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Legal Alert: Tax Cuts and Jobs Bill: Major Insurance Industry Changes

November 8, 2017

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On November 2, 2017, the House Ways and Means Committee released the "Tax Cuts and Jobs Act" (H.R. 1) (the Bill). The Bill already has been amended and likely will undergo further revision before it is voted on by the full House. In addition, it is expected that the Senate Finance Committee will release its own tax reform bill this week. Eversheds Sutherland will provide updates as the process unfolds.

The Bill (as modified by the Chairman's mark and a second amendment)[1] contains a number of provisions that are generally unfavorable for insurance companies. If enacted in its current form, the Bill could adversely impact the tax treatment of both life and property and casualty (P&C) companies, although the Bill contains more unhelpful changes for life companies than for P&C companies. Despite the overall corporate rate reduction to 20% proposed in the Bill, it is unclear whether the insurance industry will benefit from the rate reduction as a result of the number of insurance industry, life insurance industry in particular, revenue raisers contained in the Bill. Indeed, it is possible that some insurance companies may have a higher tax burden than under current law, depending on their particular circumstances.

In addition to the Bill's insurance company provisions, the Bill contains international and other provisions that could adversely affect insurance companies. Many of these proposed changes were drawn from prior tax reform proposals, but some of the proposed changes are new and have not been subject to prior input from the insurance industry. As a result, some of the Bill's negative consequences for the industry may not have been intended or fully understood.

Subtitle H of Title III of the Bill is focused specifically on changes to the tax treatment of insurance companies, including modifications to the reserve provisions for both life and P&C companies, the rules governing capitalization of policy acquisition expenses for life insurance companies, the proration rules for life and P&C companies, and net operating loss carryback/carryforward periods for life insurers. The Bill also repeals certain specialized rules related to small life insurance companies, adjustments arising out of a change in basis for calculating reserves, policyholder surplus accounts held by life insurers, and special estimated tax payments.

Title IV of the Bill contains the Bill's international provisions. The provisions are broad ranging and include a move to a territorial system and modifications to the subpart F/controlled foreign corporation regime, an excise tax on certain intra-group outbound payments, and an insurance-specific provision that modifies the exception to the PFIC rules for insurance companies.

The potential state tax implications of the Bill are unknown because states that

impose income taxes on insurance companies may not conform their tax regimes to be consistent with some of the Bill's provisions, for example, the amended net operating loss (NOL) rules or the proration rules, discussed below.

According to official revenue estimates, the insurance-specific provisions of the Bill are expected to raise approximately $40.8 billion over a 10-year period. However, the impact on the insurance industry may be greater than the revenue projections.

For a general discussion of the Bill's non-insurance provisions, see the Eversheds Sutherland general legal alert on the Bill.

Life Insurance Company Provisions

- ***Changes to Life Insurance Tax Reserves***

The Bill would fundamentally change the determination of tax reserves for life insurance companies by doing away with the longstanding "federally prescribed reserve" and substituting certain statutory reserve amounts less a 24.5% "haircut." Instead of computing tax reserves using a prescribed method, interest rate, and mortality table, a life insurance company would determine its tax reserves by multiplying its statutory life insurance, unpaid loss, and other reserves by 76.5%. For this purpose, deficiency reserves, asset adequacy reserves, unearned premium reserves, and any other amount not constituting reserves for future unaccrued claims would be excluded from the statutory reserves.

The provision would generally be effective for taxable years beginning after 2017. Under a transition rule, the effect of the provision on computing reserves for existing contracts would be taken into account ratably over eight taxable years.

Eversheds Sutherland Observations.

The change in the calculation of life insurance company tax reserves generally is expected to increase the discount in a life insurance company's tax reserves relative to its reserves taken into account for statutory accounting purposes. The resulting tax cost would increase deferred tax assets. Because deferred tax assets cannot be taken into account fully in the determination of statutory surplus, any increase in the discount for tax reserves could increase surplus strain, which could be substantial for some companies.

The "haircut" set forth in the Bill apparently would apply to both general and separate account reserves, and could possibly result in tax reserves being less than the surrender value obligations provided under a company's contracts.

As currently drafted, the reserve provision in the Bill should eliminate any

question about a life insurance company's ability to include in its tax reserves the stochastic portion of its principles based reserves.

The Bill also would make life insurance company tax reserves easier to compute and to audit as they will become a percentage of the statutory reported annual reserve.

