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US tax reform
Impact on insurance companies

Overview

Background

On December 22, 2017, President Trump signed H.R. 1, the Tax Reconciliation Act ("the Act"), into law, completing an ambitious overhaul of the United States' business and personal income tax regimes. The newly enacted law reconciles the previously proposed House and Senate versions of the bill as agreed in Conference.

From a corporate perspective, a goal of the overhaul was to reduce the corporate tax rate and redesign the taxation of international operations in order to make US companies more competitive globally. To partially offset the decrease in revenue from these measures, the Act broadens the tax base. To that end, the bill involves substantial changes to the overall corporate tax structure, as well as a host of changes specific to the insurance industry.

Significant changes that are generally applicable to all corporations include changes to the income tax rate, repeal of the corporate alternative minimum tax ("AMT"), changes to the corporate dividends received deduction ("DRD") and limits on the deductibility of interest expense:

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- The Act lowers the corporate tax rate from 35 percent to 21 percent.[1] The Act also repeals the corporate AMT and provides for an annual refund of 50 percent of remaining unutilized AMT credits from 2018 through 2020 with a full refund of any remaining unutilized credits in 2021.
- An additional, generally applicable provision of particular interest to insurance companies is the reduction of the corporate DRD. The 70 percent and 80 percent deductions currently afforded to all shareholders and greater-than-20 percent shareholders, respectively, are reduced to 50 percent and 65 percent under the Act.
- The Act further limits the deductibility of net interest expense to 30% of adjusted taxable income which is computed without regard to interest, net operating losses ("NOLs"), depreciation, and amortization (depreciation and amortization are excluded until 2021). Any limited interest expense is carried forward indefinitely. Generally, any business interest income and interest expense is considered active trade or business interest. This provision generally allows insurance companies to fully offset their interest expense by interest income, which may mitigate the impact of the new limitation for many taxpayers.
    - *The Conference Report explanation of the provision provides that the calculation should be performed at the consolidated tax return group level. This may impact life non-life consolidated return groups which calculate taxable income on a subgroup level. Further, netting of ineligible life company interest income and non-life interest expense could potentially be limited.*

Insurance-specific changes

Life insurers

Changes to the calculation of life insurance reserves, deferred policy acquisition costs ("DAC"), NOLs, changes in basis of computing reserves, and changes to the company's share of certain tax-favored investments are the biggest revenue-raisers relative to the taxation of life insurance companies:

- **Life reserves** (projected to raise $15.2 billion from 2018 through 2027):
  Under the Act, the deduction for life insurance reserves is limited to the greater of (1) 92.81 percent of the reserve computed on the basis of the applicable method or (2) the contract's net surrender value. The tax reserve method is prescribed as CRVM for life contracts, CARVM for annuities and the method prescribed by the NAIC for noncancellable A&H contracts. Separate account reserves will continue to be calculated the same way as under current law while any reserves in excess of the Section 817 reserve amount would be subject to the 7.19 percent discounting. Transition rules provide the change applies to existing contracts and the cumulative impact is to be spread over 8 taxable years.
    - *The final provision represents a significant change from the original House version, which was based on a substantial underestimate of the revenue effects of the change in life reserves. Regardless, this provision is expected to generally decrease the current deduction for reserves and increase deferred tax assets relative to current law.*
    - *The provision simplifies the tax reserve calculation allowing retroactive NAIC guidance to take precedence over historical guidance in effect at issue.*
    - *Reserves for certain products will likely be impacted more than others. Products for which the reserves are generally based on net surrender value, such as annuities, for example, will be impacted to a lesser extent than universal or term life policies.*
    - *Because the provision impacts existing contracts, under ASC 740, the effects of the enacted tax law would be accounted for on 2017 calendar year end financial statements.*
- **Deferred Acquisition Costs** (projected to raise $7.2 billion from 2018 through 2027): Similar to pre-Act law, the Act requires life insurance companies to capitalize and amortize a percentage of premiums collected as a proxy for deferred acquisition costs. The section 848 capitalization rates for each of the three categories of insurance contracts will be increased by approximately 20 percent, and the amortization period will be extended to 15 years. All amounts capitalized as of December 31, 2017, would continue to be amortized over a 10-year period.
    - *Similar to the life reserves provision, this provision is expected to increase taxable income and deferred tax assets, as it will increase the annual DAC capitalization amount and decrease the annual benefit recovered via the extended amortization period.*

