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AMERICAN TAXPAYER RELIEF ACT OF 2012—ACTIVE FINANCING INCOME EXCEPTION TO SUBPART F

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On Jan. 2, 2013, President Barack Obama signed into law the American Taxpayer Relief Act of 2012 ("The Act"). The Act included numerous individual tax provisions as well as a retroactive extension of certain business tax provisions that had been allowed to expire. Of particular note to the insurance industry were the extensions, through Dec. 31, 2013, of the exception in Subpart F allowing deferral of the income of a controlled foreign corporation ("CFC") engaged predominantly in the active conduct of a Banking, Financing or Similar Business (widely referred to as the Active Financing Exception, or "AFE"—see rules contained in Internal Revenue Code §953(e) and §954(i)), and the look-through rule for payments between related CFCs—see rules contained in §954(c)(6).

Under the AFE, certain underwriting and investment income will not constitute Subpart F income if a "qualifying insurance company" CFC and/or a "qualifying insurance company branch" is operated in a manner consistent with the provisions of sections 953(e) and 954(i).[1] This exclusion from Subpart F treatment can result in significant tax deferral for U.S. groups that have organized their overseas insurance operations with the AFE in mind. In conjunction with excluding certain home-country underwriting income, the AFE provides an additional exclusion for certain underwriting income attributable to cross-border business written through a qualifying insurance branch, and finally, for deferral of certain investment income attributable to insurance operations. Under §953 in effect prior to the initial enactment of AFE (AFE became effective for taxable years of a foreign corporation beginning after Dec. 31, 1998), neither of these additional deferral opportunities were available.

The CFC look-through rule contained in §954(c)(6) provides an exemption from Subpart F treatment for dividends, interests, rents and royalties received from a related CFC. Whether used separately, or in conjunction with the AFE, this provision allows U.S. insurance groups to reduce some of the current tax costs associated with the Subpart F regime.

The availability of cross-border deferral under the AFE provisions, coupled with the pending introduction, in some jurisdictions, of the Solvency II regime, has led some insurance groups to consider operating their foreign insurance businesses in branch form. While the initial appeal of operating as a branch was a reduced cost/regulatory structure when compared with the legal entity form of doing business, the economic appeal is enhanced under the AFE rules for qualified cross-border business in combination with capital efficiencies that are possible under Solvency II.

Although organizations continue to create branch structures to realize the benefits discussed above, uncertainty surrounding the future of U.S. tax policy, and specifically the possible non-renewal of the AFE and look-through rule, have the potential to immediately negate many of these same benefits. For example, if the expiration of the AFE at the end of 2009, and again at the end of 2011, had become permanent, many existing structures could have immediately become tax inefficient.

Another consideration stemming from the tax and regulatory efficiencies achieved through a qualifying branch structure is capital repatriation. Corporate repatriation policies of U.S. insurers with international operations are often driven by regulatory capital constraints and residual U.S. tax cost considerations. To the extent that a foreign operation is sufficiently capitalized to write business at desired levels, distributions of previously taxed income (PTI) resulting from Subpart F inclusions can be common. In a well-capitalized foreign insurer, accumulation of excess capital (as that term is defined for purposes of the AFE rules) will generate additional Subpart F income; so many insurance groups prefer to distribute PTI balances to the extent allowable under local regulations.

A final area of consequence relating to the retroactive extensions discussed above is the accounting for income tax implications. Because the taxation of international insurance operations is complex, associated income tax accounting consequences generally require significant professional judgment and substantial documentation to support a company's

CONTINUED ON **PAGE 20**

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positions. Recently, this area has experienced an increase in SEC comment letter activity, especially on the indefinite reversal criterion of Financial Accounting Standards Board Accounting Standards Codification (ASC) Topic 740, "Income Taxes" (formerly included in APB Opinion 23). Under ASC 740, deferred income taxes are not recognized on certain temporary differences related to earnings of foreign subsidiaries, unless it becomes apparent that those temporary differences will reverse in the foreseeable future.

The ASC 740 assertion of indefinite reinvestment of foreign earnings can be problematic for insurance groups subject to some level of tax on their foreign earnings. While the AFE regime may provide an element of deferral, income from insurance contracts that are not "exempt" contracts and excess capital can still produce current Subpart F inclusions. For these groups, repatriation decisions must be carefully made so that distributions of foreign earnings do not exceed existing balances of PTI as defined in section 959. Distributions in excess of PTI could jeopardize an assertion that either historic earnings and/or currently untaxed earnings are indefinitely reinvested and do not require deferred tax liabilities.

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The extension of the AFE for insurance CFCs has created several accounting issues apart from the indefinite reversal criterion. When the AFE provision expired at the end of 2009, many practitioners felt it would be extended with retroactive effect before the end of the first quarterly financial statement period of 2010. When no extension was enacted by March 31, 2010, companies relying on it had to book larger financial statement tax provisions to account for the loss of deferral previously received under the AFE. Congress finally enacted a two-year extension on Dec. 17, 2010, providing for retroactive application of the AFE for 2010 and prospective application for 2011. Enactment of retroactive application of AFE for 2010 during 2010 allowed companies to reverse the previously recorded financial statement tax provision attributable to the expiration of the AFE in their 2010 financial statements. The most recent retroactive extension of the AFE on Jan. 2, 2013 has created a more complicated circumstance with respect to the application of ASC 740 guidance.

Companies should have previously factored in the lapse of the CFC look-through rule and the AFE in measuring 2012 current and deferred taxes on earnings of foreign subsidiaries. Because of the expiration of both provisions, U.S. companies may have been required to recognize 2012 current and deferred taxes related to certain earnings of foreign subsidiaries even if the subsidiary did not plan to remit earnings to the U.S. parent. As a result of the extension of these provisions, entities may need to adjust 2013 current and deferred taxes related to those earnings of foreign subsidiaries.

Under ASC 740, the effects of new legislation are recognized upon enactment, which in the United States is the date the president signs a tax bill into law. Although the provisions discussed herein are effective retroactively for 2012, companies may only consider currently enacted tax law as of the balance sheet date in determining current and deferred taxes. For calendar-year-end reporting companies, this means that both the retroactive tax effects for 2012 and the tax effects for 2013 will be recognized in the 2013 financial statements. During the first quarter of 2013 (the period that includes the enactment date) for calendar-year-end reporting entities, any amounts pertaining to the retroactive effects for 2012 and adjustments to deferred taxes as of the enactment date, would be recognized as a discrete item and would not be reflected in the 2013 estimated annual effective tax rate. Companies may therefore wish to consider additional 2012 financial statement disclosures in which they discuss the tax impact of the retroactive extensions.

In summary, the CFC look-through rule and the AFE will continue to have a substantive effect on the tax profile of U.S.-based groups with international insurance operations, both from a cash tax and U.S. GAAP perspective. As we look ahead, the broader question of international tax reform and its impact on these provisions remains unclear. The temporary two-year extension afforded by The Act, while a welcome development, does not address planning considerations absent a permanent extension. In fact, two significant reform proposals introduced in the previous Congress (the Camp International Reform Discussion Draft—Oct. 26, 2011 and the Enzi bill titled "The United States Job Creation and International Tax Reform Act of 2012"—Feb. 9, 2012) differ on the future of both provisions. Under the Camp proposal, both provisions would be permanently repealed; while under the Enzi proposal, both provisions would be permanently extended—stay tuned as this debate continues. ◀

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END NOTES

[1] See Internal Revenue Code section 953(e)(3) for the definition of "qualifying insurance company" and Code section 953(e)(4) for the definition of "qualifying insurance company branch."