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Overview of the Tax Cuts and Jobs Act: Major Changes in the Taxation of Life Insurers

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On Dec. 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (P.L. 115-97) ("TCJA," or "Act"),[1] following a flurry of legislative activity at a pace seldom seen on Capitol Hill. Ways and Means Committee Chairman Kevin Brady (R-Texas) released his original Mark of the TCJA on Nov. 3, launching a high stakes, seven-week scramble with significant financial and business consequences to life insurance companies. This issue of *Taxing Times* is devoted to a discussion of several of the major provisions that are particularly important to life insurers, with an emphasis on domestic provisions. Later issues will address international provisions, reinsurance and other matters. This article sets the stage for that discussion by providing historical context and an overview of major themes of the Act.

"TAX REFORM": IT HAPPENS

Like death and taxes, "reform" of the Internal Revenue Code every few decades is a certainty.

1959 Act

Before the Life Insurance Company Tax Act of 1959, P.L. 86-69 ("the 1959 Act"), life insurance companies were taxed at the same rates as other corporations, but only on their net investment income.[2] After this legislation, life insurers instead were taxed on all their income, but under a complicated three-phase system, remnants of which still may be seen in the Internal Revenue Code and regulations. Specifically, Phase I generally taxed a profitable life insurer's net investment income. Phase II generally taxed half of a company's underwriting income minus certain special deductions on a current basis; and Phase III taxed the special deductions and the deferred portion of a company's underwriting income when the company made future distributions from what was known as a policyholders' surplus account.[3] For purposes of computing gain from operations, tax-deductible life insurance reserves generally were equal to statutory reserves, but could actually be increased above statutory reserves if a special "section 818(c) election" was made.

Older members of the insurance tax community still invoke concepts under "the 1959 Act" and with good reason. Even though Congress later dismantled the framework of the 1959 Act, many of the concepts and, in particular, definitions under the Act still survive. Even today, the definitions of insurance company, life insurance company, and life insurance reserves have their roots in 1959 Act authorities. Moreover, the current-law limitations on consolidated returns that include both life and nonlife members were originally enacted to protect the three-phase system of taxation under the 1959 Act.

1984 Act

Twenty-five years after the 1959 Act, Congress again amended many provisions of the Internal Revenue Code, with a particular focus on the taxation of life insurers. The changes were motivated by an unusually large increase in interest rates between 1959 and 1984, and by a need to simplify the 1959 Act's complex three-phase system of taxation.

Under the Deficit Reduction Act of 1984, P.L. 98-369 ("the 1984 Act"), life insurance companies were taxed under a single-phase system, like most other corporate taxpayers. The familiar regime under section 807 for computing tax reserves was established, including computation of a Federally-Prescribed Reserve, the use of a reserve methodology determined based on when a contract was issued, reliance on prevailing interest rate and mortality tables, and application of a statutory reserves cap and net surrender value floor. The separate accounting and diversification requirements for assets supporting variable contracts were imposed.

To the disappointment of the industry, limitations that applied to consolidated returns filed by mixed life/nonlife groups were retained, even though the three-phase system that gave rise to those limitations was eliminated. Over time, new IRS guidance addressed many issues under the provisions of the 1984 Act, and authorities under the 1959 Act remained relevant as to those provisions that carried over.[4] As a younger generation of tax professionals came up through the ranks, they spoke of the 1984 Act with the same familiarity that their elders exhibited with respect to the 1959 Act.

Nontax insurance developments in the years that followed the 1984 Act put pressure on some of the rules in Subchapter L. In particular, the adoption of Life principle-based reserving (PBR) put significant pressure on the rules for determining deductible life insurance reserves.[5] Although the IRS and industry engaged constructively in ways to make those rules work appropriately,

tax policymakers were aware of the stresses that PBR placed on the system.

The Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act represents a wholesale rewrite of many of the most important features of the Internal Revenue Code. The federal corporate income tax rate dropped significantly. The paradigm for taxing U.S. corporations on their worldwide activity, and foreign corporations on U.S. activity, was radically altered. Most importantly for life insurers, provisions that are the most impactful—reserves, deferred acquisition cost (DAC) and proration—were rewritten. In order to make sense of these changes, it is important to understand the process that led up to the Act.

