Insurance-Related Provisions of the Tax Reform Act

On December 20, 2017, Congress passed the legislation known as the Tax Cuts and Jobs Act (the Tax Act), which the president is expected to sign into law. Sidley’s general update on the final version of the Tax Act will be posted on our Tax Reform Development and Insights webpage, which can be accessed by clicking here. Below is a summary of certain insurance-specific provisions of the final bill.

**Life Company Tax Reserves**

**Current Law:**
Life insurance companies compute tax reserves using the greater of net surrender value or the federally prescribed reserve (subject to a statutory reserves cap).

**Final Bill:**
The Tax Act, like the Senate Bill, generally reflects a solution proposed by the life industry trade association. Under the Tax Act, tax reserves will be the greater of net surrender value or 92.81% of statutory reserves. This haircut on statutory reserve for non-cash value contracts is slightly larger than under the Senate Bill, which used 92.87%. The controversial current law concept of the CRVM/CARVM “in effect on the issue date” is eliminated.

The Senate bill left in place a prescribed tax reserve (2-year full preliminary term method) for noncancellable and guaranteed renewable A&H contracts (other than qualified long-term care insurance). Under the Tax Act, reserves for such contracts will be determined under the NAIC-prescribed method for such contracts, subject to the haircut described above, consistent with the treatment of other non-cash value business.

The Conference Report specifies that under a grant of rulemaking authority to require reporting of opening and closing reserve balances, and reserve methods, the IRS may require that separate account reserve items be reported on a combined basis with general account items.

**Life Reserves: Transition Rule**
Under the Tax Act, reserves are restated as of January 1, 2018, and an eight-year spread period is provided for taking the resulting reductions into income. If the restatement produces an increase in the reserve for a contract, the increase is treated similarly, as a deduction spread over an eight-year period.

**Deferred Acquisition Costs (DAC)**

**Current Law:**
Insurance companies with premium income from “specified insurance contracts” (generally life and non-qualified annuity business) must defer over 120 months arbitrary amounts of otherwise deductible business expenses. The three broad categories of specified insurance contracts are annuity (1.75% capitalization rate), group life (2.05%), and other specified contracts (e.g., individual life contracts) (7.7%).

Final Bill:

The Tax Act, like the Senate Bill, generally reflects a solution proposed by the life industry trade association. The amortization period is extended to 180 months. The capitalization rates are increased to 2.09%, 2.45%, and 9.2%, respectively. These final rates reflect very slight reductions from the capitalization rates under the Senate Bill. Existing DAC balances continue to be amortized on the existing schedule.

Dividends Received Deductions (DRD)

Current Law:

Life insurance companies are required to reduce certain tax benefits (e.g., the DRD) to reflect the portion of tax-favored income used to fund tax-deductible reserves for policyholders. Current law employs a complex formula that computes the shares of net investment income that are attributable to the company and to policyholders. The respective shares are computed separately for the company’s general account and for each separate account. Long-standing IRS guidance relating to the separate account computation resulted in substantial amounts of DRD for companies holding dividend-paying stocks in support of variable contracts.

Final Bill:

The “company share” is fixed at 70% under the Act, consistent with the solution proposed by the life industry trade association.

As for the DRD itself, the Tax Act reduces the 70% DRD under current law to 50% (same as the Senate Bill). The last-minute restoration of the corporate alternative minimum tax (AMT) under the Senate Bill had the seemingly unintended effect of eliminating the DRD benefit (among others). The Tax Act repeals the corporate AMT.

Changes to Life Reserves (807(f))

Current Law:

Changes in a life insurance company’s basis for computing reserves are spread over 10 years under Section 807(f).

Final Bill:

The Tax Act treats such a change in the same manner as an accounting method change initiated by the taxpayer with the consent of the IRS and applies Section 481. Existing Section 807(f) amounts continue to be taken into account over their remaining spread period under present law.

P&C Proration

Current Law:
P&C insurance companies are required to reduce losses incurred by 15% of (a) the company’s tax-exempt interest income, (b) the deductible portion of dividends received, and (c) the increase for the tax year in the cash value of life insurance, endowment, or annuity contracts that the company owns. The effective tax rate on these amounts under current law is 5.25%.

Final Bill:

The Tax Act increases the proration percentage to 25%, floating with any future changes in the statutory corporate tax rate, to maintain an effective tax rate of 5.25%.

