STROOCK
SPECIAL BULLETIN

The Impact of the Tax Reform Act on the Insurance Industry

February 13, 2018

On December 22, 2017, the president signed into law Public Law 115-97, informally known as the "Tax Cuts and Jobs Act" (the "Tax Reform Act" or the "Act"). The Tax Reform Act makes significant modifications to the taxation of businesses. This **Stroock Special Bulletin** discusses the potential impact of several provisions of the Tax Reform Act on the insurance industry.

Overview

The changes in the Act to domestic tax provisions that apply to corporations generally are expected to have a positive net effect on insurance companies, although the final result will depend on an insurance company's particular circumstances. The corporate tax rate reduction from 35% to 21%, and the elimination of the corporate alternative minimum tax beginning in 2018, will provide a benefit. In addition, a number of the insurance-specific changes that were intended to simplify reserve and other calculations and better align such calculations with statutory accounting practices should be welcome even if they increase the tax liability.

However, the provisions that apply specifically to insurance companies were included as revenue raising provisions. Among these are changes in the tax reserve calculations for life and property and casualty companies, changes to the capitalization of deferred acquisition costs, changes to the proration rules for life and property and casualty companies, and modification to the discounting rules for property and casualty companies.

Many of the changes to the international tax provisions that are applicable to corporations generally are likely to have significant consequences for life insurance companies with activities outside of the United States. New anti-base erosion rules are expected to adversely affect U.S. insurance companies that enter into reinsurance transactions with affiliated foreign companies by imposing a minimum tax on the U.S. insurers.

Similarly, the modification of the definition of "U.S. shareholder" and expansion of the attribution rules in the controlled foreign corporation ("CFC") tax regime will cause many foreign insurance companies that had not been treated as CFCs to be so characterized, adversely affecting the U.S. shareholders of such companies. In addition, the limitation on the active insurance exception to the passive foreign investment company ("PFIC") tax regimes could cause certain offshore insurers or reinsurers to be newly characterized as PFICs. Although the implementation of a form of territorial tax system

for business income would seem to be favorable, most offshore insurance companies with U.S. shareholders generate income that is considered to be passive and would not be able to benefit from this tax system. Instead, their shareholders would be subject to the CFC and PFIC tax regimes. Accordingly, the international tax changes would appear to be largely unfavorable for the insurance industry.

General Corporate Provisions

- The federal corporate income tax rate is reduced to a flat 21% for tax years beginning after December 31, 2017.
- Corporate alternative minimum tax is repealed (although the new Base Erosion and Anti-Abuse Tax ("BEAT") regime can have the effect of alternative minimum tax in some circumstances).
- The deduction for net business interest expense is limited to 30% of the taxable income (subject to certain adjustments). The old interest limitation of Section 163(j) has been replaced with the new limit, and the limitations of the regulations under Section 385 will be reexamined by the IRS (and probably modified or repealed).
- Corporate net operating losses ("NOLs") incurred after 2017 cannot be carried back, but can be carried forward indefinitely to offset no more than 80% of the taxable income for the year.

Insurance Company Tax Provisions

Net Operating Losses of Insurance Companies

The Tax Reform Act repeals the special operations loss carryover and carryback provision that applied to life insurance companies under Section 810. Instead, life insurance companies will use the regular NOL deductions under Section 172, as modified by the Tax Reform Act. As described above, corporate NOLs created after 2017 cannot be carried back, but can be carried forward indefinitely to offset no more than 80% of the taxable income for the year. Property and casualty insurance companies, however, keep using the old rules, which allow NOLs to be carried back for two years, to be carried forward for 20 years, and to offset 100% of the taxable income.

Computation of Life Insurance Reserves for Tax Purposes

The Tax Reform Act has special rules relating to the computation of life insurance reserves for tax purposes. Under the Act, for purposes of determining the deduction for increases in certain reserves of a life insurance company, the life reserves for any contract (other than certain variable contracts) generally would be the greater of (a) the net surrender value of the contract, or (b) 92.81% of the reserves determined under the prescribed tax reserve method (with a special rule for the interest rate used to discount them). For variable contracts, the net surrender value of the contract is replaced with the separate-account reserve amount for the contract (if greater than the net surrender value). The life reserves cannot exceed the amount which is taken into account in determining statutory reserves set forth in the financial statements of the company.

