



TaxNewsFlash

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Insurance provisions in tax bill approved by Ways and Means Committee

The Ways and Means Committee of the U.S. House of Representatives on November 9, 2017, approved H.R. 1, the “Tax Cuts and Jobs Act,” by a party-line vote of 24 to 16 and ordered the bill to be reported.

The Ways and Means Committee’s bill reflects amendments approved during the markup, including a manager’s amendment approved November 9, and a Chairman’s amendment on November 6 shortly before the conclusion of the markup. The full House could vote on the tax bill as early as this week.

A summary of provisions in the Ways and Means Committee tax bill that would affecting the insurance industry is provided below. This discussion includes changes from previous versions of H.R. 1 that were made during the Ways and Means markup (such changes are indicated as “*MODIFIED*” or “*WITHDRAWN*” in the following discussion).

Read [KPMG’s report](#) [PDF 1.8 MB] providing initial analysis and observations about the Ways and Means Committee bill.

Major insurance provisions

***MODIFIED:* Limitation on the deduction of net business interest expense (section 3301 of the Ways and Means bill)**

Section 3301 of the bill would amend 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 (and could not be less than zero) 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 amount of any net operating loss deduction; and (4) depreciation, amortization, and depletion. 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 except for certain small businesses, real property businesses, and public utilities (regardless of form), and any disallowance or excess limitation would be determined at the filer level (e.g., at the partnership level instead of the partner level). Any business interest disallowed would be carried forward to the succeeding five tax years as an attribute of the business, even if the business is a passthrough entity.

KPMG observation

There appear 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.

Modify operations loss deductions of insurance companies (section 3701 of the Ways and Means bill)

This provision would alter the operations loss carryover and carryback periods for life insurance companies (currently carried back three years and forward 15 years) by striking Code sections 810 and 844 and conforming these periods to those of other corporations.

A provision (section 3302) of the bill would repeal all net operating loss carrybacks (except for a special one-year carryback for small businesses and farms in the event of certain casualty and disaster losses) and would allow taxpayers to carry operating losses forward indefinitely. Under the provision, taxpayers would be able to deduct a net operating loss carryover (or carryback) limited to 90% of the taxpayer's taxable income for the year.

KPMG observation

Combined with the effects of the overall tax rate reduction and the general provisions under Code section 172, the provision 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 life insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

Repeal small life insurance company deduction (section 3702 of the Ways and Means bill)

This measure would repeal the Code section 806 special deduction for small life insurance companies.

KPMG observation

This provision is described as eliminating a tax subsidy for a particular industry that is not available to other industries and would remove a tax preference that is provided to the segment of the insurance industry in which the risk distribution benefits of pooling are the weakest. Some tax professionals have questioned the factual foundation of this assertion. The bill would not repeal preferential treatment for small non-life insurance companies.

***MODIFIED*: Surtax on life insurance company taxable income (section 3703 of the Ways and Means bill)**

This provision would generally preserve current law tax treatment of insurance company reserves and instead impose an 8% surtax on life insurance income.

KPMG observation

In contrast to earlier versions of H.R. 1, the version reported by the Ways and Means Committee would not alter the current law treatment surrounding reserves. However, in commentary, this was described as a placeholder and raised an expectation that the provisions taxing life insurance companies will continue to evolve.

Repeal Code section 807(f) spread, adjustment for change in computing reserves (section 3704 of the Ways and Means bill)

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 (as described above) would apply to changes in computing reserves by life insurance companies.

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. Presumably, such changes would require life insurers to request permission to change the method which is a departure from the existing Code section 807(f) requirement.

***WITHDRAWN:* Modify rules for life insurance proration for purposes of determining the dividends received deduction (DRD) (formerly section 3705 of the Chairman's mark)**

This provision was withdrawn during markup, and proration rules under the current version of H.R. 1 remain the same as under current law.

KPMG observation

In contrast to the proposed changes under earlier versions of H.R. 1, the current law treatment surrounding life insurance proration rules would not be altered, and proposed section 3705 of the Ways and Means Chairman's mark was withdrawn. However, the expectation is that the provisions taxing life insurance companies would continue to evolve.

Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts (section 3705 of the tax bill)

This measure would repeal rules (originally enacted in 1959) relating to the tax treatment of distributions from policyholders surplus accounts. From 1959 to 1984, half of a life insurer's operating income was taxed only when the company distributed it, and a "policyholders surplus account" kept track of the untaxed income. Legislation enacted in 2004 provided a two-year holiday that permitted tax-free distributions of these balances during 2005 and 2006. During this period, most companies eliminated or significantly reduced their balances.

KPMG observation

This proposal was one suggested by the ABA Tax Section Insurance Companies Committee and is not expected to raise significant revenue.

Modify proration rules for property and casualty (P&C) insurance companies (section 3706 of the Ways and Means bill)

This provision would replace the fixed 15% reduction in the reserve deduction for P&C insurance companies with a fixed 26.25% reduction in the reserve deduction.

KPMG observation

A Ways and Means section-by-section explanation states that this proposed provision would keep the reduction in the reserve deduction consistent with current law by adjusting the rate proportionately to the decrease in the corporate tax rate. However, it

is unclear how that rationale is consistent with the purpose under prior law to measure the amount of tax-exempt income credited to reserves (estimated at 15%) in order to eliminate a double benefit.