Loss Reserve Discounting

Current Law:

Unpaid losses are discounted using an interest rate equal to a rolling average of the applicable federal mid-term interest rate and based on either the company’s own loss payment patterns or an industry-wide average loss payment pattern published by Treasury. The Treasury’s published patterns generally assume payment over a period ending either three years, or 10 years, after the accident year (AY), except that for certain long-tail lines of business, the assumed loss payment pattern is extended to AY plus up to 15 years.

Final Bill:

The Tax Act requires reserve discounting based on a higher interest rate determined under a corporate bond yield curve. The election to use the company’s own loss payment patterns is repealed. Lines of business subject to the assumed AY plus 10 years payment pattern under current law are made subject to an assumed payment pattern of AY plus up to 24 years. Loss reserves as of December 31, 2017 are restated under the new discounting rules and the amount of the resulting reduction is taken into income over eight taxable years.

NOLs

Current Law:

In general, under current law, net operating losses (NOLs) may be carried back up to two years and carried forward up to 20 years. Life insurance companies, however, may carry NOLs back up to three years and forward up to 15 years.

Final Bill:

For losses arising in tax years beginning after 2017, the Tax Act repeals carryback provisions for life insurance companies, as it does for non-insurance companies, and makes the carryover period indefinite (no expiration). However, such loss carryovers may be used to eliminate only 80% of pre-NOL taxable income in any year.

Property and casualty insurance companies retain the existing 2-and-20 carryback and carryover periods without the 80% limitation described above. In this respect, the Tax Act recognizes that the existing NOL rules have special importance to the P&C industry in light of volatility due largely to natural disasters.

Corporate AMT

Current Law:
Under current law, corporations must compute their income for purposes of both the regular income tax and the AMT. A corporation’s tax liability before credits is equal to the greater of 35% of taxable income or 20% of AMT income. If 20% of AMT income is greater, the excess is paid as AMT and becomes a credit usable in future years when the regular tax liability is greater.

**Final Bill:**

The Final Bill repeals the corporate AMT. Corporations can continue to use their AMT credits to offset their regular tax liability and can obtain refunds for unused AMT credits. Calendar year corporations with AMT credits should have obtained full offsets or refunds of their AMT credits by 2021.

**Affiliated Foreign Reinsurance**

**Current Law:**

Outbound reinsurance premiums are fully deductible and are subject to a 1% federal excise tax (FET) on the gross reinsurance premium (subject to applicable treaty waivers).

**Final Bill:**

The Tax Act imposes a new corporate “base erosion” AMT at a 10% tax rate on “modified taxable income” (MTI). MTI is taxable income determined without taking into account “base erosion tax benefits” from “base erosion payments” to related foreign persons. The provision applies to groups with at least $500 million of average annual gross receipts and a “base erosion percentage” of at least 3%. No change is made to the FET.

The base erosion AMT is phased in at a 5% rate for 2018, 10% for 2019-2025, and scheduled to increase to 12.5% beginning in 2026. For groups that include a bank or securities dealer the rates are one percentage point higher and the “base erosion percentage” threshold is lower, 2%.

Uncertain aspects of the provision include:

1. The lack of an exception for foreign affiliates engaged in a U.S. business (e.g., through a U.S. branch).
2. Treatment of offsetting/related payments from foreign affiliates. Should the addback to taxable income be the gross reinsurance premium or only the net profit on the ceded business (i.e., the true amount of “base erosion”)?
3. Treatment of loss and claim reimbursements to related foreign companies that purchased coverage from a U.S. affiliate.
4. Application of the rule to modco reinsurance arrangements.
5. Determination of the base erosion minimum tax on a consolidated basis for affiliated groups.
6. MTI NOL carrybacks/carryovers.

**CFCs: Downward Attribution**

**Current Law:**

Code Section 958(b)(4) prohibits so-called “downward attribution” of stock ownership from a foreign person to a U.S. person (e.g., a U.S. corporation or U.S. partnership) in which the foreign person owns an equity interest.
Final Bill:

The Tax Act repeals Section 958(b)(4), therefore permitting the downward attribution of stock from a foreign person to a U.S. entity in which the foreign person owns an interest. This provision significantly expands the circumstances in which a foreign corporation will be classified a controlled foreign corporation (CFC). For example, foreign corporations that are subsidiaries in a foreign-parented group will in many cases be CFCs if the group includes any U.S. subsidiaries, due to the downward attribution of the foreign subsidiaries’ stock to the U.S. subsidiaries.

