Impact of US Tax Reform on Insurance Companies

Skadden

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Jessica A. Hough
Partner / Washington, D.C.
202.371.7054
jessica.hough@skadden.com

Sally A. Thurston
Partner / New York
212.735.4140
sally.thurston@skadden.com

Robert C. Stevenson
Associate / Washington, D.C.
202.371.7056
robert.stevenson@skadden.com

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Four Times Square
New York, NY 10036
212.735.3000

1440 New York Ave., N.W.
Washington, D.C. 20005
202.371.7000

skadden.com

On December 22, 2017, President Donald Trump signed into law a budget reconciliation act commonly referred to as the Tax Cuts and Jobs Act (TCJA). This sweeping tax bill represents the most comprehensive reform of U.S. tax law since 1986. The new provisions generally serve as an overlay to existing tax law rather than a complete rewrite of the Internal Revenue Code (the Code).[1] In addition to rate cuts, various individual and corporate reforms and major changes to the U.S. international tax provisions, the law makes significant changes to provisions affecting both life and property and casualty (P&C) insurance companies.

Overall, while the reduction of the U.S. corporate rate to 21 percent will generally lower the effective tax rates of insurance companies operating in the United States, some of the specific TCJA provisions could materially affect the profitability of foreign-parented insurance companies with U.S. insurance operations, making the United States a less attractive jurisdiction in which to operate. This in turn could result in decreased competition and increased insurance premiums.

Select Provisions Specifically Affecting Insurance Companies

Computation of Insurance Reserves. The TCJA changes the rules on the computation of insurance reserves for both life and P&C insurance companies, generally resulting in smaller deductions and therefore increased taxable income, which will be offset in whole or in part by the lower effective tax rate.

Under the new law, life insurance reserves for any contract are determined as the greater of the net surrender value of such contract, or 92.81 percent of the amount determined using the tax reserve method otherwise applicable. However, the tax reserves may not exceed the statutory reserve with respect to the contract as calculated for statutory reporting. Under a transition rule, life insurance companies will be required to recalculate their 2017 reserves as if the 2018 tax reform rules had been in effect at that time, compare it to the actual 2017 reserves and account for the difference over eight years beginning in 2018.

P&C insurance companies will also likely see their loss reserves decrease due to the changes in the reserve computation rules. Before TCJA, P&C loss reserves were discounted using a discount rate based on the applicable federal midterm rate. The TCJA changed the basis of the discount rate to the corporate bond yield curve (yields on investment grade corporate bonds with varying maturities). In addition to effectively increasing the discount rate, the new law extended for certain lines of business the periods for determining loss payment patterns and repealed the election, allowing taxpayers to use their own historical loss payment pattern rather than the industrywide loss payment pattern. Similar to the transition rules applicable to life insurance companies, P&C insurance companies need to restate their reserves as of the end of 2017 and take the resulting reduction into account over eight years.

Given the potential for insurance companies to have income and deduction items recognizable in future years due to these changes in the computation of insurance reserves, in the context of a merger and acquisition, transaction consideration should be given to how to value such items. For example, in the case of deductions to be taken into account in future years under Section 805(a)(2) or 832(c)(4), as applicable, consideration should be given as to whether such deductions are built-in loss items subject to Section 382 in the context of an ownership change.

[1] All section references are to the Code.

Capitalization of Certain Policy Acquisition Expenses. The TCJA made changes to the rules requiring insurance companies to capitalize and amortize a portion of policy acquisition expenses on certain specified insurance contracts. The TCJA extended the amortization period for these expenses from 120 months to 180 months. Further, it increased the percentage of expenses subject to the capitalization rule as follows: (i) from 1.75 percent to 2.1 percent for annuity contracts, (ii) from 2.05 percent to 2.46 percent for group life insurance contracts, and (iii) from 7.7 percent to 9.24 percent to all other specified insurance contracts. These changes are likely to increase the deferred tax assets of insurance companies that write business that is subject to the deferred acquisition cost provisions.

Net Operating Loss Utilization. The TCJA changed a U.S. corporation's ability to offset taxable income with net operating losses (NOLs) arising in tax years beginning after December 31, 2017, and the ability to carry such NOLs both forward and back to different tax years.

Under pre-TCJA law, NOLs could generally offset 100 percent of taxable income, and unused NOLs could be carried back two years and forward 20 years. The new law limits NOL deductions to 80 percent of taxable income, eliminates carrybacks and allows indefinite carryforwards. NOLs arising in tax years that began on or before December 31, 2017, will remain subject to the two-year carryback and 20-year carryforward rule until their expiration and also will continue to be available to offset 100 percent of taxable income. Under the TCJA, life insurance companies are now subject to these new limits on NOLs, putting them on the same footing for NOL purposes as noninsurance companies.[2]

The changes described above, however, do not apply to P&C insurance companies. The NOLs of P&C insurance companies continue to be available to offset 100 percent of taxable income and can be carried back two years and carried forward 20 years.