Life insurance contracts continue to use the Commissioners' Reserve Valuation Method (CRVM) and annuity contracts continue to use the Commissioners' Annuity Reserve Valuation Method ("CARVM"), however, instead of using the previous rule requiring using CRVM/CARVM "in effect on the issue date," the new rules require using CRVM/CARVM in effect as of the date the reserve is determined. These changes are expected to greatly simplify calculation of reserves.

For purposes of calculating the reserves on insurance or annuity contracts that do not involve life, accident, or health contingencies, the amount necessary to satisfy the obligations under such contract is discounted using "the appropriate rate of interest," which is the highest rate or rates permitted to be used to discount the obligations by the National Association of Insurance

Commissioners as of the date the reserve is determined. This is a significant simplification from the previous rule that required determining the highest of three different interest rates (applicable federal interest rate, prevailing state assumed rate, and the company's rate for guaranteed benefits) at the time when the obligation first did not involve life, accident or health contingencies.

The difference for old contracts between the new reserve and the old reserve is taken into income (or deducted) ratably over eight years.

The Tax Reform Act shortens the period for taking into account income or loss resulting from a change in method of computing life insurance company reserves. The life insurance company is required to take income into account ratably over a four-year period and take a loss into account during a one-year period (instead of the previous 10-year period for income and losses).

Computation of Accident and Health Reserves

For non-cancellable accident and health insurance contracts, the Tax Reform Act modified Section 807(d)(3)(A)(iii) to change the tax reserve method from the previous two-year full preliminary term method to the reserve method prescribed by the NAIC.

Changes to Capitalization of Deferred Acquisition Costs

Section 848 provides for the capitalization and amortization of "specified policy acquisition expenses," which are calculated as a specified percentage of the "net premiums."

Under the Tax Reform Act the capitalization rates are increased from 1.75% to 2.09% for annuity contracts, from 2.05% to 2.45% for group life contracts, and from 7.7% to 9.2% for all other specified contracts, such as individual life contracts. The amortization period is increased from 120 months to 180 months.

Changes to Proration Rules for Life Insurance Companies

Life insurance companies are required to reduce their deductions, including the dividend received deductions ("DRD") and reserve deduction, to reflect the fact that a portion of their tax-exempt income is used to increase policyholders' reserve, which give rise to a deduction. The rationale for this reduction is that it is not appropriate to give a deduction that reduces taxable income when the expense was funded with a tax-free income. Before the Tax Reform Act, the statute and IRS administrative guidance provided for a complex formula to compute the share of net investment income that is attributable to policyholders.

The Tax Reform Act simplifies the rules relating to the reduction of the DRD and reserve deduction. The company's share is fixed at 70% and the policyholders' share is fixed at 30%. Thus, effectively, the life insurance company will pay tax on 30% of the tax-exempt income and will get 70% of the otherwise applicable DRD deduction.

This provision may impact the demand for municipal bonds from life insurance companies. Previously, it was difficult for a life insurance company to predict with certainty the effective tax rate on tax-exempt income. The Tax Reform Act may provide greater certainty and make the decision to invest in tax-exempt bonds more predictable.

Changes to Proration Rules for Property and Casualty Insurance Companies

Property and casualty insurance companies are required to prorate the deductible amount of their reserves for losses incurred. Prior to the Tax Reform Act the insurance companies were required to reduce the amount of the losses by 15% of certain tax-exempt income. The Tax Reform Act replaces the fixed proration percentage with a formula that is tied to the highest corporate rate. The applicable percentage reduction after the Tax Reform Act is 25% (5.25% divided by the highest corporate tax rate of 21%).

Changes to Discounting Rules for Property and Casualty Insurance Companies

The Tax Reform Act changes the rules for determining reserves of property and casualty insurance companies by extending the discount period and increasing the discount interest rate.

All property and casualty reserves are discounted using a prescribed interest rate and using certain assumptions regarding the time between when a loss is incurred until it is paid. Previously, the interest rate was based on the mid-term Applicable Federal Rate ("AFR").

Under the Tax Reform Act, the interest rate is determined based on the corporate bond yield curve, which is a yield curve published by the Treasury Department that reflects the average, for the preceding 60-month period, of monthly yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. Historically, the corporate bond yield curve has been higher than the mid-term AFR, and this change is likely to result in lower reserves and smaller deductions.

