KPMG

TaxNewsFlash

Insurance provisions in Senate Finance Chairman's mark on tax reform

Bermuda

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On November 9, Senate Finance Committee Chairman Orrin Hatch (R-UT) released a "Chairman's mark" of his proposed tax reform legislation. This was followed by the release of a modified Chairman's mark on November 14. Markup – formal consideration of the mark by the Finance Committee – began November 13 and is scheduled to continue through the week as necessary. Further modifications to the proposals are possible throughout the markup process and could affect the provisions described below.

KPMG observation

The release of Finance Committee Chairman Hatch's mark represents another significant step towards tax reform. This action, combined with passage of the Tax Cuts and Jobs Act by the House earlier today represents significant steps toward the enactment of tax reform. However, a long road remains ahead.

The mark (including the provisions in the modified mark) provides further insight into the direction that the Senate tax-writing committee is considering with regard to tax reform. Although further changes may be made during markup, the mark provides the opportunity to examine the areas in which the Senate Republicans approach to tax reform may be similar to, or different from, the approach approved last week by the Ways and Means Committee. While the two proposals do have a large number of similarities, they also differ in substantial ways.

Perhaps the centerpiece of the mark is the reduction in the corporate income tax rate from 35% to 20%. However, unlike the 2018 effective date in the Ways and Means bill, the 20% rate in the mark is not scheduled to become effective until 2019. Like the Ways and Means bill, the full list of proposed changes for businesses in the mark is extensive, including both additional tax benefits and offsetting tax increases.

Notably, the mark includes a number of international and insurance-specific provisions of relevance to multinationals in the insurance industry.

Major provisions affecting the insurance industry

Tax on base erosion payments

Both the Ways and Means bill and the mark include a novel levy focused on deductible payments by large U.S. groups to foreign affiliates. In the Ways and Means

bill, this was the Sec. 4303 Excise Tax on "Specified Amounts." The mark's corollary proposal is a new base-erosion-focused minimum tax (the "BEMT") that differs in several key respects from the House proposal.

The BEMT applies to domestic corporations that are part of a group with at least $500 million of average annual gross receipts and which have a "base erosion percentage" of 4% or higher for the tax year. The "base erosion percentage" is determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer by the aggregate amount of certain deductions allowable to the taxpayer.

The targeted base erosion payments are generally amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable, including amounts paid in connection with the acquisition of depreciable or amortizable property from the related party (further provisions apply to taxpayers that are part of an "inverted" group).

Base erosion payments are subject to the provision when they give rise to a "base erosion tax benefit," meaning that a deduction is allowed for the tax year (further provisions apply where base erosion payments form part of a net operating loss).

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount ("BEMTA"), equal to the excess of:

(i) 10% (increasing to 12.5% after 2025 under the Chairman's modified mark) of the taxpayer's modified taxable income (i.e. taxpayer's taxable income with the base erosion tax benefit amount added back), over

(ii) an amount equal to the regular income tax liability, following adjustments for certain tax credits.

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

KPMG observation

The following example may help illustrate the formula's application.

Assume the ABC U.S. Consolidated Group ("ABC") has a regular tax liability of $20,000 (corresponding to $100,000 of taxable income after the 20% corporate income tax rate takes effect). Thus, the "floor" that the BEMTA must cross is $20,000. The BEMT would be owed to the extent that ABC's MTI equaled more than $200,000. Stated differently, ABC would have to deduct more than $100,000 of base erosion tax benefits for the year to be subject to the BEMT. The foregoing illustrates that, with a 20% corporate tax rate and ignoring the potential impact of tax credits, the BEMT is only due when the taxpayer more than halves its taxable income through base erosion deductions.

The BEMT may significantly affect many inbound companies, and furthermore would affect certain industries disproportionately. As just one example, the proposal has the potential to impact U.S. insurance companies that make significant deductible payments to foreign affiliated reinsurers.

Modification of Passive Foreign Investment Company (PFIC) Exception for insurance companies

This provision appears to be substantially similar to a provision of the Ways and Means bill (section 4501 of H.R. 1), and would have the same effective date and revenue effect.

