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Insurance industry insights from latest CAMT guidance

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. (Our prior Tax Alert discussing Notice 2023-20 can be found here.) In brief, Notice 2023-20 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.

Notice 2023-64 (the Notice), which was released by Treasury and the IRS on September 12, 2023, builds on the initial framework of interim guidance for the CAMT set forth in Notice 2023-7 and Notice 2023-20. (Our initial Tax Alert discussing Notice 2023-64 can be found here.) In brief, the Notice provides interim guidance on, among other topics, the identification of an "applicable financial statement" (AFS), the determination of "financial statement income" (FSI), and certain adjustments necessary to determine AFSI.

In general, taxpayers may rely on the interim guidance provided in the Notice, Notice 2023-7 (as modified and clarified by the Notice), and Notice 2023-20 (collectively, the Interim CAMT Guidance) for taxable years ending on or before the date forthcoming proposed regulations are published in the Federal Register. Further, as explained in the Notice, taxpayers may rely on the Interim CAMT Guidance "for any taxable year that begins before January 1, 2024." The

Notice invites comments to be submitted by October 12, 2023, on questions arising from the interim guidance.

Insurance Industry - Potential Issues of Interest Addressed by the Notice

Although the Notice is not directed to any particular industry, the Notice nevertheless offers clarifying guidance on several issues that may be of primary interest to participants in the insurance industry. In this regard, we discuss the following topics below:

- Considerations surrounding the adoption of new U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS®) insurance accounting standards — LDTI[1] and IFRS 17,[2] respectively;
- Determination of a taxpayer's AFS; and
- Exclusion of OCI from FSI

For a further discussion of the Notice, please see our initial Tax Alert, which can be found here.

Considerations Surrounding the Adoption of LDTI and IFRS 17

Background. Unless adopted earlier, LDTI and IFRS 17 requirements became effective for many entities on January 1, 2023. The specific LDTI and IFRS 17 transition provisions, however, differ:

- LDTI
    - Under GAAP, except for certain entities identified as smaller reporting entities, LDTI required adoption by public entities for fiscal years beginning after December 15, 2022; other entities are required to adopt for fiscal years beginning after December 15, 2025. Transition is required as of the beginning of the earliest period presented (e.g., generally, January 1, 2021 for a calendar-year public entity that adopted LDTI on January 1, 2023) unless adopted early (i.e., early adopters can elect to transition as of the beginning of the earliest prior period presented) in the adoption year financial statements. LDTI requires retrospective application of certain provisions (e.g., those related to market risk benefits or MRBs) and permits modified retrospective application of other provisions.
- IFRS 17
    - Entities preparing financial statements in accordance with IFRS are required to apply IFRS 17 for annual reporting periods beginning on or after January 1, 2023, unless adopted earlier. For IFRS 17, the date of initial application is the beginning of the annual reporting period in which the entity first applies IFRS 17. The transition date is the beginning of the annual reporting period immediately preceding the date of initial application (e.g., January 1, 2022 for an entity that adopts IFRS 17 on January 1, 2023), unless the entity elects to transition to IFRS 17 at the beginning of the earliest period presented. IFRS 17 requires retrospective application unless certain conditions are met.

In brief, LDTI and IFRS 17 represent significant changes to GAAP and IFRS accounting standards for insurance contracts, respectively, and adoption of the standards can result in retrospective adjustments to previously issued financial statements.

