of funds withheld reinsurance and modified coinsurance agreements. Specifically, the "embedded derivative" referenced in the Notice has been suggested to cause an income statement mismatch between the movements in value in the Withheld Assets, which pass through OCI at the ceding company, and the movements of the Withheld Assets Payable and the Withheld Assets Receivable, which pass through Net Income. The rule of section 4.02(1) of the Notice appears to address this mismatch concern by generally removing the movements of the Withheld Assets Payable (from the ceding company's perspective) and the Withheld Assets Receivable (from the reinsurer's perspective) from AFSI.

Exclusion Not Applicable Where "Fair Value" Election Made. The exclusion provided in section 4.02(1) of the Notice will not apply to the extent that (i) the Covered Insurance Company elects to account for one or more items relevant to the Covered Reinsurance Agreement (offsetting item) at fair value on its AFS and (ii) the election results in changes in the fair value of the Withheld Assets Payable (for the ceding company) or the Withheld Assets Receivable (for the reinsurer) and changes in the fair value of the offsetting item both being accounted for either through Net Income or through OCI on the AFS of the Covered Insurance Company.

Observation. As described in the Notice, Treasury and the IRS understand that, in some circumstances, each of the ceding company and the reinsurer may be able to make certain types of "fair value" elections for AFS purposes to change the accounting treatment of one or more items relevant to a funds withheld reinsurance or modified coinsurance agreement such that both offsetting items related to the unrealized change in the value of the Withheld Assets run through OCI or both run through Net Income set forth on the AFS. For example, the Notice asserts that, under U.S. GAAP, a ceding company may be able to make a "fair value option" election that would move the unrealized gains or losses on certain of the Withheld Assets into Net Income, which would offset the changes in its Withheld Assets Payable to the reinsurer that are reflected in the Net Income set forth on the ceding company's AFS. That said, the mechanics and impact of such an election by the reinsurer for AFS purposes are not well defined in the Notice.

Request for Comments. The Notice invites comments regarding, among other topics, (i) the inclusion of a reference to, and the definition of, the "embedded derivative," and (ii) how best to describe the "fair value" elections noted above and whether the rule in section 4.02(2) of the Notice appropriately adjusts the general rule in section 4.02(1) of the Notice for such elections.

Section 5: AFSI Determination Respects Congressional "Fresh Start"

General Rules. Section 5.02 of the Notice provides several rules related to so-called **Fresh-Start Entities**, which the Notice defines as any formerly tax-exempt entity the repeal of whose Subtitle A exemption is described in section 2.04(1) through (3) of the Notice. As pertinent here, section 2.04(2) of the Notice describes "existing Blue Cross or Blue Shield organizations" (as defined in [section](#)

[833\(c\)\(2\)](#)), and section 2.04(3) of the Notice refers to certain "pension business entities" that became subject to taxation under Subtitle A of the Code solely by reason of section 1042(a) of the Taxpayer Relief Act of 1997, P.L. 105-34.

For purposes of determining AFSI of a Fresh Start Entity described in section 2.04(2) or section 2.04(3) of the Notice (and any successor(s) under [section 381](#)), the gain or loss (but not depreciation, amortization, or other amounts) for any asset held by the Fresh Start Entity since the first day of its first taxable year beginning after the "testing date" is determined using its adjusted tax basis for such asset. Further, for this purpose, the testing date is December 31, 1986, in the case of a Fresh Start Entity described in section 2.04(2) of the Notice, and December 31, 1997, in the case of a Fresh Start Entity described in section 2.04(3) of the Notice.

Observation. For the Fresh-Start Entities noted above, the adjusted basis of any asset held on the first day of its first taxable year beginning after the testing date was treated as equal to the asset's fair market value on such day for purposes of determining gain or loss under Subtitle A of the Code. Thus, for purposes of determining gain or loss for such assets for AFSI purposes, the Notice appears to give effect to the fair market value basis that the Fresh-Start Entities were provided with respect to such assets for purposes of determining gain or loss for U.S. federal income tax purposes.

Request for Comments. The Notice requests comments regarding, among other topics, whether a rule like that in section 5.02 of the Notice should apply to any other entities.

ASC 740 Considerations

The issuance of the Notice represents new information which should be considered in the reporting period that the Notice was issued. Entities in their first reporting period and tax year that begins after December 31, 2022 should consider the impact of the Notice on their estimate of current taxes payable and related CAMT credit. Impacted Taxpayers that require a valuation allowance for some portion or all of their deferred tax asset (DTA) resulting from the CAMT credit should adjust their estimate of their annual effective tax rate beginning with the reporting period in which the Notice was issued. There are limited circumstances in which the CAMT can interact with an entity's valuation allowance assessment on its DTAs in the regular tax system, see [Tax Alert dated August 16, 2022 \(Last updated November 8, 2022\), Emerging ASC 740 Issues – Recent Tax Legislation](#) for a more detailed discussion. In these situations, entities should consider the impact of the Notice, if any, on their valuation allowance assessment in their reporting period which includes February 17, 2023.



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