LEGISLATIVE PROCESS

Momentum for the most recent tax code changes had been building for many years, driven in large part by consensus that the United States had become an increasingly noncompetitive jurisdiction in which to do business. For example, at 38.9 percent, the average U.S. combined federal and state statutory corporate tax rate was 14 percentage points above the average of other countries that are members of the Organisation for Economic Co-operation and Development (OECD). Some believed that this rate differential favored foreign-parented companies which, in turn, encouraged some U.S. companies to "invert," or redomesticate offshore. For property and casualty insurers, some policymakers believed that the rate differential encouraged the use of reinsurance as a means of eroding the U.S. tax base. Rep. Richard Neal (D-Mass.) and the Obama Administration both proposed legislation to address this issue by limiting tax benefits for property and casualty reinsurance transactions with an offshore affiliate.[6] The taxation of insurance companies, specifically, was not otherwise in play, though would become important as the TCJA progressed.

Camp Bill

In 2014, then-House Ways and Means Committee Chairman Dave Camp (R-Mich.) introduced a bill known as the Tax Reform Act of 2014, or H.R. 1.[7] Several months before its introduction, a draft text of the bill was made available in the form of a "Discussion Draft," which was the subject of an entire issue of *Taxing Times*.[8] Many provisions of the bill would have had a significant effect on life insurers, and Chairman Camp talked with *Taxing Times* about the bill shortly after he left Congress.[9]

Broadly, the Camp Bill included a number of features that also are in the TCJA, and was intended to accomplish many of the same goals, such as lowering tax rates and strengthening the economy. Like the TCJA, the Camp Bill would have eliminated the corporate alternative minimum tax (AMT) and would have made a number of changes to conform the taxation of insurance companies to the general rules that apply to other corporate taxpayers. The Camp Bill also would have dramatically changed the provisions that apply to life insurance companies, such as DAC, proration and, in particular, life insurance reserves. The Camp Bill's changes to the computation of life insurance reserves would have required the use of an uneconomic discount rate to determine tax reserves. This aspect led to a number of meetings with staff on Capitol Hill to discuss with staff on the business of life insurance generally, the capitalization of DAC as compared to actual capitalizable commission expenses, the problems with the economic assumptions underlying the Camp proration proposals, the importance and measurement of reserves, the choice of discount rates, and the emergence of new reserve methodologies. The provisions included in the TCJA on proration and reserves differ dramatically from those that were included in the Camp Bill.

Unlike the TCJA, the Camp Bill was projected to be revenue-neutral.

House Republican Blueprint: "A Better Way"

Early in 2016, House Speaker Paul D. Ryan (R-Wis.) announced the creation of a new Tax Reform Task Force to develop an Internal Revenue Code that would "create jobs, grow the economy, and raise wages by reducing rates, removing special interest carve outs, and [make] our broken tax code simpler and fairer." In June, the Task Force published its 35-page report, "A Better Way: Our Vision for a Confident America."[10] The report became known as the House Republican Blueprint.

The broad themes that had been building for Tax Reform—lower rates, simplification (or at least improved consistency) and international competitiveness—formed the foundation of the Blueprint. A controversial Border Adjustment Tax would have exempted exports of products, services and intangibles from tax, and would have taxed products, services and intangibles imported into the United States regardless of where they were produced. Global American companies thus would have been taxed on a territorial basis.

The House Republican Blueprint also would have eliminated any deduction for net interest expense to help equalize the tax treatment of different kinds of financing. Only one sentence addressed how this would apply to financial service companies:

> The Committee on Ways and Means will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models.[11]

Other than this sentence, there were no specific references to the taxation of insurance companies under the Blueprint.

Efforts to Repeal Obamacare Raise the Stakes

Soon after President Trump's inauguration, Republicans in both the House and Senate engaged in a dedicated effort to dismantle the Affordable Care Act ("ACA"),[12] introducing several proposals to first "repeal and replace" and then to simply repeal the ACA. Beginning in March and continuing throughout much of 2017, Congress considered numerous bills, including the American Health Care Act ("AHCA"),[13] a subsequent revision titled the Better Care Reconciliation Act ("BCRA"),[14] the Obamacare Repeal Reconciliation Act ("ORRA"),[15] and eventually the Graham Cassidy amendment to the AHCA.[16] Each of these legislative efforts included significant changes to the tax and fee structure applicable to health insurers and health care consumers.

During the fall of 2017, it became clear that efforts to unwind the ACA would not succeed. Mindful of the importance of achieving some measure of legislative success, Congressional leaders set their sights on federal income tax reform, another centerpiece of their agenda and the president's campaign.

The House Chairman's Mark

On Nov. 3, 2017, House Ways and Means Committee Chairman Kevin Brady (R-Texas) released draft statutory language of the Tax Cuts and Jobs Act in the form of a Chairman's Amendment in the Nature of a Substitute to H.R. 1—the Chairman's Mark—reflecting his thinking and that of the majority members of the Committee. Directionally, the Chairman's Mark was consistent with the broad themes that had long been in play—dramatically lower the corporate income tax rate, repeal the corporate AMT, and make dramatic changes to the taxation of U.S. corporations doing business abroad and foreign multinational groups doing business in the United States. Because there had been no public hearings or other opportunities to respond to specific proposals, many provisions were made public for the first time in the Chairman's Mark.

