

# *top issues*

*An annual report*

Insurance taxation

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## *The insurance industry in 2015*



**pwc**

# Insurance taxation

## Legislative outlook

President Barack Obama and key Republican leaders in the US House of Representatives and the US Senate have identified business tax reform as one of the key issues on which they may be able to come to an agreement. For the president, the next two years are an opportunity to define his second-term legacy. House Speaker John Boehner (R-OH) and Senate Majority Leader Mitch McConnell (R-KY) have said that they want to demonstrate Republicans' ability to govern ahead of the 2016 presidential election.

*While it appears that Administration officials and key members of Congress are conducting serious discussions about business tax reform options, differences between the two political parties over immigration, healthcare, energy policy, environmental regulations, and other economic and social issues pose challenges for the enactment of significant reform legislation.*

## Obama Administration action

On February 2, 2015, President Obama submitted an FY 2016 budget to Congress that reaffirms his support for "business tax reform" that would lower the top US corporate tax rate to 28 percent, with a 25-percent rate for domestic manufacturing income. The budget also proposes to make permanent Subpart F exceptions for active financing income, which expired at the end of 2014, along with the research credit and more than 50 other business and individual tax provisions.

The president's budget again sets aside a large number of new and previously proposed tax increases, including specific proposals affecting insurance taxation (discussed below), in a reserve fund for "long-term revenue-neutral

business tax reform," but his budget identifies only part of the revenue that would be needed to support his proposed corporate rate reductions without increasing future federal budget deficits.

Significant new international tax increase proposals include a one-time mandatory 14-percent tax on previously untaxed foreign income and a 19-percent minimum tax on future foreign income. The budget states that "transition" revenue from the 14-percent toll tax would go primarily to fund surface transportation programs. While expressing opposition to the Administration's minimum tax rates, key Republicans on the House and Senate tax committees, including House Ways and Means Chairman Ryan, have described the Administration's proposals as being "constructive" and have expressed a willingness to consider using some revenue from tax reform to provide funding for surface transportation programs.

## Congressional action

While preferring comprehensive tax reform for both individuals and business, House Ways and Means Committee Chairman Paul Ryan (R-WI) has expressed a willingness to consider a "phase one" approach to business-only tax reform, and has called for an "aggressive" timeline for action on tax reform legislation this summer. Senate Finance Chairman Orrin Hatch (R-UT) has established five bipartisan tax reform working groups to develop specific tax reform proposals by the end of May, and also has expressed hope to mark up a tax reform bill this year.

In early 2014, former House Ways and Means Chairman Dave Camp (R-MI) released a 979-page tax reform discussion draft that would lower corporate and individual tax rates, reform US international tax rules, and broaden the tax base by repealing or limiting business and individual tax deductions, credits, and income exclusions. Significant insurance tax proposals in the Camp plan included changes to the way life insurance reserves and non-life insurance reserves are computed, and changes to the taxation of deferred acquisition costs (the "DAC" tax). Shortly before the last Congress adjourned, Chairman Camp introduced his proposal as H.R. 1, the Tax Reform Act of 2014.

***Current Ways and Means Chairman Ryan has referred to the Camp tax reform bill as a “marker” for future reform efforts. Accordingly, insurance companies are advised to consider the Camp proposals carefully, along with the Administration’s proposals, and evaluate how the various proposals would affect their Federal income tax liability.***

Chairman Ryan also has said that the House will pursue a “dual track” approach to pass bills making permanent certain expired tax provisions. On February 12, 2015, Ways and Means member Pat Tiberi (R-OH) introduced a bill (H.R. 961) to make permanent the subpart F exceptions for active financing income. The Ways and Means Committee last year approved a similar bill that proposed to make active financing exceptions permanent. The timing for Senate Finance Committee action on “tax extender” legislation is unclear at this time.

If, in coming months, President Obama and Congress cannot reach an agreement on tax reform legislation that would address the expired provisions, look for Congress to make a strong push later this year to make permanent the research credit and certain other business and individual tax provisions that have expired, including possibly active financing exceptions, while providing temporary extensions of certain other provisions and possible elimination of some temporary provisions.

### **Insurance-related revenue raisers**

The Obama Administration’s business reform framework also proposes several revenue-increase measures specific to insurance companies. Among the insurance-related measures are provisions that would:

