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KPMG

TaxNewsFlash

U.S. Tax Reform: Insurance Provisions in the Conference Report to H.R. 1

Bermuda

On December 20, the U.S. Senate and House passed a revised version of the conference report to H.R. 1, the tax reform bill, setting the stage for President Trump to sign the bill into law. It is not yet clear whether President Trump will sign the bill this month or in January 2018.

- Read the conference agreement [PDF 4.25 MB] (1097 pages)
- Read a joint explanatory statement [PDF 1.77 MB] (570 pages) of the conference agreement

Major insurance provisions

Some of the changes made during the conference affect the insurance provisions described below.

Tax on base erosion payments (section 14401 of the conference agreement)

This provision establishes a base-erosion-focused minimum tax (the "base erosion and anti-abuse tax" or "BEAT") that in many cases will significantly curtail the U.S. tax benefit of cross-border related-party payments made by large multinationals.

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least $500 million of annual domestic (including effectively connected amounts earned by foreign affiliates) gross receipts (over a three-year averaging period), and which have a "base erosion percentage" (discussed below) of 3% or higher for the tax year (or 2% for certain banks and securities dealers, which are also subject to a higher BEAT rate, as discussed below). The provision also applies to foreign corporations engaged in a U.S. trade or business for purposes of determining their effectively connected income tax liability.

The targeted base erosion payments generally are amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable, and also include amounts paid in connection with the acquisition of depreciable or amortizable property from the foreign related party. The Conference Bill also specifically includes cross-border reinsurance payments as base erosion payments. Such category includes any premium or other consideration paid that is taken into account as a reduction in either life insurance gross income under section 803(a)(1)(B) or insurance company taxable income under section 832(b)(4)(A). Finally, for taxpayers that after November 9, 2017 become part of an "inverted" group, determined by reference to section 7874, base erosion payments also include "any amount that constitutes reductions in gross receipts" of the taxpayer when paid to the surrogate foreign corporation or any member of its expanded affiliated group.

There are two main exceptions to the provision's scope for otherwise deductible payments. The first is for any "amount" paid or incurred for services that qualify "for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)" and that reflects the total cost of the services without markup. The second is for "qualified derivative payments" for taxpayers that annually recognize ordinary gain or loss (e.g., mark to market) on such instruments, and subject to several exceptions.

The definition of a foreign related party is drawn from current section 6038A and includes any 25% foreign shareholder of the taxpayer, related persons thereto, and any other person related to the taxpayer under the section 482 rules.

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount. This amount equals the excess of 10% of the taxpayer's modified taxable income ("MTI") for the year (5% for 2018), over an amount equal to the pre-credit regular income tax liability reduced (but not below zero) by any credits, other than the research credit and a certain amount of "applicable section 38 credits" that include the low-income housing credit, renewable energy production credit, and energy credits allowed in that year. Applicable section 38 credits are only included to the extent of 80% of the lesser of the credits or the base erosion tax amount otherwise computed.

MTI is the taxpayer's taxable income, with the base erosion tax benefit amount (including the base erosion percentage of an NOL deduction) added back.

The BEAT computation is modified to raise additional revenue for tax years beginning after December 31, 2025 through the following changes which take effect in such years: (i) the 10% of MTI input will increase to 12.5% of MTI; and (ii) the tax liability against which 12.5% of MTI is compared is simply regular income tax liability minus all credits, which appears to remove the previously retained benefit of the research credit and qualifying section 38 credits.

The provision would introduce new reporting requirements under the existing Code section 6038A regime (Form 5472) to collect information regarding applicable taxpayers' base erosion payments. The provision would also increase that reporting regime's existing $10,000 penalty to $25,000.

The provision applies to payments paid or accrued in tax years beginning after December 31, 2017.

KPMG observation

The conference report added specific language related to the impact of the BEAT on insurance and reinsurance. The inclusion of related-party cross border reinsurance, which is very common within the insurance industry, will significantly impact large segments of the insurance market.

Modify insurance exception to the passive foreign investment company rules (section 14501 of the conference agreement)

The conference agreement modifies a current law exception from passive income that prevents certain investment income derived from the active conduct of an insurance business from causing a foreign corporation to be a passive foreign investment company (PFIC). Section 14501 of the conference agreement would amend this exception in the PFIC rules to apply only to a foreign corporation whose applicable insurance liabilities constitute more than 25% of its total assets as reported on the corporation's applicable financial statement for the last year ending with or within the tax year (the new 25% test).

Applicable liabilities of any property and casualty or life insurance business include loss and loss adjustment expenses and certain reserves, but do not include unearned premium reserves.