> The pace at which the TCJA went from Chairman Brady's Mark on Nov. 3 to an enacted law on Dec. 22 was nearly unprecedented for a bill of this magnitude.

Insurance companies were singled out with an entire subtitle in the Chairman's Mark. Although some of the provisions in the subtitle were in the category of simplification, along the lines of the Camp Bill, other provisions were without precedent and would have resulted in a dramatic increase in taxable income for life insurers. Tax-deductible life insurance reserves were proposed to equal 76.5 percent of statutory reserves, with no cash surrender value floor.[17] The life insurance company proration provision would fix the company's share of net investment income—that is, the percentage of the otherwise-allowable tax benefit a company would receive for stock and tax-exempt bonds it owns—at 40 percent.[18] The DAC capitalization percentages would increase from 1.75 percent, 2.05 percent and 7.7 percent under prior law to either 4 percent or 11 percent according to whether the contracts were group or individual contracts.[19] This would have represented a 528 percent increase in the rate applied to individual annuity contracts and appeared unrelated to actual, economic acquisition costs that companies incur.

At $23 billion,[20] the revenue estimates for these three provisions were widely believed to vastly understate the actual tax cost to

companies. The Nov. 3 release of the Chairman's Mark thus marked the beginning of a frantic seven-week period of work for both the industry and Hill staff to better understand the economics of the business of life insurance, the mechanics of various proposals, and appropriate estimates of the revenue that each would raise.

The House Bill

Within a week of the release of the original Chairman's Mark, a Manager's Amendment replaced the three most controversial life insurance provisions—reserves, DAC and proration—with a single provision that would retain prior law but impose an 8 percent surtax on Life Insurance Company Taxable Income (LICTI).[21] An accompanying explanation explicitly referred to the surtax as a "placeholder," while work on the issues continued.[22] The placeholder remained in the version of H.R. 1 that passed the House on Nov. 16.

The Senate Bill

Aware of the continued work in the House on the life insurance provisions, the Senate Finance Committee included its own placeholder for Chairman Brady's proposals on life insurance reserves, DAC and proration. Rather than impose a surtax on LICTI, the Senate Finance Committee's original markup would have retained current law for reserves and proration, and modified the rules for DAC. Specifically, the Senate Finance Committee would have nearly doubled the capitalization rates and would have increased the amortization period fivefold, from 120 months to 600 months.[23] This proposal was referred to by some as "super-DAC," and was scored to raise approximately the same amount of revenue as the original provisions in Chairman Brady's Mark and the surtax in the bill that passed the House.

The version of the bill that passed the full Senate[24] on Dec. 2 included an amendment by Sen. Tim Scott (R-S.C.), which largely became the basis for the TCJA life insurance provisions as passed. Under Sen. Scott's amendment, tax reserves were generally computed by applying a haircut to statutory reserves, DAC rates were increased, and the amortization period lengthened, but not as dramatically as under the Senate's "super-DAC" proposal, and a life insurer's company's share for purposes of proration was set at 70 percent.

Consensus Emerges in Conference

The life insurance provisions were not the only differences between the House and Senate bills, nor even the largest in terms of revenue. For example, the House bill would have repealed the corporate AMT, whereas the Senate bill would have made more modest changes to prior law. The House bill provided a special tax rate for personal service corporations, whereas the Senate bill did not. The House bill would have addressed erosion of the U.S. tax base by imposing an excise tax on certain deductible payments to foreign affiliates, whereas the Senate bill would have imposed a base erosion minimum tax amount equal to the excess of 10 percent of modified taxable income over the regular tax liability for the year.

The mechanism for resolving differences between a bill passed by the House and a bill passed by the Senate is called a "conference," in which a committee comprising members of both houses reaches a comprehensive compromise on which the two Houses then vote. In the case of the TCJA, the conference committee report was released on Dec. 15, and the House and Senate both passed the amended package on Dec. 20. The president signed the bill into law on Friday, Dec. 22. With just nine days left in the calendar year, a new scramble began to determine what steps companies should take in anticipation of the new law before Dec. 31, and what disclosures would be necessary in calendar year 2017 annual statement filings and financial statements.

The pace at which the TCJA went from Chairman Brady's Mark on Nov. 3 to an enacted law on Dec. 22 was nearly unprecedented for a bill of this magnitude. As with other tax acts, legislative history will play an important role in discerning the intent of the various provisions. In addition, the staff of the Joint Committee on Taxation will likely produce its own explanation of the provisions. That explanation is commonly referred to as "the Blue Book." Although generally not considered authoritative as legislative history, it will be another data point in future years as companies do their best to make sense of the intent of various provisions.

