TaxNewsFlash

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Insurance provisions in tax reform approved by Senate Finance Committee (as of November 20)

The U.S. Senate Finance Committee on November 16, 2017, completed its markup of a tax reform bill, and approved the bill on a party-line vote of 14 to 12, thus sending the bill to the full Senate for its consideration. On November 20, legislative text was released for the bill that was ordered reported.

The following discussion examines insurance-related provisions from the version of the tax reform approved by the Senate Finance Committee. When applicable, there is a comparison to the provision in the version of the tax reform legislation (H.R. 1) as passed by the House of Representatives on November 16, 2017.

Documents

- November 9—Senate Finance Committee Chairman Orrin Hatch released his "Chairman's mark" for tax reform (read ***TaxNewsFlash***).
- November 14—Chairman Hatch released a modified Chairman's mark (read ***TaxNewsFlash***).
- November 16—Chairman Hatch released a "manager's amendment" to the bill approved by the Senate Finance Committee (read ***TaxNewsFlash***).
- November 20—Legislative text for the bill was released (read ***TaxNewsFlash***).

Major insurance provisions

Documents

- Read the 515-page **legislative text** [PDF 812 KB] of the bill reported by the Senate Finance Committee

- Read a description [PDF 986 KB] of the Chairman's modified mark, (103 pages) prepared by the Joint Committee on Taxation (JCT)

- Read a **revenue estimate** [PDF 51 KB] of the Chairman's modified mark, prepared by the JCT

- Read a **description** [PDF 104 KB] of the manager's amendment (five pages)

Modify operations loss deductions of life insurance companies (section 13511 of the bill)

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

The provision also would modify the carryover and carryback rules for all corporations. All net operating losses would be repealed and taxpayers would be allowed to carry net operating losses forward indefinitely (except for a special two-year carryback in the case of certain losses incurred in the trade or business of farming). Under the proposed provision, taxpayers' ability to deduct a net operating loss carryover (or carryback, under the aforementioned casualty loss provision) would be limited to 90% of the taxpayer's taxable income for the year.

The modified mark issued on November 14th would further limit the net operating loss deduction to 80% of taxable income (determined without regard to the deduction).
The manager's amendment issued on November 16th would change the date to limit the net operating loss deduction to 80% of taxable income in taxable years beginning after December 31, 2022.

These provisions would be effective for losses arising in tax years beginning after 2017, other than the 80% limitation (as described above) that would be effective in tax years after 2022.

KPMG observation

This proposal would put life insurance companies on the same loss carryback and carryforward schedule as other corporations (other than nonlife insurance companies). 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 for ordinary deferred tax assets, since it allows insurance companies to use a reversal period that corresponds to the tax loss carryback provisions of the Code.

The limitation of a life insurance company's operating loss deduction to 90% of the company's taxable income would conform to current law regarding the utilization of losses to compute alternative minimum tax. The 80% limitation beginning in tax years after 2022 would also be applicable to life insurance companies. The House-approved bill includes a similar provision; however the 80% limitation in tax years beginning after 2022 is specific to the Senate mark.

Retain operations loss deductions of property and casualty insurance companies (section 13302 of the bill)

The modified mark issued November 14th would preserve current law for net operating losses of property and casualty companies. Under the modification (which would be the same as current law) net operating losses of property and casualty companies could be carried back two years and carried forward 20 years to offset 100% of taxable income in such years.

KPMG observation

This proposal would put life insurance companies and non-life insurance companies on different loss carryback and carryforward schedules. Unlike the impact on the life insurance industry, a non-life insurance's company's deferred tax asset admissibility computation for statutory accounting purposes would not change. The first part of the admissibility test under SSAP 101 would still be applicable and would allow the same computations as under current law.

The House bill does not include a similar provision that preserves current law treatment for non-life companies.

Repeal small life insurance company deduction (section 13512 of the bill)

This proposed provision would repeal the Code section 806 special deduction for small life insurance companies, effective for tax years beginning after 2017.

KPMG observation

This proposal is described as eliminating special treatment for a segment of the insurance industry in which "the risk distribution benefits of risk pooling are the weakest." The proposal would not eliminate a similar benefit for small property and casualty insurers. A similar proposal is in the House bill.

Repeal Code section 807(f) spread; adjustment for change in computing reserves (section 13513 of the 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 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 House bill, H.R. 1.

Repeal special rule for distributions to shareholders from pre-1984 policyholders surplus accounts (section 13514 of the 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.

The provision would generally be effective for tax years beginning after 2017, and any remaining balances would be subject to tax payable ratably over the first eight tax years beginning after December 31, 2017.

KPMG observation

This proposal was one suggested by the ABA Tax Section Insurance Companies Committee and is not expected to raise significant revenue. A similar proposal is included in the House bill.

Modify proration rules for property and casualty (P&C) insurance companies (section 13515 of the bill)

This provision would replace 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 would be 20%, and the percentage reduction would be 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 always equals 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 bill and the Senate Finance Committee propose a fixed rate that is tied proportionally to the change in the corporate tax rate.

