CLIENT ALERT

# Impact of the Tax Cuts and Jobs Act on the Offshore Reinsurance Industry

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On December 15, 2017, the U.S. House of Representatives and the U.S. Senate released their final compromise tax package, The Tax Cuts and Jobs Act (H.R. 1) (the "Act"). The Act would fundamentally overhaul the Internal Revenue Code of 1986, as amended (the "Code") and the U.S. tax system by, among other things, lowering the U.S. corporate income tax rate to 21 percent (and repealing the corporate alternative minimum tax) and moving the United States closer to a territorial system of taxation (including through a 100 percent dividends exemption for certain foreign source dividends received by a U.S. corporation from a 10 percent or greater owned foreign subsidiary that is not a passive foreign investment company or "PFIC"). It is expected that the Act will be voted on by both houses of Congress this week.

The Act includes a number of provisions that significantly change the landscape for the offshore insurance and reinsurance sector, particularly in the context of outbound cross-border affiliate reinsurance. This summary focuses on the provisions of the Act that could have the most significant impact in the offshore insurance and reinsurance space. We also are preparing a broader summary of the Act that will be distributed shortly.

**Prevention of Base Erosion**

The Act generally adopts the Senate provision on base erosion, requiring an "applicable taxpayer" to pay the excess of 10 percent (five percent for one taxable year beginning after December 31, 2017 and 12.5 percent for taxable years beginning after December 31, 2025) of "modified taxable income" for a taxable year over an amount equal to its regular corporate tax liability for that year reduced by certain credits (the "base erosion minimum tax amount"). Modified taxable income generally is computed by adding back the base erosion tax benefit derived from a base erosion payment, and

base erosion payment includes, among other items, any amount paid or accrued by an applicable taxpayer to a foreign related person that is deductible to the payor and any reinsurance premium paid to a foreign related person. An applicable taxpayer generally means a corporation with average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least $500 million (subject to aggregation rules for certain groups) with a “base erosion percentage” (defined as the aggregate amount of base erosion tax benefits for the taxable year divided by the aggregate amount of deductions for such year) of at least three percent. A foreign person is related to the applicable taxpayer if either (i) it owns 25 percent or more of the taxpayer, (ii) it is related to the taxpayer or any 25 percent owner of the taxpayer under Code Section 267 (related to loss disallowance rules applicable to transactions between related parties) or Code Section 707 (related to transactions between partners and partnerships) or (iii) it is related to the taxpayer under the transfer pricing rules of Code Section 482. The compromise bill modified the Senate version to specify that reinsurance premiums generally would be treated as base erosion payments, likely in response to arguments that reinsurance premiums were not deductible payments otherwise subject to the base erosion minimum tax rules under the insurance accounting rules of Subchapter L of the Code. Such premiums appear to remain subject to the one percent federal excise tax on reinsurance premiums.

An offshore insurance and reinsurance group that engages in significant outbound cross-border affiliate reinsurance will need to assess its particular fact pattern to determine whether to continue such arrangements in their current form, including considering the possibility of establishing a Code Section 953(d) reinsurer if the nontax benefits warrant the continuation of such arrangements.

**Active Insurance Exception to the PFIC Rules**

Each of the House and Senate versions of the bill included a provision to tighten the Active Insurance Exception (defined below) to the 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 Act generally limits the application of the Active Insurance Exception to companies that would be treated as insurance companies for U.S. tax purposes with (i) losses and loss adjustment expenses, (ii) reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and (iii) 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, in which case a U.S. taxable investor may elect non-PFIC treatment) (the “Reserves Test”), 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. Congress did not include unearned premium reserves in the Reserves Test calculation, despite intense industry lobbying efforts. It also is not clear how offshore life reinsurers that provide coverage on a modified coinsurance basis would avoid PFIC status.