BROAD IMPACT ON LIFE INSURERS

The nonpartisan Joint Committee on Taxation staff projected that, across all taxpayers, the Act would reduce federal revenues by $1.456 trillion over the 2018–2027 federal budget window. Some taxpayers will be winners due to a dramatic cut in corporate income tax rates and the repeal of the unpopular AMT. Other taxpayers will be losers on a net basis due to other provisions. For example, U.S.-parented groups may benefit overall from lower rates and a more territorial model for taxing corporate earnings, whereas new provisions aimed at base erosion could impose significant costs on some foreign-parented multinational groups and potentially cause them to restructure their operations. Modifications of the AMT, lower tax rates and a higher standard deduction will provide welcome relief to some individuals, whereas many individuals in high-tax states will see their tax bills increase due to a dramatic limitation of itemized deductions for state and local taxes.

For insurers, the impact is particularly acute. Like the original House Chairman's Mark, the TCJA singles out insurance companies in a unique way.

Provisions That Apply to Insurance Companies

Life insurance reserves. Under the Act, the tax-deductible life insurance reserve for a contract is generally equal to the greater of the contract's net surrender value or 92.81 percent of the statutory reserve with regard to the contract, determined based on valuation date methods. For variable contracts, only general account reserves in excess of the greater of the contract's net surrender value or separate account reserves with regard to the contract are multiplied by the 92.81 percent factor. A statutory reserves cap applies, as under prior law. The change is projected to raise $15.2 billion over the 10-year budget window, in large part from an eight-year transition rule relating to reserves on existing business, discussed later in this article. However, the industry generally supported it because it is simpler than current law and should avoid much of the uncertainty that arose under prior law as a result of the adoption of PBR methodologies. The changes to life insurance reserves are discussed at page 14 of this issue of *Taxing Times* ("Changes to the Computation of Tax Reserves Under P.L. 115-97").

The TCJA also made changes to unpaid loss reserves, such as reserves for cancellable accident and health insurance contracts. Much like proposals in the Camp Bill, those changes will incorporate a significantly higher discount rate based on a 60-month corporate bond yield curve and longer loss payment patterns. The effect of these changes will be more important for longer-tail than for shorter-tail lines of business. The changes to unpaid loss reserves are discussed at page 22 of this issue of *Taxing Times* ("Discounted Unpaid Losses: A Rate or a Curve?").

DAC. As under prior law, acquisition costs with regard to life insurance and annuity contracts are capitalized and amortized, based on a proxy percentage multiplied by net premiums received. The current-law capitalization percentages are increased by 20 percent, and the amortization period extended from 10 years to 15 years. No recomputation of existing unamortized DAC balances is required. Instead, the new capitalization percentages and amortization period apply to net premiums received in 2018 and after. As a result, companies will be able to price newly issued products and reinsurance transactions taking this change into account as appropriate. However, in-force contracts priced under the old DAC rules also will be subject to the higher rates and longer amortization period to the extent of post-2017 premiums. At $7.2 billion, this change is the second-largest life insurance-specific revenue raiser in the Act. The changes to DAC are discussed at page 24 of this issue of *Taxing Times* ("Capitalization of Certain Policy Acquisition Expenses—Changes under the Tax Cuts and Jobs Act").

Proration. For decades, prior law has required a life insurer to "prorate" net investment income between a company's share and policyholders' share in order to limit the benefits of tax-preferred income (such as dividends eligible for the Dividends Received Deduction, or DRD) on assets it owns. The computation of company's share and policyholders' share for a life insurance has historically been very complex. The Act replaces the prior law computation of the company's share and policyholders' share with fixed percentages of 70 percent and 30 percent, respectively. Like the change to life insurance reserves, this approach represents a dramatic simplification. Together with a general change of the DRD from 70 percent to 50 percent, however, this change results in an increase in the amount of dividend income that is taxed to a life insurer, albeit at a lower rate. The provision was projected to result in an increase in federal tax revenue. The impact of the provision, however, is expected to vary from company to company, and from General Account to Separate Account. The changes to life insurance proration are discussed at page 26 of this issue of *Taxing Times* ("Dividends Received Deduction—The Company Share (Proration): From a Hard Formula to an Easy One").

The TCJA also made changes in proration for nonlife companies. Under prior law, the adjustment to discounted unpaid losses for 15 percent of tax-exempt interest and DRD produced an effective tax rate of 5.25% (15% times 35%) on tax-exempt income. Under the TCJA, the adjustment increases to a percentage that preserves the same effective tax rate on tax-exempt

income. Based on a corporate tax rate of 21 percent, the proration percentage for nonlife companies in 2018 is 25 percent (5.25% divided by 21%).

