SULLIVAN & CROMWELL LLP

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U.S. Tax Reform: Insurance Company Provisions

House Ways and Means Committee Releases Draft Tax Reform Bill: Insurance Company Provisions

SUMMARY

On November 2, 2017, Republicans in the House of Representatives unveiled the long-anticipated first draft of their tax reform bill, the "Tax Cuts and Jobs Act."

Some important features of the draft legislation which would impact the taxation of insurance companies are as follows:

Life Insurance Company Provisions:

- ***Computation of life insurance reserves.*** Life insurance companies would take into account a specific percentage, 76.5%, of the increase or decrease in reserves for future unaccrued claims in computing taxable income. Certain types of reserves would not be included. The effect of the provision on computing reserves for contracts issued before the effective date would be taken into account ratably over the succeeding eight tax years.
- ***Adjustment for change in computing reserves.*** Under current law, life insurance companies may take into account changes in taxable income as a result of an adjustment in the method of computing reserves over ten years. Under the draft legislation, life insurance companies would 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).
- ***Revisions of the capitalization rule for deferred acquisition costs ("DAC").*** The DAC rules would be revised to replace the existing three categories of insurance contracts with only two categories, and by raising the percentages at which premiums are capitalized. The two categories would consist of (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.
- ***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, would be fixed at 40%, rather than determined pursuant to a proration formula.

- ***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 would be repealed.
- ***Modifications of net operating loss carryover rules*****.** Life insurance companies would be allowed to carry net operating losses back up to two tax years or forward up to twenty tax years (as opposed to a three-year period for carrybacks and a fifteen-year period for carryforwards under current law), in conformity with the general net operating loss carryover rules.
- ***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) would be repealed. Any remaining balances (as of the effective date) would be subject to tax, payable in eight annual installments.

Property and Casualty Insurance Company Provisions:

- ***Modification of proration rules for property and casualty insurance companies*****.** The reduction in the reserve deductions of property and casualty insurance companies would be increased from 15% to 26.25% 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.
- ***Modification of discounting rules for property and casualty insurance companies.*** A property and casualty insurance company would 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 would be applied similarly to all lines of business. The draft legislation also would repeal the election to use company-specific, rather than industry-wide, historical loss payment patterns. A transition rule would spread adjustments relating to pre-effective date losses and expenses over such tax year and the succeeding seven tax years.

International Provisions:

- ***20% Excise Tax on Payments to Foreign Affiliates.*** Domestic corporations would be subject to a 20% tax in making certain deductible payments to a foreign affiliate, unless the affiliated foreign corporation elected to treat the payments as effectively connected income. Reinsurance transactions with foreign affiliates would presumably be subject to these rules.
- ***Restriction on insurance business exception to passive foreign investment company ("PFIC") rules.*** The PFIC exception for insurance companies would be 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, unearned premiums, 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).

The provisions above would generally be effective for tax years beginning after 2017.

Other provisions in the draft legislation which affect corporations and multinationals could also impact insurance companies, including, amongst others, provisions which would implement a lower corporate tax rate, a shift to a territorial tax system, the mandatory deemed repatriation of offshore earnings and profits, 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.

The House Ways and Means Committee will begin acting on the bill on November 6, 2017. Many of the details that still remain to be fully drafted should be clarified as that markup progresses. Separately, the Senate Finance Committee is working on draft tax reform language, which is expected to be released by Thanksgiving. However, that timeline could change if House Republicans fail to first act on the bill in their own chamber.

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