**Controlled Foreign Corporation (“CFC”) Rules**

A “U.S. shareholder” of a CFC would be required to include in income for a taxable year its pro rata share of Subpart F income of the CFC, including certain insurance and related investment income, even if such income is not distributed. A foreign reinsurer would be considered a CFC if “U.S. shareholders” own more than 25 percent of the vote or value of its shares. The compromise bill adopted the Senate modifications to the definition of “U.S. shareholder” for CFC purposes, expanding the definition to include U.S. persons owning 10 percent or more of the **value** of the CFC’s shares (whereas current law only looks to voting power). In addition, the Act would expand certain attribution rules for stock ownership in a way that would cause foreign subsidiaries in a foreign-parented group that includes a U.S. subsidiary to be treated as CFCs. Although the conference agreement providing an explanation of the Act clarifies that the provision is intended to target transactions that avoid Subpart F by “de-controlling” a foreign subsidiary so that it is no longer a CFC and indicates that the proposed rule is not intended to impact other 10 percent U.S. shareholders that are not related to the U.S. subsidiary if the foreign subsidiaries are not otherwise treated as CFCs, the legislative language does not appear to comport with this intent. As a result of the modifications to the CFC rules, voting cutback and push-up provisions in the organizational documents of many foreign-parented insurance and reinsurance groups will be ineffective in avoiding U.S. shareholder status of 10 percent or greater U.S. economic owners in the CFC analysis. U.S. tax exempt entities subject to the unrelated business taxable income (“UBTI”) rules that own 10 percent or more of the value of a foreign reinsurer that is characterized as a CFC should consider the implications of Code Section 512(b)(17), which could result in UBTI for such investors. In this regard, it should be noted that the Act rejected a House provision that would have subjected state and local pension plans to the UBTI rules.

**Select Insurance Company Tax Accounting Rules**

The following bullets briefly summarize select insurance company tax accounting provisions in the Act that could impact the offshore insurance and reinsurance sector:

- The tax rate applicable to life insurance companies would not include the eight percent surcharge from the House bill.
- Net operating loss (“NOL”) carryovers of life insurance companies would be conformed to the general rules, which would be revised by the Act to eliminate the carryback period, provide for an indefinite carryforward and limit the offset for NOLs arising in taxable years beginning after December 31, 2017 to 80 percent of taxable income

determined before the NOL carryover. The NOLs of property/casualty insurance companies would be carried back two years and carried forward 20 years and would not be subject to the 80 percent offset limitation.

- The computation of life insurance reserves would be modified to limit the amount of the life insurance reserves for a contract (other than certain variable contracts) to the greater of the net surrender value of the contract or 92.81 percent of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined (the House version of the bill initially called for a 23.5 percent discount, which would have been catastrophic for some life insurance industry participants). The Act would allow for an eight-year spread of the difference in reserves as of December 31, 2017 resulting from the modification.

- The loss reserve discounting rules applicable to property/casualty companies would be modified by changing the prescribed interest rate, extending the periods applicable under certain loss payment patterns and repealing the election to use a taxpayer's historical loss payment pattern rather than the aggregate industry-experienced-based pattern.

- The amortization period for certain deferred acquisition costs ("DAC") would be extended from 10 years to 15 years (the original Senate plan called for a 50-year amortization), and the DAC rates would increase by roughly 19.5 percent.

- The special 10-year rule for taking into account adjustments in computing life insurance reserves under Code Section 807(f) would be replaced with the general rule for making tax accounting adjustments under Code Section 481 (generally negative adjustments are deducted in the taxable year of the change and positive adjustments are required to be included ratably over four taxable years).

- The proration rules for life and property/casualty insurance companies would be modified.

- The Act generally would require an accrual method taxpayer to recognize income that is subject to the all-events test no later than the taxable year in which the income is taken into account on the taxpayer's financial statements. The conference agreement providing an explanation of the Act states that the provision does not revise the rules associated with when an item is realized for federal income tax purposes and, accordingly, does not require the recognition of income in situations where the federal income tax realization event has not yet occurred. For example, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. Further, the provision's application to insurance companies subject to tax under Subchapter L of the Code is not clear, as the provision generally would not apply to any item of gross income for which a taxpayer uses a special method of accounting.

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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