Net operating losses. Under prior law, net operating losses of corporate taxpayers generally were carried back two years and forward 20 years, according to the taxpayer's taxable income or loss for those years. Life insurers carried losses from operations back three years and forward 15. The TCJA changed these general rules to allow losses to be carried forward indefinitely, but not back under the TCJA. Losses carryovers are allowed to offset only 80 percent of the taxpayer's income for a particular year. The loss rules for life insurers are conformed to the loss rules for other corporations, such that there is no longer an independent set of rules for losses from operations of a life insurer. Nonlife insurance companies, however, may still carry losses back two years and forward 20 years, and use those losses without regard to the new 80 percent of taxable income limitation. The application of different rules for losses of nonlife companies and other corporate taxpayers raises complex issues for those companies that file consolidated returns for groups that include both nonlife insurance companies and noninsurance companies. The issues will be even more difficult for consolidated return filers whose groups include life insurance companies, nonlife insurance companies, and noninsurance companies under the life-nonlife consolidated return regulations.

Other insurance provisions. A number of other provisions that are specific to insurance companies will have lesser financial impact:

- Repeal of a deduction that applies only to small life insurance companies.
- A change to conform the treatment of changes in basis for computing life insurance reserves with the treatment of changes in accounting method of other corporations.
- Repeal of a special rule that applies to a small number of companies that maintain a "policyholders surplus account" based on pre-1984 Act law.

The TCJA does not change the treatment of inside buildup on life insurance and annuity contracts.

- Repeal of a special rule that permits nonlife companies not to discount unpaid losses if they make "special estimated tax payments."

The broad theme of these changes is to remove provisions that have become obsolete, and to conform the taxation of insurance companies to the taxation of other corporate taxpayers where possible. Several of these changes are discussed together at page 28 of this issue of *Taxing Times* ("Repealed: Corporate AMT and Three Insurance Tax Provisions").

Effect on life insurance products. The TCJA does not change the treatment of inside buildup on life insurance and annuity contracts. The industry has long opposed any such changes out of concern for the effects of any changes on policyholders and beneficiaries and because of the important role of the products for retirement security. Commercially, however, other changes in the TCJA could have implications for the products. For example, changes in the estate tax for individuals may dampen the market for individual life insurance contracts that are purchased for liquidity purposes as part of an estate plan; a general reduction in corporate income tax rates also may change the analysis in some cases for the purchase of life insurance by banks and other corporate taxpayers. A welcome clarification that a policyholder's tax basis is not decreased by the cost of insurance provided removes uncertainty for some life settlement transactions. However, life insurers now must consider what systems adaptations are appropriate to comply with new information reporting on life settlement transactions. Amendments to the transfer for value rule are intended to capture certain indirect transfers of a life insurance contract for value. Other changes, such as changes to the life insurance reserve rules that previously were cross-referenced in the section 7702 definition of life insurance (and now are a part of that provision) also may require further careful thought in the context of Life PBR. Consequences of the TCJA to life insurance products are discussed at page 30 of this issue of *Taxing Times* ("The Life Insurance Product Tax Provisions of H.R. 1").

Provisions That Apply to All Corporate Taxpayers

As discussed, the most significant broadly applicable elements of the TCJA are the reduction in corporate tax rates and a change in the paradigm for taxing offshore operations of U.S. corporations and U.S. operations of foreign-parented groups. Together, the reduction in tax rates and elimination of the corporate AMT were projected by the Joint Committee on Taxation staff to result in a decrease in federal income tax revenues from corporations of almost $1.4 trillion over a 10-year budget window.[25] These changes dwarf all others and approximately equal the total amount the TCJA is projected to lose over the same period.

International

By far, the next most significant changes to multinational corporate taxpayers are changes to the taxation of multinational enterprises.

Territoriality and deemed repatriation. International taxation will transition from a system that taxed worldwide income of U.S. corporations to a territorial system. The mechanism for doing so is a 100 percent DRD for certain qualified foreign-source dividends received by U.S. corporations from foreign subsidiaries. However, existing regimes that tax a U.S. corporation on earnings of certain foreign affiliates—such as "Controlled Foreign Corporations" (CFCs) and "Passive Foreign Investment Companies" (PFICs) —are retained, with modifications.

