



# TaxNewsFlash - Insurance provisions in the U.S. tax reform bill

## Bermuda

**November 3, 2017**

Ways and Means Chairman Kevin Brady (R-TX) has unveiled legislative text of H.R. 1, the "Tax Cuts and Jobs Act," as well as a section-by-section summary of the proposed legislation.

While the full list of proposed changes is extensive, the centerpiece of the bill is the significant reduction in the corporate income tax rate from 35% to 20% beginning in 2018. The bill also includes a number of individual tax proposals, including changes to the current tax brackets and new limits on deductions for home mortgage interest and state and local taxes.

The bill proposes significant changes to the taxation of business income earned outside the United States, including a move to a "territorial" system of taxation, an exemption on certain dividends paid by a 10% or more owned foreign corporation to U.S. corporate shareholders, a deemed repatriation of previously deferred foreign earnings, and a new 10% minimum tax on "high return" foreign earnings of multinational businesses.

One of the more novel proposals in the bill—and one that is certain to engender discussion and debate in the coming weeks—is a proposed 20% excise tax on certain payments made by a domestic company to a foreign affiliate (discussed further below).

Earlier today, Chairman Brady released his "[Chairman's mark](#)" in preparation for a Ways and Means Committee markup of H.R. 1 next week. Chairman Brady has also announced that an additional amendment will be offered at the start of the markup on Monday to make more "substantive improvements" to the bill.

The bill includes a number of proposals specifically targeting the insurance industry, and along with the proposed changes to the international tax provisions could potentially have a significant impact on multinational insurance and reinsurance groups.

### **KPMG observation**

The release of legislative text represents the most significant step towards tax reform in over 30 years and begins the first official phase of the tax reform process. Importantly, the legislative text provides the first look at the details of many proposals that have been discussed at a high level for several months.

Keep in mind, however, that these proposals are just the first step on the long road to potential tax reform. There are numerous other steps that need to occur for the proposals to become law. More changes, possibly significant ones, are likely coming in the following days. Any broadening of the tax benefits in the bill will need to be matched by tax increase elsewhere. Because changes are expected, it is too early to opine on the political viability of the bill.

## Major Insurance Provisions

Following is a summary of some of the key proposals from the legislative text related to multinationals in the insurance industry.

### **Excise tax on certain payments from domestic corporations to related foreign corporations; election to treat such payments as effectively connected income (section 4303 of the tax bill)**

Under the provision, certain deductible payments (other than interest) made by a U.S. corporation to a related foreign corporation would be subject to a 20% excise tax, unless the related foreign corporation elected to treat the payments as income effectively connected with the conduct of a U.S. trade or business. Consequently, the foreign corporation's net profits (or gross receipts if no election is made) with respect to those payments would be subject to full U.S. tax, eliminating the potential U.S. tax benefit otherwise achieved. No credit would be allowed for foreign taxes paid with respect to the profits subject to U.S. tax. Further, in the event no election is made to treat the payments as taxable income, no deduction would be allowed for the U.S. corporation's excise tax liability.

The new 20% excise tax regime for payments to related foreign entities effectively imposes a destination-based tax on the income of a foreign- or domestic-parented multinational group that imports into the U.S. through a taxable presence. To some extent this can be viewed as in the spirit of the Border Adjustment Tax ("BAT") proposal that was abandoned earlier in the year. It does, however, differ significantly in that it applies only to transactions with related parties, and even then provides an option which allows for a formulaic deduction for costs incurred.

If enacted, the provision would be effective beginning after December 31, 2018 and would apply to international financial reporting groups with payments from U.S. corporations to their foreign affiliates totaling at least \$100 million annually.

#### **KPMG observation**

By imposing a 20% tax on most deductible payments except interest paid to a related foreign corporation, those payments become effectively non-deductible. This could have a meaningful impact to Bermudian-based insurance groups with U.S. subsidiaries which cede premiums to an affiliated reinsurer in Bermuda (or other foreign jurisdictions).

### **Restriction on insurance business exception to passive foreign investment company rules (section 4501 of the tax bill)**

This provision would expand the application of the Passive Foreign Investment Company ("PFIC") rules by limiting the exception from the rules for active insurance businesses.

Under the proposal, the current law exception from passive income for certain investment income derived from the active conduct of an insurance business would apply only to a foreign corporation that satisfies the new definition of a "qualifying insurance corporation."

