

# Treasury Provides Interim Relief for Insurance Industry Corporate Alternative Minimum Tax Friction

February 22, 2023

The Treasury Department has issued new guidance relating to insurance companies and the 15% corporate minimum tax on the book income of large corporations (the “CAMT”).<sup>1</sup> The guidance in Notice 2023-20 (the “Notice”) is intended to “help avoid substantial unintended adverse consequences to the insurance industry” from the application of the CAMT.

The Notice addresses the treatment of certain variable contracts as well as funds withheld reinsurance and modified coinsurance agreements. The Notice provides targeted relief, in these situations, for tax friction that could otherwise arise from unrealized gains and losses in investment assets held by insurance companies.

The Notice does not resolve all ambiguities insurance companies and other taxpayers will face in applying the CAMT. Treasury’s decision to provide limited relief from mark-to-market accounting may also suggest that Treasury is not currently contemplating more generalized, across-the-board relief to taxpayers in other industries who are required to mark their investment assets to market for financial statement purposes.

The Notice is intended to provide interim guidance until proposed Treasury Regulations are promulgated. Until such time, taxpayers can rely on the Notice.

## VARIABLE CONTRACTS

- Variable life insurance and annuity contracts provide policyholders with returns that are based, in part, on the performance of investment assets held in insurance company separate accounts. Existing tax rules utilize a system of adjustments, including adjustments in the tax basis of separate account assets, to ensure that

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<sup>1</sup> For more information on initial guidance issued by Treasury on the CAMT, please see our Debevoise In Depth at: <https://www.debevoise.com/insights/publications/2023/01/treasury-releases-guidance-on-15-corporate-minimum>.

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insurance companies are not taxed on the appreciation or depreciation of separate account investment assets because these results ultimately pass on to policyholders.

- For financial accounting purposes,<sup>2</sup> unrealized gains and losses on separate account investment assets are generally included in the net income (or loss) on an insurance company's applicable financial statement ("AFS"). However, corresponding and offsetting adjustments to the insurance company's obligations to policyholders of the variable contracts result in no overall financial accounting net income (or loss) from such unrealized gains and losses.
- The Notice aims to prevent substantial distortions that may otherwise result with respect to variable life insurance and annuity contracts from the CAMT rules. Specifically, for purposes of determining a taxpayer's applicable financial statement income ("AFSI"), the CAMT rules disregard unrealized gains from portfolio investments in stocks and, for investments in partnerships, take into account only a distributive share of the partnership's AFSI. However, the CAMT rules do not disregard offsetting adjustments to liabilities to variable contract policyholders. Thus, the CAMT rules, which normally can prevent taxpayer-unfavorable results such as CAMT liability from mark-to-market gains on stocks that are not marked-to-market for tax purposes, threaten to create mismatches for issuers of variable contracts.
- The Notice provides targeted relief intended to eliminate this potential mismatch by disregarding changes in variable contract liabilities to the extent that the underlying income or gain on the separate account investment assets is disregarded under the CAMT rules for investments in stocks and partnerships.

**Comment:** The relief provided by the Notice focuses narrowly on distortions caused by the CAMT's rules with respect to portfolio investments in stocks and partnerships. The Notice does not address other potential mismatches, including those that could arise within underlying partnerships and controlled foreign corporations from their own financial income, which insurance company shareholders would be required to take into account (and which may not be offset by changes in the insurance company's obligations and may not correspond to distributions attributable to such investments).

- The relief provided by the Notice also extends to certain other insurance contracts whose value depends on the value of supporting assets, where the CAMT rules may create similar AFSI mismatches. In particular, the Notice extends relief to regulated

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<sup>2</sup> For purposes of this discussion, "financial accounting" generally refers to GAAP accounting and not to statutory accounting separately required for U.S. insurance companies.

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insurance products in foreign jurisdictions where the value of the contract depends, at least in part, on the value of supporting assets and to closed block contracts created in connection with the “demutualization” of mutual insurance companies to ensure certain assets benefit only particular policyholders.