As part of the transition to a quasi-territorial system, the TCJA generally requires a U.S. shareholder of a specified foreign corporation to include in income for 2017 its *pro rata* share of the undistributed, non-previously taxed, post-1986 foreign earnings of the corporation. The TCJA permits a deduction in an amount necessary to result in a 15.5 percent tax on foreign earnings held in cash or cash equivalents, and an 8 percent tax on foreign earnings held in illiquid assets. Foreign taxes paid with respect to such foreign earnings may be treated as partly creditable. For insurance companies, the higher cash equivalent rate generally will apply, since insurance companies typically hold liquid assets.

Base erosion. To prevent erosion of the U.S. tax base that could result from making deductible payments to foreign affiliates, the TCJA imposes a "base erosion and anti-abuse" tax ("BEAT") on certain "base erosion payments" paid to foreign affiliated companies. Companies subject to the tax must pay the excess of tax computed at a 10 percent rate (5 percent in 2018) on an expanded definition of taxable income over their regular tax liability. The tax would not apply to companies with "base erosion tax benefits" less than 3 percent of total deductions of the taxpayer. Both the statutory language and the conference report identify premiums paid for reinsurance as base erosion payments. Other issues arise in practice as a result of different forms of reinsurance transactions. This change is particularly important to foreign-parented groups if there are reinsurance treaties of which U.S. members are a part. As the BEAT applies to reinsurance payments paid or accrued from Jan. 1, 2018, companies continue to consider what changes to their existing reinsurance treaties are appropriate to manage their BEAT liability.

PFIC insurance exception. U.S. shareholders of certain "Passive Foreign Investment Companies," or PFICs, are required to pay tax—or interest on tax that would be owed—on their share of offshore income earned by the PFIC. An exception applies to investment income earned in the active conduct of an insurance business, and the IRS proposed regulations interpreting this exception as recently as 2015.[26] The TCJA limits the active insurance exception to cases where a foreign insurance company has insurance liabilities that constitute more than 25 percent of its total assets. An alternate test is available to a company whose insurance liabilities constitute at least 10 percent of its assets,

if its reserves percentage falls below 25 percent solely due to run-off or rating-related circumstances. Because for this purpose insurance liabilities do not include unearned premiums or deficiency or contingency reserves, insurers with assets materially greater than their reserves, such as companies that insure catastrophic risks, may find it difficult to qualify for the PFIC insurance exception as amended. Some bona fide offshore insurance companies that have difficulty satisfying this test may have to consider reinsuring additional risks, such as certain types of life insurance business, to continue to qualify for the exception.

International tax issues under the TCJA, and their implications for life insurers, will be explored further in the October 2018 issue of *Taxing Times*.

Other Non-Insurance Changes

Repeal of the Corporate AMT. The TCJA repealed the corporate AMT. The Tax Reform Act of 1986 established the corporate AMT in order to ensure that no taxpayer with substantial economic income could avoid a tax liability through the "excessive" use of exclusions, deductions, and credits. Beginning with the 2018 tax year, taxpayers no longer will be subject to AMT and will use credits for AMT previously paid to offset their regular tax liabilities and to claim refunds for the balance not absorbed by regular tax liabilities. The TCJA requires the government to refund 50 percent of the remaining balance of AMT credits carried forward to taxpayers in each of the tax years 2018–2020, with any remaining uncredited balance fully refunded in 2021.

Limitation on interest deduction. The TCJA generally limits the deduction for business interest to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year; unused deductions can be carried forward indefinitely. Because insurance companies typically earn significant interest income as part of their insurance business, applying this limitation on a consolidated group basis[27] would result in most life-life and life-nonlife consolidated return groups having business interest income that exceeds their business interest expense.

Changes in the taxable year for recognizing income. The TCJA imposes a new "conformity" rule on accrual-method taxpayers that may require them to recognize some items of income no later than the tax year in which that income is taken into account as revenue in an applicable financial statement. The new rule does not apply, however, where special methods of accounting apply. Subchapter L of the Code provides special rules for the taxation of insurance companies, which may provide important exceptions to the new conformity rule. For example, under Subchapter L, the starting point for computing taxable income is the National Association of Insurance Commissioners (NAIC) annual statement, and explicit rules allow nonaccrual of market discount of life insurance companies. In addition, the Conference Report explains that the conformity rule 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.[28]

Other provisions. Other important changes to the taxation of corporations under the TCJA include increased expensing (rather than capitalization and depreciation) of business assets, changes in rules for business tax credits, new limitations on excessive employee remuneration, new limitations on entertainment expenses, and changes in the tax deductibility of employee fringe benefits. The impact of these other provisions is beyond the scope of what *Taxing Times* will cover, but may nevertheless be important to some companies.