[1] Unless otherwise noted, these provisions are effective for taxable years beginning after December 31, 2017, i.e., 2018 for calendar year taxpayers.

  - *Because this change is prospective only (i.e. applies to premiums earned beginning in 2018) it does not impact 2017 financial statements.*
- **Changes in computing reserves** (projected to raise $1.2 billion from 2018 through 2027): The Act eliminates the 10-year spread of adjustments for changes in a company's basis for computing life reserves under section 807(f). Rather, all future changes are to be treated the same as other automatic changes in accounting method (i.e. the adjustment will be spread over either one or four years and does not require IRS approval).
  - *The Act and Conference Report do not provide a specific transition rule indicating whether existing section 807(f) adjustments as of December 31, 2017, should be converted to the shorter spread period or continue to be amortized on the current schedule. Presumably, the new rule would apply to changes in basis of computing reserves which are made in 2018 and years thereafter.*
- **Company share of DRD and tax-exempt interest ("TEI")** (projected to raise $600 million from 2018 through 2027): The Act replaces the complex "company share" calculation in section 812 with a flat 70 percent company share allocation of the DRD and TEI.
  - *This provision will considerably simplify the separate account DRD calculation. Some companies may be impacted more substantially than others, depending on how the outcome under the new proration rule compares with the taxpayer's prior company share calculations. When considered in tandem with the reduction in the DRD rate, the effect will generally be a reduction in DRD benefit for the majority of taxpayers with separate account products.*
  - *A decrease in the overall allowable DRD, i.e., the reduction of the qualified percentage from 80 percent to 65 percent and from 70 percent to 50 percent, will reduce the after tax-benefit of investments in dividend-bearing corporations and should be considered as a part of asset allocation decisions.*
- **Life insurance loss rules** (no separate revenue projection): The Act repeals the three-year carryback, 15-year carryforward period for life insurance companies' operations losses. The Act provides that all corporations (including life companies) may carry NOLs forward indefinitely, but limits utilization of NOLs to 80 percent of a given year's taxable income with no loss carryback capacity.
  - *The Act harmonizes the NOL rules for life companies and non-insurance corporations by significantly changing the treatment of both.*
  - *The change to the general loss rules applies to losses arising in taxable years beginning after December 31, 2017. Thus, loss carryforwards as of December 31, 2017, will continue to have a 2 year carryback, 20 year carryforward window and may reduce taxable income by 100%.*
  - *The law does not expressly modify the specific consolidated return life/non-life limitations. In applying the new rules, inter-subgroup questions are likely to arise.*

Other life insurance company changes, which are expected to have minimal revenue effect, include repeal of the section 806 small life company special deduction, and repeal of section 815 and inclusion in income of existing policyholders' surplus account balances.

Life insurance product changes

The Act imposes new reporting obligations on "reportable policy sales" for both the purchaser (on the purchase of the policy) and the issuing life insurance company (upon payment of death benefit proceeds).

In addition, the Act provides clarification that a life insurance or annuity contract holder's basis in a contract is **not** reduced by the cost of insurance, and narrows the exception to the transfer for value rules.