## REINSURANCE

- In conventional coinsurance transactions, a ceding company transfers to a reinsurer both the risk of the reinsured contracts (represented by reserve liabilities) and the investment assets supporting the reserves. However, in funds withheld reinsurance transactions, the ceding company retains the underlying investment assets. The ceding company records an offsetting payable (the funds withheld payable) to the reinsurer (which in turn books a receivable, which generally is accounted for as an embedded derivative) with respect to the retained investment assets from a financial accounting perspective. Similar rules apply to modified coinsurance.
- For financial accounting purposes, both the funds withheld investment assets and the funds withheld payable are marked to market on the ceding company’s financial statements. However, the ceding company generally accounts for the unrealized gains and losses on the investment assets as part of its other comprehensive income (“OCI”) while reflecting the offsetting changes in the funds withheld payable (generally equal to the unrealized gains and losses included in OCI) in its financial statement net income. In contrast, the reinsurer takes changes in its corresponding receivable into account in financial statement net income but generally has no offsetting impact to its liabilities because the liabilities under the underlying policies are unaffected by investment performance.

**Comment:** The volatility of embedded derivative accounting was considered a serious obstacle to funds-withheld transactions for some taxpayers even prior to the Inflation Reduction Act, and this has been exacerbated by the potential for triggering the minimum tax.

- The Notice recognizes that since the CAMT rules generally look only to a taxpayer’s financial statement income (and not to OCI), funds-withheld reinsurance and modified coinsurance transactions could artificially increase or reduce AFSI, creating CAMT distortions for both ceding companies and reinsurers.

**Comment:** The Notice’s recognition that unrealized investment gains and losses accounted for in OCI are not financial statement net income (or loss) and so typically do not create a mismatch with taxable income (determined on a realization

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basis) honors Senator Ron Wyden's floor [statement of August 6, 2022](#) that OCI is not included in financial statement income.

- The Notice provides targeted relief from distortions otherwise caused by funds withheld and modified coinsurance mismatches. In the case of the ceding company, changes to net income attributable to funds withheld payables that correspond to unrealized gains and losses on the funds withheld assets are excluded from AFSI if the gains and losses themselves are not included in AFSI, eliminating the mismatch. For the reinsurer, any AFSI gains or losses attributable to changes in the value of its funds withheld receivable corresponding to unrealized gains and losses on the funds withheld assets are excluded.
- The AFSI exclusions provided by the Notice for ceding companies and reinsurers do not apply to the extent that they already made a "fair value" election to mark a balance sheet item to market that would offset the income statement volatility of the scenarios described in the Notice, such as a reinsurer election to adjust reserve liabilities based on the same mark that applies to the funds withheld assets.

**Comment:** Treasury's focus on harmonization with fair value elections may be helpful for taxpayers who are already considering such elections to mitigate similar issues with embedded derivative accounting under the OECD Pillar Two global minimum tax rules. However, there is still considerable uncertainty in the interactions between the Pillar Two and CAMT regimes.

#### FORMER TAX-EXEMPT INSURANCE COMPANIES

- The Notice provides guidance to assist certain insurance organizations that were historically tax-exempt, but became subject to tax by act of Congress, in applying the CAMT in relation to AFSI determinations involving legacy asset tax basis.

#### AREAS LEFT UNADDRESSED

- Although the Notice provides welcome guidance with respect to some of the key questions raised by the insurance industry, the Notice's targeted approach leaves remaining questions on several important issues for insurers, as well as for other industries that were hoping that guidance aimed at preventing adverse consequences to the insurance industry could provide relief more broadly.

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- **Life and Non-Life Consolidation.** Limitations that apply to the consolidation of life and non-life insurance companies for tax purposes do not apply for accounting purposes, creating potential discrepancies between taxable income and AFSI for purposes of the CAMT that could be addressed in further guidance.
  - **Other Book-Tax Differences.** Mark-to-market on investment assets (in select circumstances) is the only area where Treasury has granted the insurance industry relief on the general volatility created by the differences in tax, GAAP and statutory accounting calculations, leaving unfinished business. For example, all three sets of rules have different standards for whether a reinsurance contract is accounted for as reinsurance or a loan or deposit arrangement. Similarly, Treasury has not addressed the impact of CAMT to mark-to-market accounting for non-stock assets for taxpayers outside of the reinsurance space.

**Comment:** The hierarchy of financial statements on the CAMT prioritizes GAAP and IFRS over statutory financial statements. This approach deviates from the historic approach of U.S. tax law, which provides great deference to statutory accounting as prescribed by insurance regulators.

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