- ***Change to Policy Acquisition Expense Rules***

The Bill would significantly increase the percentages of policy acquisition expenses (DAC) that must be deferred and amortized over 10 years under section 848.[2] Under the Bill, the three categories of insurance contracts to which DAC currently applies (annuity contracts, group life insurance contracts and others) would be reduced to two categories (group contracts and other). For group contracts (whether group life, annuity or non-cancellable accident and health contracts), the percentage of premium taken into account in computing DAC would increase to 4%, and for all other contracts (i.e., all individual contracts), the percentage would increase to 11%. The greatest increase would be for individual annuity contracts, which would increase from the current 1.75% rate for annuity contracts to the 11% rate for all individual contracts. The provision would be effective for taxable years beginning after 2017.

Eversheds Sutherland Observation.
The Bill's increase in DAC capitalization percentages for life insurance companies seems to run counter to the other Bill provisions that increase current expensing for non-insurance companies.

- **Changes to Life Insurance Company Proration Rules**

In the case of a life insurance company, the dividends-received deduction is permitted only with respect to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the "policyholder's share" of tax-exempt interest. The regime for computing the company's share and the policyholder's share of net investment income generally is referred to as "proration." Section 812(a) defines "company's share" and "policyholder's share" for purposes of proration through complicated formulas roughly designed to identify the portion of a life insurance company's net investment income attributable to assets backing policyholder obligations. The Bill would amend section 812(a) to define the company's share as 40% and the policyholder's share as 60%. The provision would be effective for taxable years beginning after 2017.

Eversheds Sutherland Observation.

The Bill replaces a complicated calculation of the company's share and the policyholder's share with a simplistic 40/60 split between the company's share

and the policyholder's share. According to the Ways and Means Committee section-by-section summary of the Bill, the split is based on the industry average. Query whether use of an average is a fair and reasonable approach to proration given the variations in investments and business written across the life insurance industry.

- ***Change to NOL Carryforward and Carryback Periods for Life Insurance Companies***

The Bill would repeal the special carryback (three years) and carryforward (15 years plus an additional three years for a new company) provision applicable to life insurance company NOLs and would conform the treatment of life insurance companies' NOLs to the general treatment of NOLs applicable to other companies. Under the Bill, the general rule for NOLs would be amended to limit a company's NOL deduction to 90% of taxable income (determined without regard to the deduction) and to adjust carryovers to other years to take account of this limitation. In addition, NOLs could be carried forward indefinitely with an inflation adjustment, but could not be carried back. The provision would be effective for losses arising in taxable years after 2017.

- ***Repeal of Small Life Insurance Company Deduction***

The Bill would repeal section 806, which provides a deduction of up to $1.8 million to small life insurance companies (with assets of less than $500 million as determined on a controlled group basis). Section 806 permits a life company to deduct 60% of its first $3 million of life insurance-related income, phasing out for companies with income between $3 million and $15 million. The repeal would be effective for taxable years beginning after 2017.

- ***Repeal of 10-Year Spread for Changes in Basis of Computing Reserves and Application of the General Change in Accounting Method Spread Period***

Under Section 807, a life insurance company that changes the basis for computing its reserves generally takes into account over 10 years any resulting reserve adjustment (regardless of whether the adjustment reduces or increases taxable income). The Bill would amend section 807 to repeal the 10-year spread period and in its place would apply the general income adjustment rules applicable to changes in methods of accounting. As a result, a change in basis of computing reserves that reduces taxable income generally would be taken into account in the taxable year of the change, and adjustments that increase taxable income generally would be taken into account over four taxable years, beginning with the taxable year in which the change occurs. The provision would be effective for taxable years beginning after 2017.

- ***Repeal of Rules for Pre-1984 Policyholder Surplus Accounts***

The policyholder surplus account rules in section 815 are a vestige of the old

three-phase tax system applicable to life insurance companies in the Internal Revenue Code of 1959. Under those rules, certain operating income of life insurance companies was credited to a policyholder surplus account and subject to tax only when treated as distributed. Life insurance companies established policyholder surplus accounts to track the undistributed income. The three-phase tax system was eliminated by the Deficit Reduction Act of 1984, but life insurance companies are permitted to defer the pre-1984 operating income held in their policyholder surplus accounts until such income is treated as distributed to policyholders (or there is a corporate dissolution). The Bill would repeal the rules for deferring tax on remaining pre-1984 policyholder surplus accounts. Remaining policyholder surplus accounts would be treated as distributed and subject to tax over an eight-year period. The provision would be effective for taxable years beginning after 2017.

Eversheds Sutherland Observation.

In 2005 and 2006, the section 815 rules were suspended, and life insurance companies could make tax-free distributions from their existing policyholder surplus accounts. Given that opportunity, this provision should not impact many companies. Nevertheless, the tax cost could be material for those companies that continue to maintain policyholder surplus accounts, because they tend to be smaller companies that did not have sufficient statutory surplus to take advantage of the election in 2005 and 2006 to strip out their accounts without tax cost.