- *Companies will need to implement new product tax reporting protocols to determine compliance with their additional information reporting obligations for reportable policy sales.*
- *The new provision provides significant and needed clarity to policyholders and insurance companies with respect to basis in insurance products, overriding recent IRS rulings which specified that a contract holder's basis is generally reduced by cost of insurance in certain circumstances.*

Non-life insurers

Significant changes to the taxation of property-casualty ("P&C") and health insurance companies include changes to loss reserve discounting and proration of certain types of investment income:

- **Loss reserve discounting** (projected to raise $13.2 billion from 2018 through 2027): The Act extends the discount period for certain long-tail lines of business from 10 years to 24 years. The Act also increases the discount rate, replacing the applicable federal rate for a higher-yield corporate bond rate, and eliminates the election allowing companies to use their historical loss payment patterns for loss reserve discounting.
  - *The applicable discount rates under the Act will involve a mix of bond maturity dates and it is thus not feasible to calculate the precise rate at present. Companies will*

need to plan for the impact of this rate change on a best estimate basis until IRS guidance is issued.
  - *Furthermore, the increase in the discount period to 24 years will likely cause a significant decrease in certain long tail reserves due to the need to discount those additional years to the current period (e.g. workers compensation and reinsurance). Companies will need to account for this additional discount when evaluating profitability of different lines of business.*
  - *Further, the potential tax benefit of captive insurers' loss reserves will likely decrease—especially for these long-tailed lines.*
- **Proration rules for non-life insurance companies** (projected to raise $2.1 billion from 2018 through 2027): The Act increases the DRD and TEI proration offset to losses incurred in section 832(b)(5) from 15 percent to 25 percent.
  - *This change is intended to hold the product of the proration rate and corporate tax rate constant at 5.25 percent.*
  - *An increase in the proration offset will reduce the after-tax benefit of investment in stocks and tax-exempt bonds, and should be considered as a part of asset allocation decisions.*
- **NOLs:** Non-life insurance NOLs will retain their current two year carryback, 20 year carryforward periods under the Act and will not be subject to the 80 percent taxable income limitation applicable to general corporate NOLs.
  - *While non-life NOLs retain their present carryback and carryforward periods under the Act, this provision may lead to complications as it causes their treatment to further diverge from both life and non-insurance NOLs.*
  - *This change will bring increased complexity to the insurance company life/non-life consolidation rules as it will require companies to track and consider the interplay of three distinct types of NOLs (life, non-life, and regular corporate).*
  - *Further clarity is likely needed regarding the interplay of this new category of NOLs within the life/non-life consolidated return context.*

International provisions

In addition to the changes impacting the US operations of domestic insurance companies, as summarized above, the Act includes a significant overhaul of the international tax rules that will impact the global operations of many multinational insurance companies and groups. Most significantly for US-parented groups, while the Act retains subpart F (including the exception for active financing income) and creates a new category of foreign income loosely derived from "intangibles" that generally cannot be deferred (so-called "GILTI" income), the Act also creates a new "participation exemption" system for earnings derived by qualifying foreign subsidiaries (income from foreign "branch" operations continues to be subject to US tax on a current basis). For foreign-parented groups, the Act significantly curtails—through a new "BEAT" minimum tax—the efficiency of certain business operating models having a material cross-border component (e.g., reinsurance from a US direct carrier to a foreign related-party reinsurer) that is deemed to erode the US tax base. Such operating models may require significant restructuring to retain tax efficiency. The Act also creates a new bright-line test (in addition to existing requirements) that must be passed for a foreign insurance company to avoid classification as a "PFIC" and expands the "CFC" US shareholder definition and attribution rules.

- **Establishment of participation exemption system for taxation of foreign income**
  - **Participation exemption for dividend income:** The Act introduces a deduction for 100 percent of the foreign-source portion of dividends received from "specified foreign corporations" (SFCs). This DRD is available to domestic corporations that are "US shareholders" with respect to the SFC [i.e., own directly or indirectly 10 percent or more of the stock (by vote or value) of the foreign corporation].
    - No credit or deduction for foreign income taxes paid or accrued by the SFC and attributable to the dividends received is allowed under the new DRD system.
  - **Transition tax:** The Act provides a method for transitioning from the existing US-international tax regime to the new participation exemption system via a one-time subpart F inclusion under section 965 of all of the accumulated post 1986 deferred foreign income of a US shareholder's SFCs, determined as of either November 2 or December 31, 2017, whichever date yields a greater subpart F inclusion.
    - The transition tax subjects the subpart F inclusion to an effective tax rate of either 8% or 15.5% percent before foreign tax credits, depending on the amount of cash (which is subject to the higher rate) held by the SFCs. The definition of "cash" in the Act is very broad and appears to capture many of the investment assets of foreign insurers