Anticipated Adjustments to AFSI. Section 11.02(2) of the Notice offers a framework for the adjustments to AFSI that are needed to give effect to a "change in financial accounting principle." In such a situation, AFSI must be adjusted to take into account any cumulative adjustment to the retained earnings of the Taxpayer (as defined in Section 3 of the Notice) on its AFS if such cumulative adjustment results from a change in financial accounting principle (an Accounting Principle Change Adjustment). Further, except as otherwise provided in regulations or in other guidance, the Accounting Principle Change Adjustment must be taken into account in the Taxpayer's AFSI during the period provided in Section 11.02(2)(b) of the Notice (such period, the Adjustment Spread Period Rule). The Adjustment Spread Period Rule operates as follows:

- ***Duplication***. If an Accounting Principle Change Adjustment or a Net Accounting Principle Change Adjustment (any such adjustment, an Adjustment) is necessary to prevent a duplication of an item of income, expense, gain, or loss for AFSI purposes, the Adjustment is taken into account in AFSI ratably over the four-taxable-year period beginning with the taxable year for which the change in financial accounting principle is implemented in the Taxpayer's AFS. <u>However</u>, if the Taxpayer is able to demonstrate that the duplication is reasonably anticipated to occur over a different period, the Adjustment may be taken into account in AFSI ratably over such period (not to exceed fifteen years) beginning with the taxable year for which the change in financial accounting principle is implemented in the Taxpayer's AFS.
- ***Omission***. If the Adjustment is necessary to prevent an omission of an item of income, expense, gain, or loss for AFSI purposes, and the Adjustment results in an <u>increase</u> in AFSI, the Adjustment must be taken into account in AFSI ratably over the four-taxable-year period beginning with the taxable year for which the change in financial accounting principle is implemented in the Taxpayer's AFS. If the Adjustment is necessary to prevent an omission of an item of income, expense, gain, or loss for AFSI purposes, and the Adjustment results in a <u>decrease</u> in AFSI, the Adjustment must be taken into account in full in the taxable year for which the change in financial accounting principle is implemented in the Taxpayer's AFS.
- ***Acceleration Possible.*** If the Taxpayer ceases to engage in the trade or business that is the subject of the Adjustment, the amount of such Adjustment not taken into account in AFSI in previous years must be taken into account in AFSI for such taxable year.

Observations. While LDTI or IFRS 17 is not discussed in the rules set forth in Section 11.02(2) of the Notice, this Section appears to be discussing the potential impact of an Adjustment related to the implementation of LDTI or IFRS 17 on the determination of AFSI (assuming that each of LDTI and IFRS 17 are properly construed as a "change in financial accounting principle," as used in Section 11.02(2) of the Notice). For example, to the extent that such an Adjustment is necessary to prevent the duplication of an item of income, expense, gain, or loss for AFSI purposes, these rules indicate that such amount be taken into account in AFSI either (i) ratably over the four-taxable-year period beginning with the taxable year for which the change in financial accounting principle is implemented in the Taxpayer's AFS or (ii) if the Taxpayer is able to demonstrate that the duplication is reasonably anticipated to occur over a different period, ratably over such period (not to exceed fifteen years) beginning with the taxable year for which the change in financial accounting principle is implemented in the Taxpayer's AFS. Alternatively, to the extent that such an Adjustment is necessary to prevent the omission of an item of income, expense, gain, or loss for AFSI purposes, the relevant period over which the Adjustment is taken into account in AFSI will depend on whether the Adjustment results in an increase or a decrease to AFSI.

The Notice is not clear as to how far back a Taxpayer must look to determine if an omission or duplication has occurred with respect to a change in financial accounting principle.

Although the Notice provides AFSI must be adjusted to take into account any Accounting Principle Change Adjustment, the Notice does not provide specific guidance regarding the calculation of the cumulative adjustment to retained earnings that must be taken into account for purposes of adjusting AFSI on the AFS. Further guidance on this topic may be provided in the forthcoming proposed regulations.

Prior Period AFS and AFSI Considerations. As summarized above, entities adopting LDTI or IFRS 17 are not restating their prior period financial statements (i.e., to correct an error), but may be required to retrospectively adjust comparative amounts reported in previously issued financial statements to reflect the adoption of the new standards. For example, under GAAP, entities are required to transition to LDTI as of the beginning of the first period presented in the financial statements for the year of adoption (unless early adopted). That means a calendar-yearend public entity that adopts the LDTI as of January 1, 2023 and presents two prior comparative income statements and one prior comparative balance sheet in its financial statements, would generally recognize the effects of the new basis of accounting in its 2023 financial statements by retrospectively adjusting:

1. January 1, 2021 retained earnings
2. Income statements for the years ended 2021 and 2022
3. Balance sheet as of December 31, 2022.