An applicable financial statement is a statement for financial reporting purposes that is made on the basis of generally accepted accounting principles (GAAP), on the basis of international financial reporting standards (IFRS) if no GAAP statement is available, or, "except as otherwise provided by the Secretary in regulations," on the basis of the annual statement required to be filed with the applicable insurance regulatory body, but only if neither a GAAP nor IFRS statement is available. Unless otherwise provided in regulations, GAAP means U.S. GAAP.

Section 14501 of the conference agreement provides potential relief to a foreign corporation that cannot meet the new 25% test by giving the 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 runoff-related or rating-related circumstances involving such insurance business.

Section 14501 of the conference agreement would apply to tax years (presumably of foreign corporations being tested for PFIC status) beginning after December 31, 2017.

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 change may also have impacts on 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.

Under current law (Code section 6501(c)(8)), a U.S. person that fails to file Form 8621 for a year generally would have the statute of limitations for its tax return for that year kept open until three years after the U.S person furnishes the required information to the IRS. This provision also could require the Department of the Treasury 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 new 25% test.

Modify operations loss deductions of life insurance companies (section 13511 of the conference agreement).

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

The provision also modifies the carryover and carryback rules for all corporations (except for nonlife insurance companies, as discussed below). Generally, all net operating loss carryback provisions are repealed and taxpayers are allowed to carry net operating losses forward indefinitely (except for a special two year carryback in the case of certain losses incurred in the trade or business of farming). Under the proposed provision, taxpayers' ability to deduct a net operating loss carryover (or carryback, under the aforementioned casualty loss provision) would be limited to 80% of the taxpayer's taxable income for tax years beginning after December 31, 2017.

KPMG observation

This proposal would put life insurance companies on the same loss carryback and carryforward schedule as other corporations (other than nonlife insurance companies). The repeal of nearly all carrybacks 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 for ordinary deferred tax assets since it allows insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

Retain net operating loss deductions of property and casualty insurance companies (section 13302 of the conference agreement)

This section would preserve present law for net operating losses of property and casualty companies. Under the modification, net operating losses of property and casualty companies may be carried back two years and carried forward 20 years to offset 100 percent of taxable income in such years.

KPMG observation

This proposal would put life insurance companies and non-life insurance companies on different loss carryback and carryforward schedules. Unlike the impact on the life insurance industry, a non-life insurance's company's deferred tax asset admissibility computation for statutory accounting purposes would not change. The first part of the admissibility test under SSAP 101 would still be applicable and would allow the same computations as under current law. The 80% limitation applicable to life insurance companies and other corporations is not applicable to non-life insurance companies. The mismatch of the treatment of NOLs between life and non-life companies will potentially lead to consolidation difficulties and the need to keep detailed schedules for tracking purposes.

Modify proration rules for property and casualty (P&C) insurance companies (section 13515 of the conference agreement)

The proposed provision replaces the 15% reduction under present law with a reduction equal to 5.25% divided by the top corporate tax rate. Under the conference agreement, for 2018 the top corporate tax rate is 21%, so the percentage reduction for P&C companies is 25%. The proration percentage will be automatically adjusted in the future if the top corporate tax rate is changed, so that the product of the proration percentage and the top corporate tax rate always equals 5.25%.

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

KPMG observation

The Conference Committee description states that the increase in the haircut within the provision would keep the reduction in the reserve deduction consistent with current law by adjusting the rate proportionally to the decrease in the corporate tax rate. That rationale may not be consistent with the provision's purpose under current law, which is to measure the amount of tax-exempt income credited to reserves (estimated at 15%) in order to eliminate a double benefit. Although the reduction is significant, a rate tied to the product of the proration percentage and top corporate tax rate may still be preferable overall to many insurers as the calculated rate facilitates predictability of after-tax rates of return on tax-exempt bonds and compares those rates to other investments.

Computation of life insurance tax reserves (section 13517 of the conference agreement)

This proposed provision would allow life insurance companies to take into account the amount of the life insurance reserves for any contract, which is calculated as the greater of: (1) the net surrender value of the contract or (2) 92.81% of the reserve computed as required by the National Association of Insurance Commissioners (NAIC) at the time the reserve is determined.

The conference agreement maintains the requirements that tax reserves cannot be less than the contract's cash surrender value, or greater than the statutory reserve for the contract. The conference agreement eliminates the requirement that the reserve method used for tax purposes be the method prescribed by the NAIC in effect on the date of the issuance of the contract. A "no double-counting" rule provides that no amount or item is taken into account more than once in determining a reserve under subchapter L. The Conference report provides several examples of the application of the no double-counting provision. A reporting requirement with respect to the opening and closing balance of reserves and with respect to the method of computing reserves for purposes of determining income is added.