The new definition of a "qualifying insurance corporation" (whose investment income would not cause it to be a PFIC) would be expanded by adding the requirement that its "applicable insurance liabilities constitute more than 25% of its total assets" based on "liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year." Applicable liabilities would include loss and loss adjustment expenses, unearned premiums, and certain reserves.

The proposal would provide potential relief to a foreign corporation that cannot meet the new 25% test by giving the Treasury Secretary regulatory authority to allow a U.S. person owning stock of such a foreign corporation to elect to treat it as a qualifying insurance company if: (1) its applicable liabilities equal at least 10% of its assets; and (2) (a) the foreign corporation is predominantly

engaged in an insurance business, and (b) the failure to satisfy the greater-than-25% threshold is due solely to run-off-related or rating-related circumstances involving such insurance business.

#### KPMG observation

This provision largely tracks prior legislative proposals that were described as addressing a perceived abuse whereby some insurance activities were used to shelter large investments. The proposed change might also have significant implications for non-U.S. insurance companies that insure long-tail and catastrophic risks. U.S. persons owning stock of a corporation treated as a PFIC because it is ineligible for the active insurance exception in Code section 1297(b)(2)(B) would be required to begin filing Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, and to consider available PFIC-related elections.

The proposal in the tax bill could require the Treasury Department to issue new regulations, and the IRS to amend Form 8621, for taxpayers to take advantage of the election it would provide to U.S. shareholders of certain affected foreign corporations that fail the 25% test.

#### **Modify proration rules for property and casualty (P&C) insurance companies (section 3707 of the tax bill)**

This provision would replace the fixed 15% reduction in the reserve deduction for P&C insurance companies with a fixed 26.25% reduction in the reserve deduction.

#### KPMG observation

The Ways and Means section-by-section explanation states that this proposed 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. However, it is unclear how that rationale is consistent with the purpose under prior law to measure the amount of tax-exempt income credited to reserves (estimated at 15%) in order to eliminate a double benefit.

#### **Modify discounting rules for property and casualty (P&C) insurance companies (section 3708 of the tax bill)**

Under this provision, P&C insurance companies would be required to use a higher rate—the corporate bond yield curve (as specified by Treasury)—to discount their unpaid losses under Code section 846. In addition, the special rule that extends the loss payment pattern period for all “long-tail lines” of business would be applied similarly to all lines of business. The provision would also repeal the election to use company-specific, rather than industry-wide, historical loss payment patterns.

#### KPMG observation

This proposal is scored as a large insurance tax revenue-raiser at \$13.2 billion over the period 2018-2027 and would significantly affect the computation of P&C loss reserves. The stated rationale for modifying the discount rate to a corporate bond-based rate is to provide a “more accurate measurement of income.”

The change in loss payment patterns may provide simplification, but it would shorten or lengthen the pattern for different lines of business, which may or may not correspond more closely with actual loss payment patterns in the industry.

Elimination of the section 846(e) election would provide simplification, and would affect some insurers more significantly than others.

#### **Repeal elective deduction and related special estimated tax payment rules (section 3709 of the tax bill)**

This provision would repeal the Code section 847 elective deduction and related special estimated

tax payment rules. Under current law, insurance companies may elect 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. Companies that make this election are required to make a special estimated tax payment equal to the tax benefit attributable to the deduction.

#### KPMG observation

Code section 847 was originally enacted to provide for the admissibility of deferred tax assets associated with loss reserve discounting under the recognition rules of FAS 96. FAS 109 liberalized these requirements, and section 847 became unnecessary and administratively burdensome.

### **Modify operations loss deductions of insurance companies (section 3701 of the tax bill)**

This provision would alter the operations loss carryover and carryback periods for life insurance companies (currently carried back three years and forward 15 years) by striking Code sections 810 and 844 and conforming these periods to those of other corporations.

A provision (section 3302) of the tax reform bill would repeal all net operating loss carrybacks (except for a special one-year carryback for small businesses and farms in the event of certain casualty and disaster losses) and allows taxpayers to carry operating losses forward indefinitely. Under the proposed provision, taxpayers would be able to deduct a net operating loss carryover (or carryback) limited to 90% of the taxpayer's taxable income for the year.

#### KPMG observation

Combined with the effects of the overall tax rate reduction and the general provisions under Code section 172, the provision could have a substantial impact on a life company's deferred tax asset admissibility computation for statutory accounting purposes. The first part of the admissibility test under SSAP 101 would no longer be applicable, since it allows life insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

### **Repeal small life insurance company deduction (section 3702 of the tax bill)**

This section would repeal the Code section 806 special deduction for small life insurance companies.