which are used for capital and surplus purposes.
   - Foreign tax credits may be utilized to offset the tax, but such credits are reduced proportionately to reflect the reduced effective tax rate on the inclusion.
   - For corporations with accumulated deficits as of November 2, 2017, the specified E&P deficit may be allocated pro rata against the positive earnings of other foreign corporations, first across the US shareholder's group of specified foreign corporations, then across the broader affiliated group, for those filing consolidated returns.
   - Taxpayers with NOL carryforwards can elect to exclude the section 965 inclusion for purposes of determining the amount of NOL utilized. This would allow for increased utilization of the foreign tax credits that are repatriated with the subpart F inclusion, which, going forward, may be more difficult to utilize given the new DRD regime.
   - *As a practical matter, an accurate and updated accounting of the US tax attributes of foreign subsidiaries, including E&P, tax basis, and FTC pools, will be needed to accurately compute the transition tax.*

- **Foreign tax credits:** The Act repeals section 902 indirect foreign tax credits and eliminates pooling for section 960 credits. Section 960 credits remitted with subpart F income other than GILTI are able to be carried forward 10 years per existing tax law; credits remitted with a GILTI inclusion are in a separate basket and are not able to be carried forward.
   - *A new FTC basket also is created for foreign branch income. Consequently, the ability to cross-credit high taxed income may be significantly curtailed, absent planning that takes into account the new basket regime.*
- **"Downward" attribution for determination of CFC status:** The Act expands the ownership attribution rules of section 958(b) for purposes of determining a foreign corporation's status as a controlled foreign corporation ("CFC"). Under the new rules, stock of a foreign corporation owned by a foreign person is attributed to a related US person for purposes of determining whether the related US person is a US shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC.
   - *This rule appears to be designed to prevent "inverted" groups from de-controlling former CFCs after an inversion transaction but could cause other foreign-parented groups having controlled US subsidiaries to have new US tax compliance requirements (e.g., preparation and filing of IRS Form 5471).*
- **Expanded definition of US shareholder:** Section 951(b) previously defined a US shareholder as a US person who owns 10 percent or more of the voting stock of a foreign corporation. The Act expands this definition by including US persons who own 10 percent or more of the value of the stock of a foreign corporation.
   - *US persons that are shareholders of foreign insurance companies that rely on "voting cutback" or similar provisions to avoid being classified as CFCs could be impacted by this change.*
- **Global Intangible Low-Taxed Income:** The Act introduces a new category of income (treated in a manner similar to subpart F income) called Global Intangible Low-Taxed Income ("GILTI") under section 951A. GILTI seeks to include in US taxable income the low-taxed income of a CFC that is not otherwise subpart F income under another section of the Code and that exceeds a "routine" (10%) return on the US tax basis in a CFC's depreciable tangible assets. GILTI is equal to the amount of a CFC's net tested income which exceeds the net deemed tangible income return (based on a percentage of qualified business assets, less interest expense).
   - Net tested income excludes income that would otherwise be subpart F income under other existing provisions of the Code or excluded from subpart F via the high-taxed income exception under section 954(b)(4). However, income that would have been exempt from subpart F either under the active finance or active insurance exceptions (the "AFE") provided in sections 954(h) and (i) is not excluded from the definition of tested income, nor would it be eligible for the election under section 954(b)(4) as it is not subpart F income. Thus, the high-tax exception exclusion from GILTI is likely not available to foreign insurers for insurance and investment income that is excluded from subpart F pursuant to the AFE.
   - A deduction is available for 50 percent of the GILTI inclusion inclusive of the section 78 gross-up on foreign taxes remitted under section 960. The foreign taxes remitted with GILTI are limited to 80 percent of the amount otherwise calculated by dividing the pro rata GILTI inclusion over the US shareholder's net tested income for the CFC in question. Interestingly, the section 78 gross-up is still inclusive of 100 percent of the tested taxes deemed remitted, as updated section 78 expressly

ignores the 80 percent limitation in new section 960(d)(1). Additionally, GILTI income is in its own basket for foreign tax credit limitation purposes.