Modify discounting rules for property and casualty (P&C) insurance companies (section 3707 of the Ways and Means bill)

Under this provision, P&C insurance companies would be required to use a higher rate—the corporate bond yield curve (as specified by Treasury)—to discount their unpaid losses under Code section 846. In addition, the special rule that extends the loss payment period for all “long-tail lines” of business would be applied similarly to all lines of business. The provision would also repeal the election to use company-specific, rather than industry-wide, historical loss payment patterns.

KPMG observation

This proposal is scored as a large insurance tax revenue-raiser at \$13.2 billion over the period 2018-2027 and would significantly affect the computation of P&C loss reserves. The stated rationale for modifying the discount rate to a corporate bond-based rate is to provide a “more accurate measurement of income.”

The change in loss payment patterns may provide simplification, but it would shorten or lengthen the pattern for different lines of business, which may or may not correspond more closely with actual loss payment patterns in the industry.

Elimination of the section 846(e) election would provide simplification, and would affect some insurers more significantly than others.

Repeal elective deduction and related special estimated tax payment rules (section 3708 of the Ways and Means bill)

This provision would repeal the Code section 847 elective deduction and related special estimated tax payment rules. Under current law, insurance companies may elect to claim a deduction equal to the difference between the amount of reserves computed on a discounted basis and the amount computed on an undiscounted basis. Companies that make this election are required to make a special estimated tax payment equal to the tax benefit attributable to the deduction.

KPMG observation

Code section 847 was originally enacted to provide for the admissibility of deferred tax assets associated with loss reserve discounting under the recognition rules of FAS 96. FAS 109 liberalized these requirements, and section 847 became unnecessary and administratively burdensome.

***WITHDRAWN:* Capitalize certain policy acquisition expenses (DAC) (formerly section 3710 of the Chairman's mark)**

This provision was withdrawn during markup, and DAC capitalization rules under the current version of H.R. 1 remain the same as under current law.

KPMG observation

When section 848 was originally enacted, there was significant debate over the appropriate capitalization percentage and amortization period. In contrast to earlier versions surrounding H.R. 1, the current law treatment surrounding DAC under section 848 would not be altered, and the proposed section 3710 was withdrawn. However, the expectation is that the provisions taxing life insurance companies will continue to evolve.

***MODIFIED:* Excise tax on certain payments from domestic corporations to related foreign corporations; election to treat such payments as effectively connected income (section 4303 of the Ways and Means bill)**

Section 4303 would impose a new excise tax on deductible payments by domestic corporations to related foreign corporations. The new tax would be sweepingly broad in scope, applying to virtually every form of payment, other than interest, that would give rise to a reduction in U.S. taxable income, and would apply to both U.S. and foreign-headquartered groups, thus including payments by U.S. multinationals to their CFCs.

The rate of the proposed excise tax (new Code Sec. 4491) would equal the highest corporate tax rate (20% after enactment). The excise tax thus would effectively deny the benefit of a deduction for covered payments, unless the foreign recipient elects to treat the payment as income effectively connected with a U.S. trade or business (ECI) and as income attributable to a permanent establishment for tax treaty purposes. If the election were not made and the excise tax were to be paid, it would not be deductible from the domestic corporation's taxable income.

The original version of the provision did not allow foreign tax credits to be used against an electing foreign corporation's resulting U.S. income tax liability. The Ways and Means bill, however, would permit the Code's existing foreign tax credit mechanism, section 906(a), to apply, but with an 80% limitation.

KPMG observation

The proposal would impose a new tax on certain payments to foreign affiliates. For example, one insurance industry segment includes off-shore reinsurance to an affiliated entity as an integral part of its business model. The proposal would have an economic impact on related party cross border reinsurance. In addition, because the provision is written to cover a broad range of payments, the application to specific

types of reinsurance agreements raises questions regarding the scope of the paid or accrued specified amounts.

Restrict insurance business exception to passive foreign investment company rules (section 4501 of the Ways and Means bill)

This provision would expand the application of the passive foreign investment company (PFIC) rules, which deny U.S. investors the benefit of deferral of their U.S. tax on the PFIC's earnings, by limiting the exception from the rules for active insurance businesses.

Under the proposal, the current law exception from passive income for certain investment income derived from the active conduct of an insurance business would apply only to a foreign corporation that satisfies the new definition of a "qualifying insurance corporation."

The new definition of a "qualifying insurance corporation" (whose investment income would not cause it to be a PFIC) would be expanded by adding the requirement that its "applicable insurance liabilities constitute more than 25% of its total assets" based on "liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year." Applicable liabilities would include loss and loss adjustment expenses and certain reserves, but do not include deficiency, contingency, or unearned premium reserves.

The proposal would provide potential relief to a foreign corporation that cannot meet the new 25% test by giving the Treasury 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.

KPMG observation

This provision largely tracks prior legislative proposals that were described as addressing a perceived abuse whereby some insurance activities were used to shelter large investments. The proposed change might also have significant implications for non-U.S. insurance companies that insure long-tail and catastrophic risks.

U.S. persons owning stock of a corporation treated as a PFIC because it is ineligible for the active insurance exception in Code section 1297(b)(2)(B) would be required to begin filing Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, and to consider available PFIC-related elections.

Under current law (Code section 6501(c)(8)), a U.S. person that fails to file Form 8621 for a year generally would have the statute of limitations for its tax return for that year

kept open until three years after the U.S person furnishes the required information to the IRS.

The proposal in the Ways and Means bill could require the Treasury Department to issue new regulations, and the IRS to amend Form 8621, for taxpayers to take advantage of the election it would provide to U.S. shareholders of certain affected foreign corporations that fail the 25% test.

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