P&C Insurance Company Provisions

- ***Changes to Discounting Rules***

The Bill would change the prescribed interest rate for discounting P&C unpaid loss reserves from the mid-term applicable federal rate to an annual rate determined by Treasury on the basis of the corporate bond yield curve found in the rules relating to minimum funding standards for single-employer benefit pension plans. The Bill also would modify the computational rules for loss payment patterns by extending the payout periods by up to an additional 15 years (i.e., up to 18 years for the current three-year payment pattern and up to 25 years for the current 10-year payment pattern) and limiting the amount of losses to be taken into account in the third, or tenth, years and subsequent years.

For lines of business to which the three-year rule applies, the Bill provides that the amount of losses that would have been treated as paid in the third year after the accident year is treated as paid in that year and each subsequent year in an amount equal to the average of the losses treated as paid in the first and second years after the accident year, or, if lesser, the portion of the unpaid losses not previously taken into account. Similarly, for lines of business to which the 10-year rule applies, the Bill provides that the amount of losses that would have

been treated as paid in the tenth year after the accident year is treated as paid in that year and each subsequent year in an amount equal to the average of the losses treated as paid in the seventh, eighth and ninth years after the accident year, or, if lesser, the portion of the unpaid losses not previously taken into account.

The Bill also would repeal the company-specific historical payment pattern election found in section 846(e).

The provision generally would be effective for taxable years beginning after 2017, with a transition rule for spreading adjustments relating to pre-effective date losses and expenses over eight taxable years.

- ***Change to P&C Company Proration Rules***

Under section 832(b)(5)(B), a P&C company's losses incurred are reduced by 15% of certain income items that are not subject to tax, including tax-exempt interest and deductible dividends received. The Bill would increase the proration percentage under section 832(b)(5)(B) from 15% to 26.25%. The Ways and Means Committee section-by-section summary of the Bill notes: "The provision would keep the reduction in the reserve deduction consistent with current law by adjusting the rate proportionately to the decrease in the corporate tax rate." The provision would be effective for taxable years beginning after 2017.

Eversheds Sutherland Observation.

In other words, under current law, the P&C company proration rule effectively imposes tax of 5.25% on the income subject to proration (35% tax rate multiplied by 15% of income subject to proration, which amount reduces the losses incurred deduction). To retain that effective rate of tax on income subject to proration in an environment with a 20% tax rate, proration must increase to 26.25% (35% * 26.25% = 5.25%).

- ***Repeal of Rules for Special Estimated Tax Payments***

The Bill would repeal the special estimated tax payment rules of section 847. Because of limitations on the recognition of deferred tax assets for accounting purposes, the adoption of loss reserve discounting rules in 1986 created a strain on the accounting surplus reported by P&C insurance companies. Section 847 was enacted to help ameliorate that strain. Section 847 provides for an additional deduction equal to the difference between the amount of undiscounted reserves over discounted reserves, provided that the taxpayer makes the special estimated tax payments required by section 847. The special estimated tax payments must be made in an amount equal to the tax benefit attributable to the additional deduction. The provision effectively converts actual tax expense into an estimated tax payment with the understanding that the

amounts of estimated tax payments can be reflected as an asset for accounting purposes, eliminating the surplus strain otherwise associated with loss reserve discounting. The repeal would be effective for taxable years beginning after 2017.

Eversheds Sutherland Observation.

Section 847 was intended to be revenue neutral, but has not always functioned that way in practice. Nevertheless, the Joint Committee on Taxation estimate is that the repeal of section 847 would raise less than $50 million of revenue over 2018-2027.

International Provisions

- ***Movement to a Territorial System and Modifications to the Subpart F/Controlled Foreign Corporation (CFC) Regime***

The main focus of the international provisions in the Bill is a shift toward a territorial system, including a participation exemption that allows a 100% dividends received deduction to corporate US 10% shareholders of "specified 10% owned foreign corporations," and what amounts to a deemed immediate repatriation of the untaxed non-US earnings of such corporations by requiring US 10% shareholders to include such earnings in subpart F income over eight years. In addition, modifications are made to the subpart F regime.

The territorial and subpart F/CFC regime modifications proposed in the Bill are not insurance industry specific.

Please see the Eversheds Sutherland general legal alert on the Bill and international legal alert for a more comprehensive discussion of the provisions.

Eversheds Sutherland Observations.

It is important to note that under the repatriation provisions US 10% shareholders of "specified 10% owned foreign corporations" would have income inclusions regardless of whether the non-US corporation was/is a CFC.

Although the Bill provisions apply equally to insurance companies and other companies, they may have less of an immediate impact on the insurance industry. The current law exclusions from subpart F income for insurance income are more limited than other exclusions, and thus, depending on an insurer's particular factual situation, there may be less of a repatriation burden.