- *US domiciled multinational insurers may be unprepared with regard to GILTI, as the new regime is complex and the interaction with existing tax law may put pressure on the ability to fully offset GILTI income with foreign tax credits, regardless of the foreign effective tax rate on GILTI income. Key issues and considerations include:*
  - *How the taxable income limitation for the 50 percent deduction interacts with NOL carryforward utilization*
  - *Whether additional guidance will be issued to address consolidation of the GILTI inclusion and the 50 percent deduction (as these are currently only computed on a separate company basis)*
  - *Application of existing expense allocation and apportionment rules to the GILTI basket for foreign tax credit limitation calculations*
  - *The increase in foreign baskets may hamper recapture of existing overall domestic loss ("ODL") carryforwards, as ODLs are also basket-specific*
  - *Life/nonlife groups must analyze the interaction of GILTI and BEAT with the life/nonlife subgroup consolidated return regulations*
- *For certain groups, there may be an advantage to restructuring in a manner that causes high-taxed foreign income to be treated as subpart F income rather than GILTI (e.g. via reinsurance to fail the home-country risk requirement in section 953(e)) as the ability to offset the inclusion with foreign tax credits may be more straightforward and the credits may be carried forward, unlike GILTI credits.*

- **Base Erosion and Anti-Abuse Tax:** Effective for tax years beginning after December 31, 2017, taxpayers with three-year average annual gross receipts in excess of $500 million and outbound deductible payments to affiliates in excess of 3 percent of total deductions in respect of US taxable income may be subject to the Base Erosion and Anti-Abuse Tax ("BEAT"). For purposes of these tests, the receipts and deductions of related parties that are treated as part of the same controlled group are aggregated. The BEAT is computed as the excess of 10 percent (5 percent only for 2018) of "modified taxable income" (MTI) over the taxpayer's regular tax liability before certain credits are taken into account. In tax years beginning after December 31, 2025, the rate is scheduled to increase to 12.5 percent and credits may not be used to reduce the BEAT. MTI is calculated by adding back related party payments which are deductible for regular taxable income purposes. The Act defines certain reinsurance payments to foreign related life and non-life insurers as "base erosion payments" and provides that the resulting deduction is a tax benefit subject to recapture for purposes of calculating MTI.
  - *Base erosion payments do not include outbound payments to affiliates that would qualify for the services cost method under section 482; insurance and reinsurance do not qualify for such treatment under Treasury regulations. Further, qualified derivative payments are excluded from the definition of base erosion payment. Specific language is included which prevents certain insurance contracts from qualifying for the derivative exception.*
  - *Broker-Dealers and banks are subject to a 1 percent higher minimum tax rate than other taxpayers, and the safe harbor threshold for the base erosion percentage (base eroding payments over total deductions) is reduced to 2 percent for these businesses. This may impact life insurance affiliated groups which own a broker-dealer.*
  - *This is a highly complex new tax that is already generating consternation amongst some in the industry. Many questions remain with respect to how to interpret specific provisions in the law. For example, different types of reinsurance agreements provide for different amounts of payments and some require a netting of premiums and reserves whereby no cash "payment" is made. In addition, the treatment of deductible claims payments from US insurers to related party foreign affiliates under the BEAT is uncertain.*
  - *Many inbound insurers are actively looking at restructuring options (such as novating or amending existing reinsurance agreements) and other alternatives to reduce the impact of the BEAT. An increase in M&A activity is also expected as a result of the BEAT as insurers analyze their projected returns under the new law.*