The Tax Reform Act also repeals the election permitting a taxpayer to use its own historical loss payment pattern with respect to its lines of business (instead of fixed patterns that the IRS determines apply to a particular line of business) and extends the period over which the reserves are discounted, which results in lower reserves and smaller deductions. The Act retains the three-year period for certain lines of business, but the previous 10-year period is extended by up to 14 years, for a total of up to 24 years.

The reserves at the end of 2017 are adjusted using the new rules, and any income (or loss) resulting from the adjustment is included ratably in taxable income over eight taxable years starting in 2018.

Changes to Rules for Purchasing and Selling Life Insurance Contracts in the Secondary Market

The Tax Reform Act makes significant changes to the rules for purchasing and selling life insurance contracts in the secondary market.

The Tax Reform Act overrules one of the holdings of Revenue Ruling 2009-13, which held that on sale (but not surrender) of a life insurance policy, the seller's basis is reduced by the cost of insurance. The ruling was widely criticized for putting the seller in a life settlement transaction in a less favorable tax position than if the seller has surrendered the policy to the insurer. The Tax Reform Act's repeal of this holding applies retroactively to sales of life settlement policies entered into after August 25, 2009.

A new reporting requirement applies to any person who acquires, directly or indirectly, any interest in a life insurance contract, if the acquirer has no substantial family, business, or financial relationship with the insured (a "reportable sale"). The acquirer reports the information about the purchase to the IRS, the insurance company, and the seller. This reportable sale then triggers a series of obligations for the issuing insurance company.

The issuing life insurance company also is required to report to the IRS information regarding the transfer of the policy in a reportable sale or to a foreign person, including the tax basis of the contract. The issuing life insurance company further has to report to the IRS when the death benefit is paid on a policy that has been transferred in a reportable sale.

The Tax Reform Act does not apply the exceptions from the transfer for value rule (which allow certain transferees to receive death benefits free of tax) to transfers in a reportable sale.

Other Changes

The Tax Reform Act also repeals some outdated and rarely used provisions of the law.

- The small life insurance company deduction is repealed for tax years beginning on or after January 1, 2018.
- The provision for policyholder surplus accounts put into effect prior to 1984 is repealed, with any remaining policyholder surplus account balances taken into income over an eight-year period.

International Taxation

Base Erosion Minimum Tax

A new BEAT tax imposes a "base erosion minimum tax." For purposes of this minimum tax, taxpayers are required to (i) calculate 10% (5% for tax years starting in 2018, and 12.5% for tax years starting after 2025, and in each case the rate is 1% higher for members of a financial group) of their taxable income after adding back deductions for deductible payments to foreign affiliates and a portion of any net operating loss carryforwards and (ii) calculate the taxpayer's tax liability reduced by any tax credits claimed by the taxpayer (other than, for years prior to 2026, the R&D credit and certain provisions of the business tax credit). If (i) is greater than (ii), the taxpayer must pay the difference as a tax. The base erosion minimum tax applies to taxpayers (including certain affiliated members) that have annual gross receipts in excess of $500 million (for the three prior tax years) and that have a "base erosion percentage" of at least 3% or higher for the taxable year (2% or higher for a member of a financial group).

The BEAT tax affects insurance companies with foreign affiliates because base erosion payments include any premium or other consideration paid to a related foreign person for any reinsurance payments taken into account in computing premiums earned. Any premium paid by a U.S. non-insurance company to a foreign insurance affiliate is also a base erosion payment.

Although the BEAT tax affects reinsurance with foreign affiliates, a statement during the Senate debate indicated that at least with "modco" and "funds withheld" arrangements, the minimum tax addback is computed on a net basis. For other offshore reinsurance arrangements, there is no guidance whether the addback of deductions will apply to gross premiums or net profit on the ceded business.

Participation Exemption and Repatriation Tax for Existing E&P

The Tax Reform Act shifts the U.S. corporate tax system closer to a territorial system by providing a participation exemption for foreign-sourced dividends (but not for Subpart F inclusions) paid by a foreign shareholder to a 10% U.S. shareholder which held the foreign corporation's stock for at least 365 days. This exemption, however, is unavailable for hybrid dividends (dividends that are deductible in the country of the paying company).