Thus, an initial question concerns the nature and impact of such adjustments to comparative periods presented in current year financial statements for CAMT purposes.

Section 4.02(3) of the Notice provides a definition for what constitutes a "restatement" of FSI and describes the potential impacts of such a restatement on the AFS determination for a taxable year. Specifically, Section 4.02(3) of the Notice provides as follows:

> **(3) Restatements.** If a Taxpayer restates its FSI (as defined in section 5.02(2) of this notice) for a taxable year prior to the date that the Taxpayer files its original Federal income tax return for such taxable year, the AFS that reflects the restated FSI (Restated AFS) must be prioritized over the first AFS that is issued for that specific accounting period (Original AFS). If a Taxpayer restates its FSI for a taxable year after the date that the Taxpayer files its original Federal income tax return for such taxable year, see section 11.02(3) of this notice. ***For purposes of this notice, a Restated AFS is a revised AFS for a specific accounting period that is reissued to correct the Original AFS for that accounting period. Adjustments to the financial results of a prior accounting period that are disclosed in the notes to an Original AFS for comparison purposes (for example, in the case of a change in accounting principle) do not constitute a Restated AFS for that prior accounting period for purposes of this notice.*** [Emphasis added.]

Section 11.02(3)(a) of the Notice provides a corresponding rule where a Taxpayer restates an AFS and, as a result, the Taxpayer's FSI for a taxable year is restated after the Taxpayer filed its original Federal income tax return for such taxable year. Notably, Section 11.02(3)(a) of the Notice directs that Taxpayers are to "[s]ee section 4.02(3) of this notice for what constitutes a restatement[.]"

Observation. Taking into account the emphasized language in the preceding excerpt from Section 4.02(3) of the Notice, the implementation of LDTI as a result of adoption of ASU 2018-12 or IFRS 17, in and of itself, is

not expected to give rise to a "restatement" of FSI. As a result, changes reflected in prior periods in the comparative income statement and balance sheet due to a Taxpayer's implementation of LDTI or IFRS 17 are not anticipated to impact the AFS or AFSI determinations for those prior years. That is, the rules provided in Sections 4.02(3) and 11.02(3) of the Notice, which collectively address the potential impacts associated with a "restatement" of a prior year's AFS, are not expected to impact the CAMT analysis with respect to the implementation of LDTI.

Request for Comments. Along with a general request for comments on the interim guidance, Section 16.01(3) of the Notice requests comments on two aspects of Section 11; specifically:

1. Can an Adjustment be traced to a separate trade or business (within the meaning of Treas. Reg. § 1.446-1(d))?
2. What events should be considered a cessation of a trade or business for purposes of accelerating inclusion of an Adjustment? Should rules similar to those in Section 7.03(4) of Rev. Proc. 2015-13 apply?

Determining a Taxpayer's AFS

AFS Determination Generally Follows the Prioritization Rules of Section 451(b)(3). Building upon the initial guidance set forth in Section 2.01(3)(b) of Notice 2023-7 and the statutory provision under section 56A(b), Section 4.02(1) of the Notice offers a detailed definition of AFS, which appears to be largely based on the prioritization rules set forth in section 451(b)(3) and the underlying regulations, with two notable additions. First, certain unaudited external financial statements (or audited but not certified financial statements) other than a tax return, may constitute an AFS if prepared for an external non-tax purpose and prepared using GAAP, IFRS, or any accepted accounting standard issued by an accounting standard board. Second, an income tax return or information return filed with the IRS also constitutes an AFS.

