December 22, 2017

U.S. Tax Reform

Insurance Company Provisions

SUMMARY

On December 20, Congress voted to pass a comprehensive tax reform bill (the "Act"),[1] and today, the President signed the Act into law. The Act represents the most significant reform of the U.S. tax code in over 30 years.

The Act is generally consistent with the proposals contained in the bill released by the Senate on November 14 (the "Senate bill"), but also incorporates certain provisions of the bill released by the House of Representatives on November 2 and amended thereafter (the "House bill"). The Act also removes some provisions that were contained in both earlier draft bills, and includes some new provisions that were contained in neither draft bill.

This memorandum describes some of the important features of the legislation which will impact the taxation of insurance companies, and highlights certain areas where the Act diverges from the earlier draft legislation.

Other provisions in the Act which affect corporations and multinationals could also impact insurance companies, including, among others, provisions which implement a lower corporate tax rate, a shift to a territorial tax system, the mandatory deemed repatriation of offshore earnings and profits, changes in the determination of whether a foreign corporation is a "controlled foreign corporation," and new limits on interest deductibility. These provisions are described in a separate memorandum, which may be obtained by following the instructions at the end of this memorandum.

Most of the provisions described below will be effective for tax years beginning after 2017.

Life Insurance Company Provisions:

- ***Modifications of net operating loss carryover rules.*** Life insurance companies will not be allowed to carry net operating losses back to prior tax years, but will be allowed to carry net

operating losses forward indefinitely (as opposed to a three-year period for carrybacks and a 15-year period for carryforwards under prior law), in conformity with the general net operating loss carryover rules. Net operating losses arising after December 31, 2017 are deductible only to the extent of 80% of the taxpayer's taxable income.

- Under some versions of the House bill, net operating losses would have been deductible to the extent of 90% of the taxpayer's taxable income. The Senate bill had a similar 90% limitation, which would have decreased to 80% after December 1, 2022. The House bill would have increased amounts carried forward by an interest factor to preserve the value of those amounts.
- The rules for property and casualty companies will not change.

- ***Revisions of the capitalization rule for deferred acquisition costs ("DAC").*** The DAC rules are revised to extend the amortization period from 120 months to 180 months and to amend the capitalization rates to 2.09% for annuity contracts (from 1.75% under prior law), 2.45% for group life contracts (from 2.05%), and 9.2% for all other specified contracts (from 7.7%).
  - Under the House bill, the amortization period would not have been extended and the DAC rules would have been revised to replace the existing three categories of insurance contracts with only two categories: (1) group contracts, which would be capitalized at a 4% rate, and (2) all other specified contracts, which would be capitalized at an 11% rate. Under the Senate bill, the capitalization rates would have been 2.1% for annuity contracts, 2.46% for group life contracts, and 9.24% for all other specified contracts.
- ***Modification of rules for determining the dividends-received deduction.*** A life insurance company's share of dividends, for purposes of computing its dividends-received deduction, will be fixed at 70%, rather than being determined pursuant to a proration formula.
  - Some versions of the House bill would have fixed the company's share at 40%.
- ***Computation of life insurance reserves.*** Life insurance companies will take into account with respect to any contract (other than certain variable contracts, which are subject to a special rule) the greater of the net surrender value of the contract or 92.81% of statutory reserves in calculating increases in reserves. A rule against double counting provides that no amount may be taken into account more than once in determining reserves. The effect of the provision on computing reserves for contracts issued before the effective date will be taken into account ratably over the succeeding eight tax years.
  - Under the Senate bill, the computation would have been the greater of the net surrender value of the contract or 92.87% of statutory reserves. Some versions of the House bill included only a specified percentage (76.5%) that would have been taken into account, rather than a "greater of" formula.
- ***Adjustment for change in computing reserves.*** Under prior law, life insurance companies took into account changes in taxable income as a result of an adjustment in the method of computing reserves over 10 years. Under the Act, life insurance companies will take such adjustments into account in the same manner as non-life insurance companies (*i.e.*, in the tax year during which the accounting method change occurs for an adjustment that reduces taxable income, or over the course of four tax years for an adjustment that increases taxable income).
- ***Reporting requirements for acquisitions of life insurance contracts.*** A direct or indirect purchaser of a life insurance contract, which contract insures the life of a person unrelated to the purchaser, will be required to report tax information about the purchase to the IRS and to the issuer and seller of the contract. Upon receipt of such information, or upon receipt of any form of notice of the transfer of a life insurance contract to a foreign person, the issuer will be required to report the basis of the contract and certain other information to the IRS. An insurance company that pays death benefits under a life insurance contract that was transferred in a reportable sale will be required to report information about the payment of benefits to both the IRS and the payee.