The new TCJA rules on NOL utilization may result in additional complexity in the case of consolidated groups that include both life and nonlife companies, as the groups will need to separately track the different NOL limitations.[3]

Adjustment for Change in Computing Reserves. The TCJA repealed the special 10-year period for adjustments to take into account changes in a life insurance company's basis for computing reserves. The TCJA now aligns reserve strengthening and weakening with the general rules under Section 481 for accounting method changes. This generally means that the strengthening or weakening of reserves will change from a 10-year period of inclusion to a four-year period of inclusion for unfavorable changes and a one-year period of inclusion for favorable changes.

Proration. The TCJA modified the proration rules for P&C insurance companies with respect to tax-exempt interest and the dividends-received deduction by replacing the 15 percent reduction under prior law with a reduction equal to 5.25 percent divided by the top corporate tax rate. Given the 21 percent corporate tax rate, the current proration percentage is 25 percent, resulting in the same after-tax yield for tax-exempt bonds as under prior law. Note, however, that the after-tax yield of taxable bonds is likely to increase given the reduction in tax rates, resulting in potential uncertainty as to whether the reduction of the yield gap between tax-exempt and taxable bonds will affect investment decisions.

Other Provisions Impacting Insurance Companies

Base Erosion and Anti-Abuse Tax. One of the most dramatic changes to the international tax rules came in the form of a new base erosion anti-abuse tax (BEAT), essentially a 10 percent minimum tax for certain U.S. corporations. The BEAT is intended to mitigate erosion of the U.S. tax base by corporations that make deductible payments to related non-U.S. parties, as well as impose a minimum corporate tax. The BEAT applies to taxpayers that have average annual gross receipts of at least $500 million and a base erosion percentage of 3 percent or higher. The base erosion percentage is generally the ratio between the company's base erosion payments and all of the company's deductible payments.

The BEAT is the amount by which a U.S. corporation's modified income tax liability, computed without taking into account certain deductible base erosion payments and NOLs attributed to such payments, and using a 10 percent rate, exceeds the U.S. corporation's regular income tax liability after reduction for certain tax credits. Instead of the 10 percent rate, the BEAT applies at the rate of 5 percent for 2018 and at the rate of 12.5 percent for taxable years beginning after December 31, 2025. While the BEAT is generally intended to operate as a minimum tax, for companies with NOL carryforwards it will effectively result in a 10 percent excise tax on any deductible outbound payments to related parties (and in some cases effectively a tax on the use of foreign tax credits). Further, the BEAT applies even if the payment is treated as effectively connected income or subpart F income.

[2] Previously, a life insurance company was allowed a deduction for operations loss carryovers and carrybacks in lieu of the deduction for net operation losses. The operations loss carried back three year and carried forward 15 years. The TCJA repealed the operations loss deduction for life insurance companies and allows a regular NOL deduction instead.

[3] For example, pre-2018 life insurance company NOLs will need to be tracked separately from post-2017 life insurance company NOLs, and pre-2018 noninsurance company NOLs will need to be tracked separately from post-2017 noninsurance company NOLs. (P&C insurance company NOLs will need to be tracked separately as well.)

Base erosion payments generally include deductible payments made to related foreign parties, such as interest and payments for services and royalties. Further, any premium or other consideration for reinsurance payments that are taken into account under Section 803(a)(1)(B) (return premiums, and premiums and other consideration arising out of indemnity reinsurance of life insurance companies) or 832(b)(4)(A) (return premiums and premiums paid for reinsurance of other insurance companies) are specifically included in the definition of the base erosion payment.

Insurance companies need to carefully analyze how the BEAT affects their current activities. We expect the BEAT to materially limit the feasibility of offshore affiliated reinsurance arrangements and expect that most of these reinsurance arrangements will be eliminated or significantly altered. Many reinsurance arrangements between related U.S. and foreign affiliates were commutated or recaptured back to the U.S. effective January 1, 2018, in order to avoid the imposition of the BEAT on such reinsurance arrangements.[4] The commutation or recapture of business that was ceded offshore could result in changes to product pricing and adjustments to their capital structure. Note that many insurers with sizeable deferred tax assets may already be dealing with capitalization issues due to the write-down of their deferred tax assets given the changes pursuant to the TCJA.