As with the provision of the Ways and Means bill (section 4501 of H.R. 1), the current law exception from passive income for certain income derived from the active conduct of an insurance business would be modified 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.

Like the Ways and Means bill's provision, the Senate Finance Chairman's mark would provide 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 run-off-related or rating-related circumstances involving such insurance business.

The provision would apply to tax years (presumably of foreign corporations being tested for PFIC status) beginning after December 31, 2017.

KPMG observation

It remains unclear which liabilities of an insurance company would be included in the definition of "applicable insurance liabilities" for purposes of the 25% limitation. The description of the Chairman's mark prepared by the Joint Committee on Taxation specifies that applicable insurance liabilities would include loss reserves for property and casualty, life, and health insurance contracts and annuity contracts, but would not include unearned premium reserves with respect to any type of risk. Conversely, the Senate Finance Committee staff's description of the bill (issued on November 12) specifies that 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 percent of the foreign corporation's total assets. Resolution as to whether unearned premium reserves are included in the determination of applicable insurance liabilities has the potential to significantly impact the number of entities affected by this provision.

Modification of subpart F provisions - Definition of United States shareholder

The mark includes a proposal (Item IV.C.5 of the mark) to revise the definition of "U.S. shareholder" in section 951(b) of the Code to include a U.S. person who owns at least 10% of the value of the shares of the foreign corporation. As a result of this proposal, a U.S. person would be treated as a U.S. shareholder of a foreign corporation for subpart F purposes when the person owns at least 10% of either the voting power or the value of the foreign corporation. The Ways and Means bill does not contain any similar provision.

The proposal in Item IV.C.5 of the mark would be effective for the last tax year of foreign corporations beginning before January 1, 2018, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

KPMG observation

This proposal would increase the scope of U.S. persons who are required to include amounts in income under the subpart F rules. The mark does not describe any coordination rules that may be necessary to prevent double-inclusion of subpart F income when multiple U.S. shareholders hold CFC shares with disproportionate vote and value.

Limitation on the deduction for interest

The proposed provision within the Senate Finance Chairman's mark would amend Code section 163(j) to disallow a deduction for net business interest expense of any taxpayer in excess of 30% of a business's adjusted taxable income.

For this purpose, adjusted taxable income generally would be a business's taxable income computed without regard to: (1) any item of interest, gain, deduction, or loss that is not properly allocable to a trade or business; (2) business interest or business interest income; (3) the 17.4% deduction for certain pass-through income; and (4) the amount of any net operating loss deduction. Business interest would be defined as any interest paid or accrued on indebtedness properly allocable to a trade or business.

The provision would apply to all businesses, regardless of form, and any disallowance or excess limitation would be determined at the filer level. In the case of a group of affiliated corporations that file a consolidated return, it would apply at the consolidated tax return filing level. For pass-through entities, it would apply at the partnership level instead of the partner level. Any business interest disallowed would be carried forward indefinitely. Carryover amounts would be taken into account in the case of certain corporate acquisitions described in section 381, and would be subject to limitation under section 382.

KPMG observation

There appears to be no special rules for financial services entities. As a result, the determination of net business interest expense is unclear for a company like an insurer that generates significant interest income related to investments as an integral part of its active insurance business. The Ways and Means bill (H.R. 1) contains a similar proposal. However, unlike the provision within H.R. 1, the Senate Finance Chairman's mark would determine adjusted taxable income by including certain deductions allocable to the trade or business such as depreciation, amortization, and depletion. In addition, any disallowed interest would be carried forward indefinitely (as opposed to the five-year carryover in the House Ways and Means bill).

Modify proration rules for property and casualty (P&C) insurance companies

This proposed provision replaces the 15% reduction under present law with a reduction equal to 5.25% divided by the top corporate tax rate. For 2018, the top corporate tax rate is 35%, and the percentage reduction is 15%. For 2019 and thereafter, the corporate tax rate is 20% resulting in a percentage reduction of 26.25% under the proration rule for P&C companies. The proration percentage would 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 would always equal 5.25%. The provision would be effective for tax years beginning after 2017.