#### KPMG observation

This provision is described as eliminating a tax subsidy for a particular industry that is not available to other industries and would remove a tax preference that is provided to the segment of the insurance industry in which the risk distribution benefits of pooling are the weakest. Some tax professionals have questioned the factual foundation of this assertion. The tax reform bill would not repeal preferential treatment for small non-life insurance companies.

### **Computation of life insurance tax reserves (section 3703 of the tax bill)**

Under this provision, life insurance companies would take into account a specific percentage—76.5%—of the increase or decrease in reserves for future un-accrued claims (as reported on the insurer's regulatory annual statement and on tax schedule M-3) in computing taxable income. Deficiency reserves, asset adequacy reserves or other types of reserves would not be included.

#### KPMG observation

This proposal is scored as the largest revenue raiser under the changes to the subchapter L provisions. This reflects a significant departure from the current rules under section 807 which calculate tax reserves based on (albeit conservative) actuarial principles. The 23.5% "haircut" on

statutory reserves would create a reduced tax reserve amount without incorporating the time value of money or other actuarial principles.

The Ways and Means section-by-section summary states that the new rules take into account reserves on an economically neutral basis, and that the current law uses a regulatory-based measurement that generally understates income. However, the resulting tax reserves would be significantly less than the actuarial reserves that are used for any other purpose by the actuarial community.

The proposal also excludes deficiency reserves, asset adequacy reserves, and certain other unidentified reserves from section 807 reserves. It is unclear whether these reserves are expected to follow statutory accounting definitions or tax specific definitions.

The tax reform bill appears to eliminate the section 807 floor that stipulates tax reserves cannot be less than the contract's cash surrender value. As a result, certain contracts, such as certain deferred annuities, could have tax reserves that are significantly less than the contract's cash surrender value.

In addition, these provisions could result in a significant impact on surplus in light of the statutory accounting limitations on admissibility of deferred tax assets.

### **Repeal Code section 807(f) spread – adjustment for change in computing reserves (section 3704 of the tax bill)**

This provision would repeal the special 10-year period for adjustments to take into account changes in a life insurance company's basis for computing reserves. The general rule for tax accounting method adjustments (as described above) would apply to changes in computing reserves by life insurance companies.

#### **KPMG observation**

This proposal would put life reserve computation changes on the one-year or four-year spread rules applicable to general changes in methods of accounting. The proposal appears to provide that changes in life insurance reserve basis would continue to be an automatic adjustment and not require prior approval for such changes. Presumably, such changes would require life insurers to request permission to change the method which is a departure from the existing Code section 807(f) requirement.

### **Modify rules for life insurance proration for purposes of determining the dividends received deduction (DRD) (section 3705 of the tax bill)**

This provision would change the life insurance company proration rules for the DRD in Code section 805(a)(4) by changing the company share to 40%.

#### **KPMG observation**

The current rules are overly complex and based on an archaic system of life insurance company taxation. This provision would set the industry average of the company share as the company share for tax purposes. Some tax professionals believe this change would significantly increase taxable income for companies that have large variable life products.

### **Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts (section 3706 of the tax bill)**

This proposed measure would repeal rules (originally enacted in 1959) relating to the tax treatment of distributions from policyholders surplus accounts. From 1959 to 1984, half of a life insurer's operating income was taxed only when the company distributed it, and a "policyholders surplus

account” kept track of the untaxed income. Legislation enacted in 2004 provided a two-year holiday that permitted tax-free distributions of these balances during 2005 and 2006. During this period, most companies eliminated or significantly reduced their balances.

#### KPMG observation

This proposal was one suggested by the ABA Tax Section Insurance Companies Committee and is not expected to raise significant revenue.

### **Capitalize certain policy acquisition expenses (DAC) (section 3710 of the tax bill)**

This proposal would substantially increase the capitalization rates applicable to specified insurance contracts under Code section 848, and would replace the current three categories of contracts with only two categories: group contracts (4%) and all other specified contracts (11%).

#### KPMG observation

This provision would represent a significant tax increase on the life insurance industry. When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. The proposal would have the effect of significantly increasing the amount of tax DAC capitalized. The proposed measures would further reduce current deductions for these expenses.

### **Documents**

- Read the [Chairman's mark](#)
- Read legislative text of [H.R. 1](#)
- Read a [section-by-section summary](#) prepared by the Ways and Means Committee
- Read a related [Ways and Means press release](#)
- Read a revenue estimate prepared by the Joint Committee on Taxation: [JCX-46-17](#)

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