In order to transition to the "participation exemption" system of taxation, the Tax Reform Act provides for a one-time tax on all unrepatriated and previously untaxed earnings and profits of specified foreign corporations at the rate of approximately 15.5% for cash and other liquid assets and approximately 8% for reinvested earnings (non-corporate U.S. shareholders are subject to a higher rate of tax, but this may be a drafting error that may be corrected in the future).

For this purpose, the term "specified foreign corporation" includes (i) any CFC that is not also a PFIC and (ii) any foreign corporation with respect to which one or more domestic corporations owns, directly, indirectly, or by certain attribution rules, at least 10% of the vote. The tax on unrepatriated income may be paid in installments of 8% of the amount of tax for each of the first five years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% in the eighth year. If an installment is not paid in full (or in certain other circumstances), the remaining installments of tax are immediately due and payable.

The Tax Reform Act repeals the indirect foreign tax credit for dividends received from a foreign

corporation, but retains the indirect foreign tax credit for Subpart F inclusions.

Other Modifications of Subpart F Provisions

Notwithstanding the general territoriality rule, the Tax Reform Act will tax a U.S. shareholder's share of a CFC's "global intangible low-taxed income," or "GILTI," at a 10.5% rate. GILTI is active income in excess of an implied return of 10% of the CFC's adjusted basis in tangible depreciable property used to generate the active income. In addition, a special deduction applies to the intangible income of a U.S. corporation derived in connection with foreign sales or foreign use (effectively a "patent box"), which reduces the effective U.S. federal corporate income tax rate on such income to approximately 13.125%. The GILTI deduction, however, does not apply to profits from a foreign branch of a U.S. corporation.

The Act also exempts a CFC from recognizing gain on the distribution of intangible property to a U.S. shareholder that is a corporation if made by the CFC before the last day of the third tax year of the CFC beginning after December 31, 2017. However, incorporation of a foreign branch generally now will be subject to tax on any recognized gain or transferred loss amount.

Modifications of CFC Definitions

The Tax Reform Act also makes a slight, but very important, change to the definition of "U.S. Shareholder" for purposes of the application of Subpart F provisions. Under the new definition, a "U.S. Shareholder" is a person who owns at least 10% of the vote or value of the foreign corporation, as opposed to the previous rule that required at least 10% of the vote. Another significant change is that certain stock owned by foreign persons may now be attributed to a U.S. partnership, corporation, trust, or estate for purposes of making the U.S. person a "U.S. Shareholder" in determining if an entity is a CFC. Many existing corporate structures will have to be reexamined and modified in light of these changes.

PFIC Insurance Company Exception

A PFIC is generally defined as any foreign corporation if 75% or more of its gross income for the taxable year consists of passive income, or 50% or more of its assets consists of assets that produce, or are held for the production of, passive income.

Under the provisions of the Tax Reform Act, passive income for purposes of the PFIC rules does not include income derived in the active conduct of an insurance business by a corporation (1) that would be subject to tax under subchapter L (for insurance companies) if it were a domestic corporation; and (2) the applicable insurance liabilities of which constitute more than 25% of its total assets as reported on the company's applicable financial statement for the last year ending with or within the taxable year.

Applicable insurance reserves include (1) loss and loss adjustment expenses, and (2) reserves for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. Unearned premium, deficiency and contingency reserves are not treated as applicable insurance liabilities. The applicable insurance reserves are further limited to the lesser of (1) amounts reported to the applicable insurance regulatory body in the applicable financial statements, or (2) amounts determined under regulations prescribed by the Treasury.

If the insurance company fails to satisfy the 25% asset test, then the U.S. shareholder may still elect to treat the stock as stock of a qualifying insurance company if (1) the applicable insurance liabilities of the company constitute at least 10% of its total assets, and (2) based on the facts and circumstances, the corporation is primarily engaged in an insurance business, and (3) the failure to satisfy the 25% test is due to runoff-related or rating-related circumstances.

Conclusion

Stroock tax attorneys have been closely monitoring the development and implementation of the Tax Reform Act, which is the single most significant change to the federal tax laws since 1986. Insurance companies and offshore reinsurance structures are significantly affected by the Tax Reform Act. We are available to discuss any questions you may have regarding the Tax Reform Act and its effect on your tax planning.

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