EVERSHEDS SUTHERLAND

Legal Alert: Tax Cuts and Jobs Bill Update, November 14: Major Insurance Industry Changes

November 14, 2017

Related People/Contributors

- Dennis L. Allen
- Thomas A. Gick
- Saren Goldner
- Michael R. Miles
- Mary E. Monahan
- M. Kristan Rizzolo
- Susan E. Seabrook
- Linda A. Sciuto
- Carol P. Tello
- P. Bruce Wright
- William J. Walderman
- Andrew D. Appleby
- Christopher W. Schoen
- Caroline C. Setliffe
- Graham R. Green
- Rich Sun

As noted in a previous Eversheds Sutherland Legal Alert, on November 2, the House Ways and Means Committee released the "Tax Cuts and Jobs Act" (H.R. 1) (the House Bill). An amended version of the House Bill (the Ways and Means Markup) was reported out of the Ways and Means Committee on November 10. On November 9, the Joint Committee on Taxation issued a description of the Senate version of the "Tax Cuts and Jobs Act" (the Senate Bill). The Senate is not expected to release actual bill language prior to the Markup by the Senate Finance Committee. Instead, the Markup will be based on the Joint Committee's description.

Like the House Bill, the Senate Bill would reduce the corporate tax rate to 20%, but, unlike the House Bill, only beginning in 2019. It also would make changes to a number of insurance-specific provisions and includes certain international provisions that could have significant impacts on insurance companies.

Senator Tim Scott has introduced an amendment to the Senate Bill (the Scott Amendment) which would:

- For contracts described under section 807(c)(1),[1] apply a 5% "haircut" to reserves for those contracts reported in the National Association of Insurance Commissioners annual statement subject to a cash value/deposit floor determined on a seriatim basis (no deduction for asset adequacy or deficiency reserves would be allowed);

- Impose a single rate of 70% for determining the company share in both the separate and general account of life insurance companies; and

- Extend the amortization period for deferred acquisition costs from 10 years to 15 years, maintain the three product categories, and modify the rates by increasing the capitalization rates 20% for new premiums.

At this time, the Scott Amendment has not been incorporated into the Senate Bill.

What follows is a side-by-side comparison of provisions in the House Bill and the Senate Bill (without taking into account the Scott Amendment) of particular interest to the insurance industry.

Life Insurance Company Provisions

Changes to Life Insurance Tax Reserves	
The Ways and Means Markup, consistent with Chairman Brady's	The Senate Bill would not make any changes to the calculation of life

second amendment to the House Bill, does not include a provision in the original House Bill that would have eliminated the longstanding "federally prescribed reserve" and substituted a reserve calculation equal to certain statutory reserve amounts less a 24.5% "haircut." For this purpose, deficiency reserves, asset adequacy reserves, unearned premium reserves, and any other amount not constituting reserves for future unaccrued claims would have been excluded from the statutory reserves.	insurance tax reserves.
Change to Policy Acquisition Expense Rules	
The Ways and Means Markup, consistent with Chairman Brady's second amendment to the House Bill, does not include a provision in the original House Bill that would have significantly increased the percentages of policy acquisition expenses (DAC) that must be deferred and amortized over 10 years under section 848. Under the House Bill, the three categories of insurance contracts to which DAC currently applies (annuity contracts, group life insurance contracts, and other) would have been 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 have increased to 4%, and for all other contracts (i.e., all individual contracts), the percentage would have increased to 11%. The	The Senate Bill would retain the three existing categories of contracts to which DAC applies, but would increase the percentage of premium taken into account in computing DAC to 3.17% for annuity contracts, to 3.72% for group life insurance contracts, and to 13.97% for all other specified insurance contracts. In addition, the Senate Bill would increase the DAC amortization period from 10 years to 50 years. The Senate provision would be effective for taxable years beginning after 2017.

greatest increase would have been for individual annuity contracts, which would have increased from the current 1.75% rate for annuity contracts to the 11% rate for all individual contracts.	
Changes to Life Insurance Company Proration Rules	
The Ways and Means Markup, consistent with Chairman Brady's second amendment to the House Bill, does not include a provision in the original House Bill that would have amended section 812(a) to define the company's share of an insurance company's net investment income as 40% and the policyholder's share as 60%. This "proration" rule would have been relevant for determining a life insurance company's dividends-received deduction net increase or net decrease in reserves.	The Senate Bill would not make any changes to the life insurance company proration rules.
Surtax on Life Insurance Company Taxable Income	
The **House Ways and Means Markup** includes a provision that would impose a tax on a life insurance company's taxable income in addition to the tax imposed on such income at the regular corporate tax rate. The additional tax would be equal to 8% of the life insurance company's taxable income. This surtax was added in Chairman Brady's second amendment to the House Bill and, reportedly, is a "placeholder" in lieu of the changes to the life insurance tax reserve calculations, the policy acquisition expense rules, and the life insurance company proration rules discussed above. However, because the surtax is described as a "placeholder," the House could	The Senate Bill would not impose a surtax on life insurance companies.