Transition

The transition rules for the many changes made by the TCJA are varied. The most significant of the insurance provisions—changes to both life insurance and unpaid loss reserves—entail the computation of a transition reserve adjustment that is taken into account over eight years. Other significant provisions, such as changes in rates, changes in DAC and proration, and changes in the utilization of losses, are generally effective for tax years beginning after 2017. Throughout this issue of *Taxing Times* and the next, each article about a specific provision or change will include a discussion of the transition rules and issues that arise as they apply to life insurers.

MISSED OPPORTUNITIES

Although the changes made by the TCJA were comprehensive by any standard, they did not include at least two items that are important to life insurers and would have been appropriate as a matter of policy: updating of the rules that apply to consolidated returns that include both life and nonlife insurance companies, and correction of a mismatch in the character of income and loss recognized by insurance companies.

Life/Nonlife Consolidated Returns

Current law imposes significant limitations on the ability of a life insurer to join in a consolidated income tax return that also includes group members that are not life insurance companies. Prior to the 1984 Act, the regime for taxing life insurance companies differed significantly from the regime that applied to other corporate taxpayers. In order to protect differences between those regimes, the tax law restricted a life insurer's ability to consolidate and share losses with nonlife affiliates.[29]

The 1984 Act removed the primary differentiating three-phase system of life insurance company taxation, and the taxation of life insurers became largely consistent with the taxation of nonlife and non-insurance companies. Following the 1984 Act, life insurance company taxable income includes premium and investment income and allows deductions for underwriting losses and general business expenses. Regardless of this parity with other taxpayers, life insurance companies remain subject to complex rules that include a five-year waiting before joining a consolidated group and a restriction on the utilization of losses generated by affiliates.[30] The simplification provisions of the TCJA did not remove these restrictions.

Character of Gain/Loss on Asset Disposals

Banks and other similar financial institutions invest in bonds and other debt instruments to fund deposit liabilities and reserve obligations undertaken in the ordinary course of business. These financial institutions have long enjoyed the benefit of characterizing gains and losses on the disposal of bonds and other debt instruments as ordinary (not capital) in keeping with the ordinary nature of the obligations they support.[31] For this reason, many such financial institutions are not burdened by limitation on the use of capital losses. This relief is not, however, afforded to insurance companies.

Much like banks and other financial institutions, insurance companies invest in bonds and other debt instruments to support policy reserves and other underwriting obligations undertaken in their ordinary course of business. Insurers utilize interest income and maturity proceeds to fund anticipated claims. Although interest income from these securities is generally taxed as ordinary income, gains and losses on disposal are not. Insurers often dispose of bond and other investment holdings prior to maturity to pay claims arising from unforeseen events, or to better match asset and liability duration. The Internal Revenue Code characterizes losses on the disposal of these investments as capital in nature, unavailable to offset taxable income from ordinary operations. Though these capital losses may carry forward to offset future capital gains, insurers face the risk that such carryforwards will expire before recognizing sufficient capital gains, particularly in rising interest rate environments. The TCJA did not address this issue.

Technical Corrections

The text of the TCJA itself was hundreds of pages long, representing a Herculean legislative effort in a small number of weeks. Unsurprisingly, as companies, practitioners, and the IRS work through the new law, minor errors become apparent. The process for correcting those errors is known as "technical corrections." The term technical correction is a term of art, and generally refers to a drafting mistake, or an error where the plain language of a provision is contrary to its clear intent, and correcting the error will have no effect on federal tax revenue. At some point, Congress likely will correct those errors in what is known as a technical corrections bill. Where such errors have been identified for provisions affecting life insurers, the relevant articles in this issue of *Taxing Times* will discuss them.

NONTAX CONSEQUENCES OF THE TCJA

The pervasive and dramatic changes enacted in the TCJA so close to calendar year-end 2017 caused significant challenges with respect to the accounting and financial statement reporting of the related effects. The breadth of the changes to the taxation of life insurance companies resulted in additional turmoil within the industry, particularly for companies with both U.S. and non-U.S. operations.

In recognition of the TCJA's widespread impact to U.S. taxpayers and the related challenges to year-end 2017 financial reporting, the Securities and Exchange Commission ("SEC") quickly published Staff Accounting Bulletin 118, allowing companies to report the effects of the change in tax law as those effects are reasonably determined, but no later than year-end 2018. In early February, the NAIC Statutory Accounting Principles Working Group issued INT 18-01, *Updated Tax Estimates under the Tax Cuts and Jobs Act*, which generally adopted the concepts outlined in SAB 118 and provided additional guidance with respect to reporting tax effects of the TCJA in the statutory annual statement. This guidance helped to ease the burden of year-end 2017 reporting. Significant questions remain as to the impact of future guidance from Treasury and the proper

financial statement reporting of the tax balances impacted by the base erosion provisions of the TCJA.

