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CLIENT ALERT

# Impact of the Tax Cuts and Jobs Act on the Insurance Industry

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On November 2nd, the House of Representatives unveiled their long-awaited bill to implement comprehensive tax reform proposals. The Tax Cuts and Jobs Act of 2017 (H.R. 1) would lower the corporate income tax rate to a flat 20 percent and shift the U.S. tax code towards a territorial system to a large extent (including a 100 percent dividend exemption for foreign source dividends paid by foreign corporations to U.S. corporate shareholders owning at least 10 percent of the foreign entity).

The bill includes proposals that could impact the offshore insurance and reinsurance sectors. The bill proposes a 20 percent excise tax on the gross amount of deductible payments (other than interest) made by a U.S. corporation to an affiliated foreign corporation if the entities are part of a group that prepares consolidated financial statements with annual gross receipts of more than $100 million and the average annual aggregate amount of such payments for the three-reporting-year period ending with the test year exceeds $100 million. The excise tax would be paid by the domestic corporation (which would not be able to deduct it) and could be avoided if the foreign corporation elected to pay U.S. corporate income tax (and potentially branch profits tax) on such payments (in which case the tax would be imposed on the excess of such payments over a deduction for “deemed expenses” calculated on the basis of net income ratios of the group).

This excise tax, which would have a similar economic effect to that of the so-called Neal bill proposals targeted at cross-border affiliate reinsurance, applies across all industries. In the cross-border affiliate reinsurance space, the gross amount of the reinsurance premium paid by a domestic corporation to its foreign affiliate could be subject to this 20 percent excise tax absent an election by the foreign corporation to pay U.S. tax on such payments. This proposal would be effective for tax years after 2018.

Another proposal in the bill that could impact the offshore insurance and reinsurance sectors tightens the Active Insurance Exception (defined below) to conform to the passive foreign investment company ("PFIC") rules. A U.S. taxable investor in an offshore insurer or reinsurer is generally able to defer U.S. taxation until a sale of its shares in the offshore insurer or reinsurer and to pay tax on such sale at long-term capital gain rates, if, among other things, the offshore insurer or reinsurer qualifies for an exception to classification as a PFIC because it is treated as an insurance company for U.S. tax purposes that is predominantly engaged in the insurance business and is engaged in the active conduct of an insurance business (the "Active Insurance Exception"). The proposal generally limits the application of the Active Insurance Exception to companies that would be treated as insurance companies for U.S. tax purposes with (1) losses and loss adjustment expenses, (2) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and (3) life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks equal to more than 25 percent of its total assets as reflected on the company's financial statement (with a lower 10 percent threshold applying in the case of certain run-off or rating-related circumstances), provided certain other requirements are satisfied. Among other things, this proposal could result in the treatment of offshore insurers or reinsurers that write business on a low frequency/high severity basis, such as property catastrophe companies and financial guaranty companies, as PFICs, as significant reserves for losses are not recorded until a catastrophic event actually occurs. This proposal would be effective for tax years after 2017.

Other provisions of the bill of interest to the insurance industry more generally, which would be effective for tax years after 2017, include the following:

- net operating loss carryovers of life insurance companies would be conformed to the general rules (two year carryback/20 year carryforward)
- computation of life insurance reserves would be changed
- the special 10 year period for taking into account adjustments in computing life insurance reserves would be removed, and the general rule for making tax accounting adjustments would apply
- the "proration" rules for life and property and casualty insurers would be modified
- the discounting rules for property and casualty insurers would be modified
- the deferred acquisition cost rules that spread expenses over 10 years would apply to two categories of insurance contracts rather than three, and the percentage of net premiums subject to the spread would be 4 percent for certain group contracts and 11 percent for all other specified contracts.

It is important to note that the House bill is a starting point, and details of the bill are likely to change in the coming weeks (with the Senate plan expected to emerge as early as next week).

If you have any questions regarding this client alert, please contact the following attorneys or the attorney with whom you regularly work.

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