insist in a Senate/House Conference on changing the 8%-rate or making other modifications to the reserve, DAC, or proration rules.	
Change to NOL Carryforward and Carryback Periods for Life Insurance Companies	
The House Bill would repeal the special carryback (three years) and carryforward (15 years plus an additional three years for a new company) provisions applicable to life insurance company net operating losses (NOLs) and would conform the treatment of life insurance companies' NOLs to the general treatment of NOLs applicable to other companies. Under the House 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 into account 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.	The Senate Bill also would limit a company's NOL to 90% of taxable income and would make the same changes to NOL carryforward and carryback periods for life insurance companies as would the House Bill. The effective date would be the same as under the House Bill.
Repeal of Small Life Insurance Company Deduction	
The House 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 insurance company to deduct 60% of its first $3 million of life insurance-related income, phasing out for companies with income	The Senate Bill also would repeal the small life insurance company deduction for taxable years beginning after 2017.

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 for 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 House 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 for 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.	The Senate Bill also would replace the 10-year spread period for taking into account a life insurance company's change in basis for computing reserves with general adjustment rules applicable to changes in methods of accounting. The effective date would be the same as the House Bill.
Repeal of Rules for Pre-1984 Policyholders Surplus Accounts	
The policyholders 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 policyholders surplus account and subject to tax only when treated as distributed. Although the three-	The Senate Bill also would repeal the policyholders surplus account rules for years after 2017 and would impose tax on any remaining policyholders surplus account balances equally over eight years.

phase tax system was eliminated by the Deficit Reduction Act of 1984, companies were permitted to continue to defer amounts in their policyholders surplus accounts until distributed to policyholders. Under the House Bill, remaining policyholders 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.	
New Reporting Rules for Life Settlement Transactions and Related Changes to Basis and Transfer-for-Value Rules	
The House Bill would not impose any new reporting rules for life settlement transactions or make any change to basis and transfer-for-value rules.	The Senate Bill would impose new reporting requirements with respect to reportable sales of existing life insurance contracts. Specifically, a buyer of a previously-issued life insurance contract that does not have a substantial family, business, or financial relationship with the insured would be required to report to the Internal Revenue Service (IRS), to the insurance company that issued the contract, and to the seller the following: (i) certain identifying information about the buyer and any other persons that receive payments in the transaction, (ii) the date of the transaction, and (iii) the amount of each payment. The provision also would impose reporting requirements on an insurance company when it receives notice of a reportable sale of one of its in-force policies or when it makes a payment of a death benefit following a reportable policy sale. The reporting rules would apply to reportable policy sales occurring and reportable death benefits paid after 2017. In addition, the Senate Bill would provide that the basis of a life insurance or annuity contract would not be reduced by

	the cost of insurance. This provision would reverse the IRS's published position that the cost of insurance is deducted from the basis of a life insurance or annuity contract. Other than the basis adjustment, the Senate Bill generally follows the IRS's position in Rev. Rul. 2009-13 and Rev. Rul. 2009-14. The basis provision would apply to transactions entered into after August 26, 2009. The current transfer-for-value rules limit the amount of a death benefit payment that may be excluded from the recipient's income if the policy with respect to which the payment is made previously was transferred for valuable consideration. Certain transfers are excluded from the limitation, including transfers giving rise to carry-over basis in the life insurance contract and transfers to a partner of an insured or to a partnership or corporation in which the insured has an interest. The Senate Bill would prevent the transfer-for-value exclusions from applying to a transfer in a reportable policy sale. The modification to the transfer-for-value exclusions would apply to transfers occurring after 2017.

Property and Casualty (P&C) Insurance Company Provisions

Changes to Discounting Rules	
The House 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 House Bill also would modify the computational rules for loss payment patterns by extending the payout periods by up to an	The Senate Bill would not make any changes to the discounting rules for P&C companies.

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 House 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 ten-year rule applies, the House 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 House 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 House Bill would increase the proration percentage under section	The Senate Bill would replace the proration percentage with a percentage equal to 5.25% divided by the top corporate rate. Because the Senate Bill retains the

832(b)(5)(B) from 15% to 26.25%. The Ways and Means Committee section-by-section summary of the House 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.	35% corporate tax rate until 2019, at which time the rate drops to 20%, under the Senate Bill, the proration percentage would remain at 15% for 2018 and would increase to 26.25% for 2019 and thereafter.
Repeal of Rules for Special Estimated Tax Payments	
The House Bill would repeal the special estimated tax payment rules of section 847. Section 847 provides for an additional deduction equal to the difference between the amount of undiscounted loss reserves over the amount of discounted reserves, provided that the taxpayer makes the special estimated tax payments 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 financial accounting strain otherwise associated with loss reserve discounting. The repeal would be effective for taxable years beginning after 2017.	The Senate Bill also would repeal the special estimated tax payment rule for years after 2017. The Senate Bill contains a transition rule that would require a P&C company that had elected to apply section 847 to include in income for the first taxable year beginning after 2017 the entire balance of its special loss account and to apply the full amount of its current special estimated tax payment balance against the tax attributable to that inclusion. Any excess amount of special estimated tax payments would be converted to regular estimated tax payments.