- ***Repeal of special estimated tax payments.*** The election to claim a deduction equal to the difference between the amount of reserves computed on a discounted basis and the amount computed on an undiscounted basis and related special estimated tax payment rules is repealed.
- ***Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus accounts.*** The rules for policyholders' surplus accounts (keeping track of operating income which would be taxed only when distributed) are repealed. Any remaining balances (as of the effective date) will be subject to tax, payable in eight annual installments.
- ***No surtax on life insurance income.*** The second amendment to the House bill introduced by Chairman Brady included a placeholder provision imposing an 8% surtax on life insurance income. This surtax is not included in the Act.

Property and Casualty Insurance Company Provisions:

- ***Modification of proration rules for property and casualty insurance companies.*** Under prior law, property and casualty insurance companies were required to reduce the amount of their reserve deductions by 15% of (1) the company's tax-exempt interest, (2) the deductible portion of dividends received, and (3) the increase for the tax year in the cash value of life insurance, endowment, or annuity contracts the company owns. Under the Act, the 15% reduction is replaced with a reduction equal to 5.25% divided by the top corporate tax rate, meaning that, for 2018 and subsequent years, the percentage reduction will be 25%.
  - Under the House bill, the reduction in the reserve deductions of property and casualty insurance companies would have been increased to 26.25%.
- ***Modification of discounting rules for property and casualty insurance companies.*** A property and casualty insurance company will be required to discount unpaid losses by corporate bond yields (as specified by Treasury), as opposed to mid-term applicable Federal rates. In addition, the special rule that extends the loss payment pattern period for long-tail lines of business now will apply such that the 10-year period will be subject to extension for up to 14 additional years (instead of 15 more years under the House bill). The Act also repeals the election to use company-specific, rather than industry-wide, historical loss payment patterns. A transition rule spreads adjustments relating to pre-effective date losses and expenses over the first tax year beginning after 2017 and the succeeding seven tax years.

International Provisions:

- ***Base Erosion Minimum Tax ("BEAT").*** Similar to the Senate bill, the Act includes a base erosion minimum tax, which is essentially a 10% minimum tax calculated on a base equal to the taxpayer's income determined without tax deductions or other tax benefits arising from "base erosion" payments. A "base erosion payment" is generally an amount paid or accrued by a taxpayer to a related foreign person that is deductible to the taxpayer, but does not include cost of goods sold or qualified derivative payments. Cross-border reinsurance premiums are specifically included as base erosion payments. The provision only applies to corporations that have average annual gross receipts of at least $500 million (for the three prior tax years) and that have a "base erosion percentage" of at least 3%. The base erosion percentage means, for any taxable year, the percentage determined by dividing the corporation's base erosion tax benefits by the total deductions allowed with respect to the corporation.
  - The 20% excise tax that domestic corporations would have been subject to when making certain deductible payments to a foreign affiliate under the House bill, unless the affiliated foreign corporation elected to treat the payments as effectively connected income—which presumably would have applied to reinsurance transactions with foreign affiliates—is not included in the Act.
- ***Restriction on insurance business exception to passive foreign investment company ("PFIC") rules.*** The PFIC exception for insurance companies is amended to apply only if the foreign corporation would be taxed as an insurance company were it a U.S. corporation and if

loss and loss adjustment expenses and certain reserves constitute more than 25% of the foreign corporation's total assets (or 10% if the corporation is predominantly engaged in an insurance business and the reason for the percentage falling below 25% is solely due to temporary circumstances).

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ENDNOTES

[1] The Act is commonly referred to as the "Tax Cuts and Jobs Act," but the formal name for the Act is "An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

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