Repeal elective deduction and related special estimated tax payment rules (section 13516 of the bill)

This provision would repeal the Code section 847 elective deduction and related special estimated tax payment rules. The entire balance of an existing account would be included in income of the taxpayer for the first tax year beginning after 2017, and the entire amount of existing special estimated tax payments would be applied against the amount of additional tax attributable to the inclusion. Any special estimated tax payments in excess of this amount would be treated as estimated tax payments under section 6655.

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 as a result, section 847 is largely unnecessary and administratively burdensome. The House bill (H.R. 1) also proposes to repeal section 847.

Capitalize certain policy acquisition expenses (DAC) (section 13517 of the bill)

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 form a 120-month period to the 600-month period beginning with the first month in the second half of the tax year. The proposal does 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 would 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 House bill's proposal, which does not currently suggest a change to DAC. Before the House Ways and Means Committee, it was initially proposed to increase 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 (sections 13518, 13519, and 13520 of the bill)

Under current law section 101(a)(1), there is an exclusion from federal income tax for amounts received under a life insurance contract paid by reason of the death of the insured. Under section 101(a)(2), under the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable is generally limited.

Further, in Rev. Rul. 2009-13, the IRS ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of a sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup") and excess is long-term capital gain.

In Rev. Rul. 2009-14, the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (for example, premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance. The Senate Finance bill 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. Lastly, 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.

Reporting requirements for acquisitions of life insurance contracts

The reporting requirement would apply to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Under the reporting requirement, the buyer would report information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase would include: (1) the buyer's name, address, and taxpayer identification number (TIN); (2) the name, address, and TIN of each recipient of payment in the reportable policy sale; (3) the date of the sale; and (4) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of seller's basis in the life insurance contract

On receipt of a report (described above), or on any notice of the transfer of a life insurance contract to a foreign person, the issuer would be required to report to the IRS and to the seller: (1) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)); (2) the name, address, and TIN of the seller or the transferor to a foreign person; and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person would be intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company would be required to report information about the payment to the

IRS and to the payee. Under this reporting requirement, the payor would report: (1) the gross amount of the payment; (2) the taxpayer identification number of the payee; and (3) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale. For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

Determination of basis

This provision provides that in determining the basis of a life insurance or annuity contract, no adjustment would be made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This would reverse the position of the IRS in Rev. Rul. 2009-13, that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

Scope of transfer for value rules

The provision provides that the exceptions to the transfer for value rules would not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract could be includable in income.

Under this provision, the reporting requirement would be effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017. The clarification of the basis rules for life insurance and annuity contracts would be effective for transactions entered into after August 25, 2009. The modification of exception to the transfer for value rules would be effective for transfers occurring after December 31, 2017.

KPMG observation

The provision would add to the 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 surrender 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 bill.

Modification of insurance exception to the passive foreign investment company rules (section 14502 of the bill)

This provision appears to be materially the same as section 4501 of H.R. 1, and has the same effective date and revenue effect.

The description of the Senate Finance Chairman's mark indicates that this amendment would also expand the application of the passive foreign investment company (PFIC) rules by limiting the exception from the rules for active insurance businesses.

Current law contains an exception from passive income that prevents certain investment income derived from the active conduct of an insurance business from causing a foreign corporation to be a PFIC. As under section 4501 of the House bill, this exception in the PFIC rules 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. Applicable liabilities of any property and casualty or life insurance business would include loss and loss adjustment expenses and certain reserves, but not unearned premium reserves.

An applicable financial statement is a statement for financial reporting purposes that is made on the basis of generally accepted accounting principles (GAAP), on the basis of international financial reporting standards (IFRS) if no GAAP statement is available, or, "except as otherwise provided by the Secretary in regulations," on the basis of the annual statement required to be filed with the applicable insurance regulatory body, but only if neither a GAAP nor IFRS statement is available. Unless otherwise provided in regulations, GAAP means U.S. GAAP.

Like a provision in the House-approved bill, the Senate Finance bill 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

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 change may also affect 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. Like a provision of the House bill, H.R. 1, the Senate Finance version also 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% liabilities test.

Limitation on the deduction for interest (section 13301 of the bill)

The Senate Finance Committee's provision 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 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 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. The House bill, H.R. 1, contains a similar proposal. However, unlike the provision within H.R. 1, the Senate Finance proposal 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 bill).

Tax on base erosion payments (section 14401 of the bill)

This base erosion provision imposes a surtax on the tax benefits associated with certain payments between related parties.

KPMG observation

While the proposal would significantly affect most inbound companies and many U.S.-headquartered companies, the proposal would affect certain industries disproportionately. As just one example, the proposal would have an economic impact on related-party cross border reinsurance, and therefore would significantly affect insurance companies that include off-shore reinsurance to an affiliated entity as an integral part of their business model.

Read a **table** [PDF 53 KB] prepared by KPMG LLP comparing the insurance provisions within the current versions of the House-passed bill and the version of the legislation approved by the Senate Finance Committee

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