As set forth in Section 4.02(1) of the Notice, the financial statements are, in order of descending priority, as follows:

a) **GAAP statements.** A financial statement that is certified, within the meaning of Section 4.02(2) of the Notice, as being prepared in accordance with United States GAAP and is:
    i. A Form 10-K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC);
    ii. An audited financial statement of the Taxpayer that is used for:
        A. Credit purposes;
        B. Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or
        C. Any other substantial non-tax purpose; or
    iii. A financial statement, other than a tax return, filed with the Federal Government or any Federal agency, other than the SEC or the IRS;

b) **IFRS statements.** A financial statement that is certified, within the meaning of Section 4.02(2) of the Notice, as being prepared in accordance with IFRS and is:
    i. Filed by the Taxpayer with an agency of a foreign government that is equivalent to the SEC, and has financial reporting standards not less stringent than the standards required by the SEC;
    ii. An audited financial statement of the Taxpayer that is used for:
        A. Credit purposes;
        B. Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or
        C. Any other substantial non-tax purpose; or

  iii. A financial statement, other than a tax return, filed with the Federal Government, a Federal agency, a foreign government, or an agency of a foreign government, other than the SEC, the IRS, or an agency that is equivalent to the SEC or the IRS; or

c) **Other government and regulatory statements.** A financial statement, other than a tax return, filed with the Federal Government or any Federal agency, a state government or state agency, a foreign government or foreign agency, or a self-regulatory organization ***including, for example, a financial statement filed with a state agency that regulates insurance companies***, or the Financial Industry Regulatory Authority, or a comparable foreign self-regulatory organization.

d) **Unaudited external statements.** A financial statement, other than a tax return or a financial statement described in Section 4.02(1)(a) through (c) of the Notice (as articulated above), that is unaudited (or audited but not certified within the meaning of Section 4.02(2) of the Notice), prepared for an external non-tax purpose, and prepared using:
  i. GAAP;
  ii. IFRS; or
  iii. any other accepted accounting standards that are issued by an accounting standards board charged with developing accounting standards for one or more jurisdictions; or

e) **The Taxpayer's Federal income tax return or information return filed with the IRS.**

"Certified" Financial Statement. Section 4.02(2) of the Notice clarifies that a "certified" financial statement is a financial statement that is subject to **(i)** a certified opinion by an independent auditor that the financial statement is in conformity with the relevant financial accounting standards; **(ii)** a qualified or modified opinion by an independent auditor that the financial statement presents fairly the financial position, except for the effects of the matter to which the qualification or modification relates; <u>or</u> **(iii)** an adverse opinion, but only with disclosure of the disagreement with the statement.

AFS Covering a Group of Entities. Following the initial guidance set forth in Section 2.01(3)(c)(i) and (ii) of Notice 2023-7 and the statutory provisions under section 56A(c)(2)(A) and (B), Section 4.02(5) of the Notice provides rules applicable to situations where an AFS covers a group of entities (an AFS Group).

- ***General Rule.*** If a Taxpayer's financial results are consolidated with the financial results of one or more other Taxpayers on a Consolidated AFS (as defined in Section 2.03(1) of the Notice; the "AFS for the AFS Group"), the Taxpayer's AFS is the Consolidated AFS. <u>However</u>, <u>save for the two exceptions described below</u>, if the Taxpayer's financial results also are separately reported on an AFS that is of equal or higher priority to the Consolidated AFS under Section 4.02(1) of the Notice (a Separate AFS), then the Taxpayer's AFS is the Separate AFS.
- ***Exception #1: Members of a Tax Consolidated Group.*** A corporation that is a member of a Tax Consolidated Group – that is, an affiliated group of corporations that join in filing a consolidated return for U.S. federal income tax purposes – must use the Consolidated AFS that contains the financial results of the Tax Consolidated Group, regardless of whether the corporation's financial results also are reported on a Separate AFS that is of equal or higher priority to the Consolidated AFS.
- ***Exception #2: Members of a Foreign-Parented Multinational Group (FPMG).*** If **(i)** a Taxpayer is a member of a FPMG and **(ii)** the FPMG Common Parent (as defined in Section 2.04(3) of the Notice) prepares a Consolidated AFS (a FPMG Consolidated AFS) that includes the Taxpayer, the Taxpayer must use the FPMG Consolidated AFS, <u>regardless</u> of whether the Taxpayer's financial results also are reported on a Separate AFS that is of equal or higher priority to the FPMG Consolidated AFS.