While arguments could be made under a policy-based approach that the BEAT should only apply on any net reinsurance payments, under the literal language in the TCJA, the BEAT seems to be imposed on the gross amount of reinsurance premiums. As a result, in the case of quota share arrangements, for example, the gross amount of reinsurance premium would be subject to the BEAT without taking into account any inbound payments such as reserve adjustments, ceding commissions and claims payments. Similarly, in the case of modified coinsurance or funds withheld coinsurance, the BEAT could apply to the whole outbound gross premium as well as to the interest on the funds withheld paid over to the assuming company.[5]

As the BEAT only applies to payments to foreign related parties, it should not affect third-party reinsurance. The introduction of the BEAT could thus result in increased demand for reinsurance from unaffiliated insurance companies looking for alternatives to reinsure their U.S. risks. Note that any such third-party reinsurance arrangements — such as a conduit transaction or the use of intermediaries — cannot be used to prevent the avoidance of the BEAT, as the TCJA specifically contemplates that regulations will be issued to subject such arrangements to the BEAT.

Finally, the TCJA did not repeal the excise tax payable on outbound insurance and reinsurance premiums. Thus, in addition to potentially attracting a BEAT liability, insurance and reinsurance premiums paid to foreign insurers and reinsurers with respect to risks located in the U.S. continue to be subject to an excise tax at the rate of 1 or 4 percent.

CFC, RPII and PFIC Rules. The TCJA generally did not change the subpart F rules applicable to insurance income. For example, for purposes of taking into account insurance income, the special definition of a controlled foreign corporation (CFC), *i.e.*, 25 percent vote or value owned by "10% U.S. Shareholders," continues to apply. Further, the TCJA did not change the definition of Section 953 insurance income. Similarly, the rules on taxation of related party insurance income, or RPII, generally remain unchanged.

The new law did, however, change the definition of a "10% U.S. Shareholder." Before the enactment of the TCJA, a "10% U.S. Shareholder" was defined as a U.S. person who owned (directly, indirectly or constructively) 10 percent or more of the total combined voting power of the corporation. The TCJA expanded the definition to include a U.S. person who owns 10 percent or more of the stock of the corporation by vote or value. By expanding the definition to also reference value, voting cutbacks that have historically been used by non-U.S. insurance companies to prevent U.S. shareholders from becoming a "10% U.S. Shareholder" for CFC purposes will no longer be effective for this purpose.[6]

The TCJA also changed the passive foreign investment company (PFIC) statutory provision that excludes income derived from the active conduct of insurance business from the definition of passive income. Under the new rules, the active insurance exception is available only to "qualified insurance companies." To qualify, the applicable insurance liabilities of the foreign insurance company must exceed 25 percent of its total assets. Applicable insurance liabilities generally include loss and loss adjustment expenses and reserves (other than deficiency, contingency or unearned premium reserves). However, due to ambiguities in the definition of applicable insurance liabilities, there is some uncertainty as to how the liability reserves of P&C insurance companies are taken into account to determine the applicable insurance liabilities. The TCJA does provides potential relief for a foreign corporation that fails to meet the

[4] In addition, some insurance companies have considered making elections under Section 953(d) to treat the foreign affiliate as a domestic corporation for U.S. federal income tax purposes.

[5] In addition to analyzing the effects of the BEAT on their outbound reinsurance arrangements, insurance companies need to be aware of the potential effect of the BEAT on any inbound reinsurance arrangements. While payments in connection with inbound reinsurance would generally be excluded from the BEAT if accounted for as a reduction of gross receipts, there might be some situations in which these payments would attract the BEAT.

[6] Note, however, that the TCJA did not alter Section 1248(a) to conform to the new definition in Section 951(b). Therefore, a U.S. shareholder may be a "10% U.S. Shareholder" for purposes of Section 951(b) because they own 10 percent or more of the value, but if such U.S. shareholder does not own at least 10 percent of the voting power, Section 1248(a) would not apply.

25 percent test by allowing a U.S. shareholder to elect to treat the foreign corporation as a qualifying insurance company if (i) its applicable insurance liabilities constitute at least 10 percent of its total assets, and (ii) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business, and its failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

Limits on Interest Deductibility. The TCJA sharply limits the ability of businesses to deduct interest payments when calculating their taxable income, which could cause a fundamental re-evaluation of the capital structure of businesses that are subject to U.S. tax. Under the new limitation, a taxpayer's allowable deduction for business interest expense in a particular tax year is limited to the sum of (i) business interest income plus (ii) 30 percent of adjusted taxable income. "Business interest income" means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business and does not include investment interest within the meaning of Section 163(d). There is no special rule in Section 163(j) for interest income generated in a financial services business. As such, the determination of net business interest expense is unclear for an insurance company that generates significant interest income related to investment activity that is an integral part of its insurance business. Given that Section 163(d) only applies to noncorporate taxpayers, and given that interest income is earned by an insurance company in connection with its insurance business, there are very strong arguments that such interest income should not be treated as investment income for purposes of Section 163(j), but in the absence of definitive guidance on this issue, some uncertainty exists.

International visiting attorney Laura Puro contributed to this client alert.