Given the effective date for many of the TCJA provisions, life insurers are working expeditiously to consider what changes in their business are appropriate in response to the new legislation. Insurance contracts are being reevaluated for compliance with the new provisions; systems and processes are being reconsidered; income tax accounting frameworks are being reconsidered; processes to monitor tax law and accounting changes are being strengthened; and the response of the various states are being monitored to be sure that companies and their products are in compliance and transactions are reconsidered to avoid traps for the unwary.

Many of these activities bear directly on the work of actuaries, company tax professionals, outside consultants, and tax and nontax regulators. Whatever your role, we hope you find this issue of *Taxing Times* helpful. ■

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ENDNOTES

1 More precisely, "An act to provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018," P.L. 115-97, enacted Dec. 22, 2017.

2 More specifically, the Revenue Act of 1921 taxed life insurers only on net investment income. Before then life insurers were taxed on all their income.

3 For a more detailed description of the 1959 Act, *See* William B. Harman, Jr., "The Pattern of Life Insurance Company Taxation under the 1959 Act," presented at the 15th Annual Tulane Tax Institute Sept. 28, 1965 and published by the *Journal of Taxation*. The late Bill Harman was a giant in the field of insurance company taxation. He was the attorney at the Treasury Department Office of Tax Policy specializing in insurance at the time the 1959 Act was enacted, and was a founding partner of Davis & Harman, LLP.

4 The 1984 Act legislative history expressly directs that in the absence of contrary guidance, authorities under the 1959 Act provisions are to serve as interpretive guides to the new provisions. S. Rep. No. 98-169, 98th Cong., 2d Sess. 524 (1984).

5 *See, e.g.,* Notice 2008-18, 2008-1 C.B. 363; Peter Winslow, "Options for Inclusion of Stochastic Reserves in Federally Prescribed Reserves," *Taxing Times*, Vol. 12, Issue 1, at 21 (March 2016).

6 *See* H.R. 6270, 114th Cong., 2d Sess. (2016); Treasury Department, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," page 21 (February 2016).

7 H.R. 1, 114th Cong., 2d Sess. (2014).

8 *Taxing Times*, Vol. 10, Issue 3—Supplement (October 2014).

9 Kristin Norberg, "The Road to Tax Reform—An Interview with Chairman Dave Camp," *Taxing Times*, Vol. 11, Issue 3, at 4 (October 2015).

10 House Republican Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

11 *Id.*, page 26.

12 Patient Protection and Affordable Care Act (P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), together the "ACA."

13 American Health Care Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

14 Better Care Reconciliation Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

15 Obamacare Repeal Reconciliation Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

16 S.Amdt. 1030 to the American Health Care Act of 2017, H.R. 1628, 115th Cong., 1st Sess. (2017).

17 Chairman's Mark, section 3703.

18 Chairman's Mark, section 3705.

19 Chairman's Mark, section 3710.

20 The Ways and Means Committee Majority Staff's Section-by-Section Summary of the Act, released Nov. 3, 2017, estimated that the reserves provision would raise $14.9 billion (page 51), the DAC provision would raise $7.0 billion (page 55), and the life insurance proration provision would raise $1.1 billion (page 52) during the 10-year scoring window.

21 Life Insurance Company Taxable Income already is a defined term in the Internal Revenue Code and is the base on which income tax of life insurers is computed.

22 H. Rept. No. 115-409, 115th Cong., 1st Sess., page 319 (2017) ("[T]he bill includes a surtax on life insurance company taxable income that is intended to have the same overall revenue consequences as reforms that were proposed [for reserves, DAC, and proration] in the introduced version of the bill. The surtax is intended only as a placeholder and the Committee intends to develop reforms in those three areas as the bill moves through the legislative process.")

23 The Senate Finance Committee DAC proposal was described by the staff of Joint Committee on Taxation, *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), Nov. 9, 2017, at page 139.

24 *Tax Analysts* Doc. No. 2017-98547.

25 H.R. Conf. Rept. 115-466, 115th Cong., 1st Sess., Table, "Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act,' " page 8 (2017).

26 Prop. Treas. Reg. section 1.1297-4.

27 *See* Notice 2018-28, 2018-16 I.R.B. 492 (April 16, 2018).

28 H.R. Conf. Rept. 115-466, 115th Cong., 1st Sess., page 275, footnote 872 (2017).

29 The rules that apply to the filing of consolidated returns by a group that includes both life and nonlife members are set forth at Treas. Reg. section 1.1502-47. Industry comments on the need for updating and simplifying the regulations are set forth in comments of the American Council of Life Insurers (ACLI), Tax Analysts Doc. No. 2002-18864 (July 26, 2002).

30 *See generally* Treas. Reg. section 1.1502-47.

31 Internal Revenue Code section 582(c).