- ***New Excise Tax***

The Bill includes a new – and controversial – 20% excise tax[3] on "specified amounts" paid or incurred by a US corporation to a non-US corporation that is included in the same "international financial reporting group" as the US

corporation. The excise tax is imposed on the US corporation making the payment.

An “international financial reporting group” is a group of entities that prepares consolidated financials and for which the three-year average annual aggregate specified amounts paid or incurred that would be subject to the excise tax exceed $100 million. “Specified amounts” include any amount that is allowed as a deduction by the payor or includible in costs of goods sold, inventory, or the basis of a depreciable or amortizable asset.

“Specified amounts” do not include interest; amounts with respect to which the 30% withholding tax under section 881 was imposed,[4] and certain amounts paid in connection with the acquisition of certain securities and commodities described in section 475. The excise tax also would not apply to amounts characterized as effectively connected income (these amounts are treated as paid to a US corporation), and would not apply if the recipient corporation elects to treat the payments as income effectively connected with the conduct of a US trade or business. There is also an exception for payments made for intercompany services that a US company elects to pay for at cost (i.e., no markup).

A deduction would not be allowed for any excise tax paid, and if a non-US corporation makes the election to treat the payments as income effectively connected with the conduct of a US trade or business, foreign tax credits under section 901 would not be allowed with respect to any taxes paid on specified amounts, although a credit calculated on the basis of the “effective foreign tax rate” with respect to the net effectively connected income so included, equal to the lesser of 20% or half of the “effective foreign tax rate” of the “international financial reporting group” would be permitted.

Both the US payor corporation and non-US recipient corporation would have an information reporting requirement with respect to the intra group payments.

This provision applies both to insurance and non-insurance companies and is discussed further in the Eversheds Sutherland international legal alert.

The provision would be effective for taxable years beginning after 2018.

Eversheds Sutherland Observations.

The new excise tax presumably would apply to intra-group reinsurance premiums, but the Bill does not repeal the existing federal insurance excise tax on premiums paid to foreign insurers and reinsurers.

- ***Modification of PFIC Exception for Insurance Companies***

Current law provides that a non-US corporation will be characterized as a PFIC if 75% or more of its gross income for the taxable year is passive income or if the average percentage of assets held by the corporation during the taxable year that produce passive income or are held for the production of passive income is 50% or more. Under this definition, almost all non-US insurance companies would be characterized as PFICs. However, there is an exception for insurance companies that excludes from the definition of passive income:

> income "derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation."

The Bill would modify the current law insurance exception from passive income by providing that:

> income "derived in the active conduct of an insurance business by a qualifying insurance corporation'" is not passive income.

A "qualifying insurance corporation" for a taxable year includes only a non-US corporation that meets the following requirements: (i) it would be subject to tax under subchapter L if it were a US domestic corporation; and (ii) its "applicable insurance liabilities" constitute more than 25% of its total assets (or meet an alternative facts and circumstances test). For these purposes, "applicable insurance liabilities" include: loss and loss adjustment expenses, and reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks.[5]

The alternate facts and circumstances test allows a corporation that does not meet the 25%-test to otherwise qualify for the exception if the corporation is predominantly engaged in an insurance business, at least 10% of its total assets comprise "applicable insurance liabilities," and the reason for the failure to meet the 25%-test is solely due to run-off or ratings-related circumstances.

In general, the quantum of "applicable insurance liabilities" must be the amount reported to an applicable insurance regulatory authority and must be made on a GAAP or IFRS basis.

The provision would be effective for taxable years beginning after 2017.

Eversheds Sutherland Observations.

Although the Bill would add the new 25% (and alternate limited 10%) insurance liabilities test, the revised statutory provisions still require "active conduct."

The Bill excludes from the definition of reserves unearned premiums; thus, it may be difficult for some insurance companies to meet the 25%-test under these parameters.

The Bill does not provide an alternative for insurance companies that may have limited unpaid loss reserves due to the nature of the business they write, such as companies that write significant catastrophe business.

The insurance company exception proposed in the Bill only applies to non-US corporations, leaving questions as to the application of the exception to multi-national groups with significant US operations.

[1] All subsequent references to the Bill herein are to the Bill as modified by the Chairman's mark and the second amendment.

[2] All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.

[3] The rate of the excise tax is the highest rate imposed under section 11.

[4] If the 30% withholding tax rate on a withholdable payment is reduced pursuant to a treaty, or otherwise, the entire amount of the withholdable payment will not be excluded from the excise tax; the only amount excludable will be the portion of the withholdable payment that equals the amount of tax paid divided by 30%.

[5] The description of the provision by the Joint Committee on Taxation states that "loss reserves for property and casualty, life, and health insurance contracts and annuity contracts" are included within the definition of losses and reserves.

If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.