This could result in annual inclusions of subpart F income for other U.S. persons that directly or indirectly own a stake in the CFC if their total direct, indirect and constructive ownership is 10% or greater. The Senate explanation, restated in the Conference Report, indicates that this result is not intended to apply where such U.S. person, and the U.S. entity to which stock is attributed downward from a foreign person, are not “related” to one another, but the text of the Tax Act does not include any language to implement such intention. The provision is generally effective retroactively beginning with the 2017 tax year.

CFCs: 10% Shareholder By Value

Current Law:

For subpart F purposes, a “United States shareholder” is generally defined as a U.S. person that owns (directly, indirectly or constructively) 10% or more of the voting power of the stock of a foreign corporation.

Final Bill:

The Tax Act expands the definition of “United States shareholder” to include a U.S. person that owns (directly, indirectly or constructively) 10% or more of the value of the stock of a foreign corporation. The provision would therefore render obsolete common planning techniques used to avoid subpart F income inclusions by limiting the voting power (but not the value) of the stock of a foreign corporation owned by a U.S. person (e.g., voting power cutbacks, use of nonvoting stock). The provision is generally effective beginning with the 2018 tax year.

PFIC Insurance Exception

Current Law:

A foreign corporation that owns predominantly financial assets such as securities is generally treated as owning “passive” assets that produce “passive” income, making the corporation a PFIC. However, a foreign corporation is not a PFIC if it derives income from its financial assets “in the active conduct of an insurance business,” is “predominantly engaged in an insurance business,” and would qualify to be taxed as an insurance company if it were domestic. Little guidance is available regarding the application of this active insurance exception.

Final Bill:

The Tax Act revises the insurance exception to add the concept of a “qualifying insurance corporation,” defined as a corporation that would qualify to be taxed as an insurance company if it were domestic and that has “applicable insurance liabilities” greater than 25% of its total assets. Qualifying insurance corporation status may also be available to a company that does not meet this threshold under certain circumstances.
Under the Tax Act “applicable insurance liabilities” include unpaid losses and loss adjustment expenses and certain reserves for life and health insurance risks. The Conference Report indicates that annuity reserves are intended to be applicable insurance liabilities. Unearned premium reserves are not applicable insurance liabilities.

This revised exception should provide somewhat greater certainty than current law, but uncertainty will remain because the revised exception still requires “the active conduct of an insurance business.”

**Taxable Year of Income Inclusion**

**Current Law:**

A taxpayer generally is required to include an item of income no later than the time of its actual or constructive receipt, unless the item is properly accounted for in a different period under the taxpayer's method of accounting, e.g., the accrual method.

**Final Bill:**

The Tax Act provides that accrual method taxpayers must take income into account no later than when the item of income is taken into account in an “applicable financial statement.” The rule does not apply to “any item of gross income for which the taxpayer uses a special method of accounting” under a provision other than Sections 1271–1288 (relating to OID and market discount).

An “applicable financial statement” means a financial statement prepared in accordance with GAAP, IFRS, or, if neither is applicable, a financial statement specified by Treasury.

The Conference Agreement clarifies that this provision is not intended to require a taxpayer to recognize income when a realization event has not occurred. For example, a taxpayer will not need to recognize gain or loss solely as a result of marking securities to market for financial reporting purposes.

The scope of this provision remains unclear. The timing rules of subchapter L relating to premiums, as well as the nonaccrual of market discount for life companies under Section 811(b)(3), would appear to be special methods of accounting applied under provisions other than Sections 1271–1288. Provisions of subchapter L indicating that tax treatment generally conforms to statutory accounting may arguably constitute a special method of accounting; otherwise this new provision of the Tax Act could arguably give GAAP financial statements a higher priority than statutory financial statements for certain items of income.

The provision is generally effective for taxable years beginning after December 31, 2017. However, the provision will not apply to income from a debt instrument having OID until taxable years beginning after December 31, 2018.

If you have any questions regarding this Sidley Update, please contact the Sidley lawyer with whom you usually work or

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