International Provisions

Movement to a Territorial System	
The House 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	The Senate Bill also provides for 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

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.	corporations by requiring US 10% shareholders to include such earnings in subpart F income. The provision also allows for payment of the tax over eight years (8% each year for the first five years, 15% in the sixth year, 20% in the seventh year and 25% in the eighth year). There is also a special inversion provision that imposes a 35% rate on amounts so included by a US 10% shareholder if the US 10% shareholder becomes an "expatriated entity" (as defined in section 7874(a)(2)). Modifications are also made to the subpart F regime. One that is important to note is the modification of the definition of US 10% shareholder to include those persons who hold 10% by value (in addition to those who hold 10% by vote). The territorial and subpart F/CFC regime modifications proposed in the Senate Bill are not insurance industry specific. See our International Legal Alert for a more complete description of the Senate Bill's proposals related to the territorial system.
Excise Tax/Base Erosion and Anti-abuse Provision	
The Ways and Means Markup retains the new – and controversial – 20% excise tax[2] 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, but modifies the provision with respect to foreign tax credits. The Markup would allow a foreign tax credit under section 906(a) with respect to amounts taken into account under	Although the Senate Bill does not impose an overt excise tax on deductible amounts, or amounts includible in costs of goods sold, inventory, or the basis of a depreciable or amortizable asset, it does add these amounts back into taxable income and imposes a 10% base erosion tax on excess "modified taxable income." The provision applies only to "applicable taxpayers" that have (i) average annual gross receipts of at least $500 million for the three-year taxable period ending with

the ECI Election discussed below, but limits the credit to 80% of the amount of taxes paid or accrued and determined without regard to section 906(b)(1). The excise tax would be imposed on the US corporation making the payment. Under the House Bill, an "international financial reporting group" is defined as 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;[3] 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	the preceding taxable year, and (ii) a "base erosion percentage" of 4% or higher for the taxable year. The term "applicable taxpayers" appears, for purposes of the above thresholds, to include as one person all corporations (other than RICs, REITs and S corporations) that are part of a section 1563 controlled group (substituting 50% for the 80% ownership requirement) and certain non-US corporations that have income effectively connected to a US trade or business (ECI) (but only to the extent of their ECI). Similar to the House Bill, the Senate Bill does not apply to amounts subject to the 30% withholding tax, and only applies to a part of such payment if the withholding rate is reduced by treaty. "Base erosion percentage" is defined as the aggregate amount of the applicable taxpayer's "base erosion tax benefits" for the year divided by the aggregate amount of deductions allowable under Chapter 1 of the Code (excluding deductions allowed under sections 172 (NOLs), 245A (the new DRD provisions) and 250). A "base erosion tax benefit" is any deduction allowed for the taxable year with respect to a "base erosion payment." A "base erosion payment" is any amount paid or accrued to a related party that is deductible, including any amounts paid or accrued in connection with the acquisition of depreciable or amortizable property, or that constitutes a deduction to gross receipts and is paid to a "surrogate foreign corporation" or to a person in the same "expanded affiliated group" as a "surrogate foreign corporation" (as those terms are defined under the inversion provisions of section 7874, but not including a corporation treated as a domestic corporation under section 7874).

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 (an ECI Election), 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. These provisions apply to amounts paid or incurred after December 31, 2018.	The definition of related party is very broad and includes 25% owners and persons related within the meaning of sections 267(b), 707(b)(1) and 482, and the section 318 constructive ownership rules apply with certain modifications. "Modified taxable income" is the applicable taxpayer's taxable income for the year determined without regard to any "base erosion payments." To determine the base erosion tax, the applicable taxpayer's "modified taxable income" is multiplied by 10%; this amount is then reduced by the applicable taxpayer's regular tax liability for the year. This amount may be further reduced by the excess of allowed Chapter 1 credits over the section 38 credits allocable to the research credit under section 41. This provision applies to both insurance and non-insurance companies. The provision is applicable for taxable years beginning after December 31, 2017.
Modification of Passive Foreign Investment Company (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	The Senate Bill is almost identical to the House Bill. However, the Senate Bill does not limit the application of the insurance

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 absent an insurance exception. The House Bill would modify the current law's 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	exception to only non-US corporations. In addition, if an insurance company does not meet the 25% insurance liabilities test, its US shareholders may elect to treat their stock as stock of a qualifying insurance corporation, if at least 10% of its total assets comprise "applicable insurance liabilities," and based on an applicable facts and circumstances test the corporation is predominantly engaged in an insurance business and its failure to meet the 25% test is due solely to specified circumstances involving such insurance business. For this purpose, "specified circumstances" would include being in run-off.

coverage for mortality or morbidity risks.[4] 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, and the reason for the failure to meet the 25%-test is solely due to run-off or ratings-related circumstances. In general, the "applicable insurance liabilities" must be the amount reported to an applicable insurance regulatory authority on a GAAP or IFRS basis. The provision would be effective for taxable years beginning after 2017.	

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

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

[3] 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%.

[4] 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.