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

KPMG observation

The provision generally simplifies the current complex section 807 reserve calculation. The current rules in the Tax Code do not explicitly provide how reserves measured using principle based approaches should be taken into account for tax purposes. The conference agreement approach largely clarifies how principle based reserves should be treated.

The proposed provision in the conference agreement uses a 7.19% haircut of statutory reserves. The elimination of the current law requirement that the reserve method be set at the time the contract is issued will also eliminate any question about whether changes made by the NAIC to reserve methods should be reflected in the tax reserve.

As under current law, deficiency reserves and asset adequacy reserves cannot be included in reserves computed for federal tax purposes. The provision includes a prohibition on double-counting reserves. The Conference Committee explanation for this provision indicates that it is intended that reserves for each contract be included only once in computing life insurance company taxable income.

Modify rules for life insurance proration for purposes of determining the dividends received deduction (DRD) (section 13518 of the conference agreement)

This section would change the life insurance company proration rules for the DRD in Code section 805(a)(4) by changing the company share to 70% and the policyholder share to 30%. The provision would be effective for tax years beginning after 2017.

KPMG observation

The current rules are complex and based on an archaic system of life insurance company taxation. This provision would simplify the proration calculation by setting the company share and policyholder share percentages to a fixed amount.

Capitalize certain policy acquisition expenses (DAC) (section 13519 of the conference agreement)

This provision would increase the capitalization rates applicable to specified insurance contracts under Code section 848. The current proxy rates applied to net premiums on "specified insurance contracts" are 1.75% for annuity contracts, 2.05% for group life insurance contracts and 7.7% for individual life insurance, group and individual health insurance, and other insurance contracts. The current provision allows for a 10-year spread.

The proposed capitalization rates are as follows:

- Annuity Contracts (2.09%)
- Group Life Contracts (2.45%)
- All other specified contracts (9.20%)

The proposal extends the amortization period from a 120-month period to the 180-month period beginning with the first month in the second half of the taxable year. The proposal does not change the special rule providing for the 60-month amortization of the first $5 million (with phase-out).

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

KPMG observation

When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. Also important to note is that unamortized DAC amounts that exist before the law change becomes effective would not be impacted and the associated amortization would continue over the previous 10 year period.

Modify discounting rules for property and casualty (P&C) insurance companies (section 13523 of the conference agreement)

This provision would require P&C insurance companies to use a higher rate—the corporate bond yield curve (as specified by Treasury)—to discount their unpaid losses under Code section 846, instead of using the applicable mid-term federal rate. The corporate bond yield curve is defined by section 430(h)(2)(D)(i), but a 60-month period is substituted for a 24-month period. The corporate bond yield curve means, with respect to any month, a yield curve that reflects the average, for the preceding 60-month period of monthly yields on investment grade corporate bonds with varying maturities and that in the top three quality levels available.

The provision would also repeal the election in section 846(e) to use company-specific, rather than industry wide, historical loss payment patterns.

The present-law three-year period for discounting certain lines of business other than long-tail lines of business is not modified under the conference agreement.

The special rule that extends the loss payment pattern period for long-tail lines of business remains (but with the five-year limitation on the extended period increased to 14 years) so that:

- The amount of losses which would have been treated as paid in the 10th year after the accident year shall be treated as paid in such 10th year and each subsequent year in an amount equal to the amount of the average of the losses treated as paid in the 7th, 8th, and 9th years after the accident year (or, if lesser, the portion of the unpaid losses not therefore taken into account).
- To the extent such unpaid losses have not been treated as paid before the 24th year after the accident year, they shall be treated as paid in the 24th year.

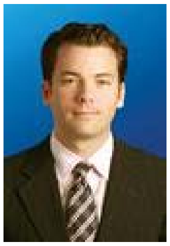
The provision generally would be effective for tax years beginning after 2017, with a transition rule that would spread adjustments relating to pre-effective date losses and expenses over such tax year and the succeeding seven tax years.

KPMG observation

This provision was included in the House's version of H.R. 1, but was not included in the Senate's version. The conference report reintroduces this amendment to the loss reserve discounting rules. The change in loss payment patterns may provide simplification, but will 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 will provide simplification, but will affect some insurers more significantly than others.

For more information contact:



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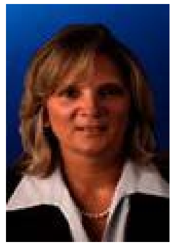

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