KPMG observation

The JCT 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 purpose under current law 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. Both the House Ways and Means bill and the Senate Finance Chairman's mark propose a fixed rate that is tied proportionally to the change in the corporate tax rate.

Net operating loss (NOL) deduction

Pursuant to the original Chairman's mark, the following revisions were proposed with respect to future NOL deductions:

- Limit the NOL deduction for a given year to 90% of taxable income, effective with respect to losses arising in tax years beginning after 2017 (similar to the current limitation of NOLs in the corporate alternative minimum tax regime, which would be repealed under the mark)

- Repeal NOL carrybacks

- Provide for the indefinite carry forward of an NOL as opposed to the current 20-year carry forward

- Alter the NOL carryover and carryback periods for life insurance companies (currently carried back 3 years and forward 15) by conforming these periods to those of other corporations.

However, the Chairman's modification to the mark would preserve present law for NOLs of property and casualty insurance companies. Under the modification, NOLs of property and casualty insurance companies may be carried back two years and carried over 20 years to offset 100 percent of taxable income in such years.

Separately, the Chairman's modification limits the NOL deduction to 80% of taxable income in taxable years after December 31, 2023 for all other corporations.

KPMG observation

This proposal would put life insurance companies on the same loss carryback and carry forward schedule as other corporations. The House Ways and Means bill (H.R. 1) has a similar proposal. 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, since it allows insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

Repeal Code section 807(f) spread – adjustment for change in computing reserves

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 would apply to changes in computing reserves by life insurance companies, generally ratably over a four-year period, instead of over a 10-year period. The provision would be effective for tax years beginning after 2017.

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. A similar proposal is in the Ways and Means bill (H.R. 1).

Capitalize certain policy acquisition expenses (DAC)

This provision would substantially 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 would be as follows:

- Annuity contracts (3.7%)
- Group life contracts (3.72%)
- All other specified contracts (13.97%)

The proposal would extend the amortization period from a 120-month period to the 600-month period beginning with the first month in the second half of the tax year. The proposal would 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. The proposal would have the effect of significantly increasing the amount of DAC capitalized as well as extending the amortization period to 50 years and would have a substantial impact on reducing current deductions for these expenses. The proposed 50-year amortization period would result in a DTA that amortizes over an exceptionally long period.

In addition, the increased amortization amounts appear to continue to be capped by the company's general expenses. There also may be a significant change in the amount of the admitted DTA relating to DAC for statutory reporting purposes. This is a significant increase from the current House Ways and Means proposal, which does not currently suggest a change to DAC. The Ways and Means proposal initially increased the DAC capitalization rates, but that proposal was withdrawn and an 8% surtax on life insurance companies was inserted as a placeholder.

Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules

The Senate Finance Chairman's mark would impose reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and would impose reporting requirements on the insurance company issuing the life insurance or annuity contract. In addition, the provision would modify the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

KPMG observation

The provision adds to an insurer's reporting responsibilities by requiring it to identify and report seller information to the IRS. In addition, the reversal of the IRS's position in Rev. Rul. 2009-13 would simplify the insurer's reporting responsibilities by eliminating the bifurcated basis and investment in the contract calculations for contracts surrendered at a gain vs. contracts surrendered at a loss. Whether or not to reduce a seller's basis by the cost of insurance has been a controversial issue, and the provision provides clarity to this situation. This provision was not included in the House Ways and Means bill.

Documents

- Read a **description** of provisions in the Senate's proposed legislation prepared by the Finance Committee staff
- Read a **description** of the Chairman's mark, prepared by the Joint Committee on Taxation (JCT)
- Read a **revenue estimate** of the mark, prepared by the JCT
- Read a **description** of the Chairman's modified mark.
- Read a **revenue estimate** of the Chairman's modified mark
- Read a Finance Committee **policy highlights document**

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