CLIENT MEMORANDUM

Application of Border Adjusted Tax Proposals Creates Uncertainty for Offshore Insurers

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AUTHORS

Arthur J. Lynch | **Russell L. Smith**

With a Republican sweep of the executive and legislative branches of government in November's elections, it is expected that Republicans in Congress will begin consideration of comprehensive tax reform legislation during the early days of the new Congress, which convenes in January. Republican congressional leaders want to vote on a final bill that can be signed into law by President Trump before the end of 2017. These tax reform efforts will build upon proposals previously released on June 24, 2016 by the House (Republican) Tax Reform Task Force (the "Blueprint") and by presidential candidate Donald Trump during the campaign. In addition, Senate Republican leaders have been working on a comprehensive plan designed to eliminate the current system of double taxation of corporate earnings that would appear to differ significantly from either the Blueprint or the Trump plan.

While President-elect Trump has promised across-the-board individual and business tax cuts, and expressed little concern about resulting tax losses or deficits, the Blueprint is consistent with congressional Republican leadership commitments over the past few years to the policy that comprehensive tax reform should be revenue neutral, such that lower rates are more or less offset by the closing of loopholes and the reduction or elimination of deductions. This difference of approach could be the basis for some tension between the new administration and congressional Republicans. However, Trump seems willing to show a good deal of deference to congressional leaders on tax reform, while reserving to presidential leadership such areas as immigration, trade, and foreign relations. As a result, while there may be tension, there is a high probability that Republicans, motivated by this “once in a lifetime” chance for comprehensive tax reform, will quickly resolve their differences.

Both the Blueprint and the Trump plan call for significant reductions in corporate tax rates. The Blueprint, which is the far more developed plan, allows for full and immediate write-offs of investment in tangible and intangible assets, indefinite carryforward of net operating losses (“NOLs”) (although NOLs cannot be carried back and the NOL carryforward to a particular taxable year can be used to offset only 90% of the taxable income in that taxable year), and a reduction in the tax imposed on individual shareholders with respect to dividends and capital gains from the disposition of shares to mitigate the effective double taxation of corporate earnings. The Blueprint also would eliminate the deductibility of interest expense in excess of interest income in a bid to equalize the tax treatment of different types of financing and eliminate tax-induced distortion in investment financing decisions. In a nod to the importance of interest expense and interest income to the business models of financial services companies, including insurance companies, the Blueprint would provide for an exception to the interest expense limitation for such companies.

In a dramatic shift in the corporate income tax system, the Blueprint moves towards a territorial system based on consumption, largely repealing the subpart F anti-deferral rules that require U.S. multinationals to include in their U.S. corporate income tax base certain types of income for foreign subsidiaries on a current basis, and excluding dividends received from those foreign subsidiaries. The shift to a consumption-based, or destination-based, approach for taxing business income would tax income based on where goods or services are consumed rather than where they are produced. This means that income from exports (consumed outside the United States) would be exempt from tax, while income from imports (consumed domestically) would be taxed. The jurisdiction in which a subsidiary is incorporated would be irrelevant. As a result, the sales of products, services or intangibles to U.S. customers would be taxed but sales to foreign customers would be tax-exempt, regardless of the location of the production activities or whether the taxpayer is foreign or domestic.

The Republican leaders who drafted the Blueprint have stated that their intent in including a “border adjusted tax” (“BAT”) is to eliminate the incentives under current law to move, or locate, operations outside the United States. The application of a consumption-based system to the insurance industry, absent an exemption of some kind, would be extremely complex and the method for collecting any such tax is unclear. The Blueprint provides no substantive detail regarding these issues. Insurance industry participants have been meeting with House Ways and Means Committee members to discuss concerns about how these proposals would be implemented.

In addition to the concerns being raised by the insurance industry, there is growing negative reaction from the U.S. manufacturing, retail, and energy sectors. As a result, while Republican Committee members and House Republican leaders continue to state their commitment to the BAT in some form in tax reform legislation, it is still too early to predict whether Congress will pass, and whether President Trump will sign, such a dramatic change into law. We will have a better feel for what form comprehensive tax reform will take by the spring of 2017.

If you have any questions regarding this memorandum, please contact Arthur J. Lynch (212-728-8225; alynch@willkie.com), Russell L. Smith (202-303-1116; rsmith@willkie.com) or the attorney with whom you regularly work.

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