- **PFIC insurance exception:** The Act limits the active insurance company exception to PFIC status by adding a new eligibility requirement: in addition to existing requirements, a foreign insurance company's "applicable insurance liabilities" must exceed 25 percent of its gross assets on an annual basis, as determined by reference to annual filings made with the applicable insurance regulator. The definition of "applicable insurance liabilities" generally includes only (i) loss and loss adjustments expenses and (ii) reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance. An alternative test is provided for electing shareholders in the event the foreign insurer fails to meet the minimum liabilities test; the alternative test relaxes the required insurance liabilities percentage to 10 percent, provided the insurance company is predominantly engaged in an insurance business and the failure to have sufficient insurance liabilities relative to assets primarily relates to run-off or rating-related circumstances.

- *This law provides a bright-line test for qualification where none existed previously. Insurance companies with low frequency but high severity risk which require significant assets to back these low frequency risks may be negatively impacted.*
- *Insurers may decide to acquire a different mix of risk to ensure that their reserves increase above 25 percent of assets.*

Financial accounting implications

In addition to the tax technical changes highlighted above, this legislation has significant implications on the presentation of audited financial statements under US GAAP and Statutory Accounting Principles:

- The enactment of the law in late December 2017 is certain to place significant strain on calendar year financial statement filers, as they must reflect the material impacts of the tax law on their 2017 financials in accordance with ASC 740.
- Deloitte publishes and continuously updates the ASC 740 implications of tax reform. Updates related to the Financial Reporting Alert 18.1 - FAQs about tax reform can be found here. Updates related to the Financial Reporting Alert 18.2 - Financial Accounting Standards Board meeting can be found here.
- Further, while filing 2017 financial statements is a clear priority for many insurers, it will be important to keep in mind the variety of changes occurring on a go-forward basis as we enter tax year 2018. The Act brings material changes to the way companies estimate items adjustments such as DRD, DAC, interest deductions, NOLs, the BEAT and GILTI and potential issues and complications from these changes should be closely monitored as part of the first quarter 2018 close.
- Insurers have the added complication of filing Statutory financial statements for its insurance companies. The same analysis performed for GAAP purposes must be undertaken for each separate insurance company Statutory filing. Of significant concern to insurers is the reduction in Surplus from a decrease in the corporate tax rate as well as navigating the complexities of the SSAP 101 admissibility calculation in light of a drop in rates, changes to loss carryback and carryover rules, and changes to estimates of DTA reversals.
  - *As noted above, the life/nonlife consolidation rules have added an additional complication with the enactment of divergence between nonlife insurance and life insurance NOL rules. The interplay of these rules within a consolidated return and the SSAP 101 admissibility calculation has not yet been fully explored.*
  - *The decrease in tax rates and potential decrease in surplus from a reduction in net admitted deferred tax assets must be factored into Risk-Based Capital calculations.*

Overall takeaways

- The sweeping changes in the Tax Cuts and Jobs Act promise to touch every facet of the insurance business.
- The reduction in the corporate tax rate from 35 to 21 percent should increase the profitability of US operations (separate from the impact of the BEAT and GILTI) and may require a fresh look at global operating models.
- Changes to reserving methodologies may impact virtually all policy lines, particularly decreasing the after-tax profitability of certain long-tail property casualty lines and shorter-tail life policies with low cash surrender values.
- A reduction in the DRD for all corporations, coupled with changes to the life company share calculation and proration rules for P&C companies will impact investment mix decisions of insurance companies of all types.
- The changes to the US taxation of worldwide groups and cross border transactions may alter the underlying economics of certain inbound transactions, and are generally expected to drive industrywide M&A and restructuring efforts to mitigate their impact.
- In the face of the significant changes made by the Act and the absence of specific IRS guidance, insurers face both uncertainty and opportunity. Businesses face a highly truncated timeline to understand and implement processes to account for the new laws.

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