> ***Observation.*** While the Notice offers clarifying guidance concerning the determination of a Taxpayer's AFS, the Notice does not appear to address situations in which a Tax Consolidated Group includes one or more members that are not part of a Consolidated AFS. For example, consider a situation in which a life insurance company is a member of a Tax Consolidated Group, but is not included in a Consolidated AFS that includes other members of the Tax Consolidated Group and, instead, prepares a Separate AFS in accordance with statutory accounting principles. Overall, the open questions surrounding this factual paradigm (and other variations) persist in the CAMT context. Notably, the Notice does address considerations raised by FPMGs in which a FPMG may file a Consolidated AFS using IFRS but a member of the FPMG may file a Separate AFS under GAAP or statutory accounting principles by requiring that a Taxpayer use the FPMG Consolidated AFS regardless of whether the Taxpayer's financial results also are reported on a Separate AFS that is of equal or higher priority to the FPMG Consolidated AFS.

Exclusion of OCI from FSI

Section 5 of the Notice adopts the term "financial statement income" – FSI – which means the net income or loss of the Taxpayer set forth on the income statement included in the Taxpayer's AFS. The Notice clarifies that FSI includes all items of income, expense, gain, and loss reflected in the net income or loss set forth on such income statement for the taxable year, including nonrecurring items and net income or loss from discontinued operations, and regardless of whether the amount is realized or recognized for U.S. federal tax purposes. <u>However</u>, as reiterated in Section 5.02(2) of the Notice, FSI does <u>not</u> include amounts reflected elsewhere in the Taxpayer's AFS, including in equity accounts such as retained earnings and OCI.

> ***Observation.*** The exclusion of OCI from FSI is generally consistent with the approach taken by Treasury and the IRS in Section 4 of Notice 2023-20, which provides rules intended to assist taxpayers in determining AFSI with respect to Covered Reinsurance Agreements (as defined in Section 2.05(5) of Notice 2023-20).

> ***Observation.*** Although retained earnings and OCI are excluded from the definition of FSI, the Notice provides that certain items within retained earnings may be included as an adjustment to AFSI to prevent certain duplications and omissions. For example, an adjustment to AFSI is required if there is a restatement of FSI.

Other Areas Explicitly Noted as Being Under Study

Section 16.02 of the Notice states that Treasury and the IRS are continuing to study issues surrounding **(i)** the scope of section 56A(c)(2)(C) (that is, the rule describing the treatment of dividends and other amounts with respect to a corporation not included in a consolidated return with the Taxpayer), **(ii)** the extent to which any unrealized mark-to-market gains and losses that are recognized in the Taxpayer's FSI should be adjusted in determining the Taxpayer's AFSI, <u>and</u> **(iii)** the manner in which a partner in a partnership determines its distributive share of partnership AFSI. As described in the Notice, Treasury and the IRS intend to address these issues in forthcoming proposed regulations.

Accounting Considerations

For U.S. GAAP and IFRS purposes, the Notice represents new information that generally should be considered in the reporting period that includes the issuance date (i.e., September 12, 2023). In determining the implications, an

entity should consider, in the reporting period the Notice was issued, whether or not it intends to follow the proposed rules described in the Notice.

Footnotes

[1] Accounting Standards Update 2018-12 (August 2018), *Targeted Improvements to the Accounting for Long-Duration Contracts*, as amended (commonly referred to as "LDTI") amends ASC 944, *Financial Services – Insurance*.
[2] IFRS 17, *Insurance Contracts*.

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