- ***Disallow the deduction for non-taxed reinsurance premiums paid to affiliates*** – This proposal would disallow any deduction to covered insurance companies for the full amount of reinsurance premiums paid to foreign affiliated insurance companies with respect to reinsurance of property and casualty risks if the premium is not subject to US income taxation. The proposal would provide a corresponding exclusion from income for reinsurance recovered with respect to a reinsurance arrangement for which the premium deduction has been disallowed. The proposal also would provide an exclusion from income for ceding commissions received with respect to a reinsurance arrangement for which the premium deduction has been disallowed. The exclusions are intended to apply only to the extent the corresponding premium deduction is disallowed. The proposal would
- provide that a foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this provision may elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States. If that election is made, the disallowance provisions would not apply.
- ***Conform net operating loss rules of life insurance companies to those of other corporations*** – This proposal would modify the carryback and carryforward periods for losses from operations of life insurance companies to conform the treatment to that of other taxpayers. Under the proposal, losses from operations of life insurance companies could be carried back up to two taxable years prior to the loss year and carried forward 20 taxable years following the loss year.
- ***Modify rules that apply to sales of life insurance contracts, including transfer for value rules*** – This proposal would create a reporting requirement for the purchase of any interest in an existing life insurance contract with a death benefit equal to or exceeding \$500,000. The proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies, and would apply to sales or assignment of interests in life insurance policies and payments of death benefits for tax years beginning after December 31, 2015.
- ***Modify dividends received deduction for life insurance company separate accounts*** – This proposal would repeal the present-law proration rules for life insurance companies and apply the same proration regime separately to both the general account and separate accounts of a company. Under the proposal, the policyholders’ share would be calculated based on a ratio of the mean of the reserves to the mean of the total assets of the account. The company’s share would be equal to one less the policyholders’ share. The proposal would be effective for tax years beginning after December 31, 2015.
- ***Expand pro rata interest expense disallowance for company-owned life insurance (“COLI”)*** – This proposal would curtail an exception to a current law



interest disallowance of a pro rata portion of a company's otherwise-deductible interest expense, based on the unborrowed cash value of COLI policies. As modified, the exception would apply only to policies covering the lives of 20-percent owners of the business. The proposal would apply to contracts issued after December 31, 2015, in tax years ending after that date.

- **Repeal special estimated tax payment provision for insurance companies under section 847** – This proposal would repeal IRC Section 847 and would include the entire balance of an existing special loss discount account in income in the first tax year beginning after 2015. Alternatively, the proposal would permit an election to include the balance in income ratably over four years. Existing special estimated tax payments would be applied against the liability created by the income inclusion.

**Depending on legislative developments pertaining to taxation of overseas profits, insurers may need to re-evaluate their incentives to shift and leave profits offshore.**

#### Insurance developments: Judicial and administrative

A number of judicial and administrative developments occurred in 2014 concerning insurance companies. These developments affected insurers in various lines of business:

- **Life insurers** – An Industry Director's Directive instructed LB&I examiners not to challenge the tax hedge qualification of certain transactions insurance companies enter into with respect to variable annuities with guaranteed minimum benefits. The Directive also provided a safe harbor accounting method for insurers to account for gains and losses that result from such tax hedges. Although the Directive provides clarity on tax hedges of obligations that relate to variable annuities issued before December 31, 2009, it does not cover hedges of obligations under contracts issued on or after

December 31, 2009. It is not clear at this point whether the Directive's method would be acceptable for such hedges or whether other existing methods utilized for such hedges would be acceptable as a clear reflection of income. The IRS also modified and superseded a controversial ruling that it issued in 2007 concerning the Dividends Received Deduction for Separate Account dividends. In doing so, the IRS republished a noncontroversial portion of the earlier ruling, and removed the more controversial part of that ruling from the books without directly revoking it. It is expected that the IRS will continue not to raise that issue based on an earlier administrative directive.

- **Non-life insurers** – The IRS issued technical advice denying insurance contract treatment for certified pre-owned vehicle warranties where the warranties were not evidenced by a separate contract and separate consideration. Because case law that the Service previously cited with approval appeared to conclude otherwise, the technical advice raises the question if this is a change in IRS position.
- **Health insurers** – During 2014, health insurance providers were required to make their first payments of the Health Insurance Providers Fee, an amount that is borne by the industry in proportion to each company's share of net premiums written. It is not yet clear how the IRS will approach refund requests by companies that overpaid their share of the fee. Also, health insurers are for the first time considering the appropriate tax accounting for amounts that are payable or receivable under the Affordable Care Act's "3 R's" (the Transitional Reinsurance Fee, Risk Adjustment, and Risk Corridor).
- **Captive insurance companies** – During 2014, the Tax Court decided two cases that call into question that IRS's longstanding position that an arrangement cannot qualify as insurance if the risks are concentrated in a small number of policyholders. Those two cases are *Rent-A-Center v. Commissioner*, 142 T.C. 1 (January 14, 2014), and *Securitas Holdings v. Commissioner*, T.C. Memo 2014-225 (October 29, 2014). In addition, during 2014 the IRS issued Rev. Proc. 2014-15 addressing the treatment

of a captive insurance arrangement entered into by a voluntary employees' beneficiary association ("VEBA"). Consistent with its longstanding treatment of insurance provided for the benefit of employees, the IRS concluded that reinsurance between a third-party reinsurer and the captive insurance subsidiary qualified as insurance. The IRS utilized its analysis in prior rulings to look through the reinsurance arrangement and conclude that the insurance requirements of risk shifting and risk distribution were met.

- **Foreign insurance arrangements** – During 2014, the United States District Court for the District of Columbia issued a ruling in *Validus Reinsurance v. US*, 19 F.Supp 3d 225 (February 5, 2014). The court held that the plain language of section 4371, imposing the insurance federal excise tax, does not apply to retrocessions covering US risks between two foreign reinsurance companies. An appeal of this decision is pending in the United States Court of Appeals for the District of Columbia Circuit.

As in prior years, the IRS and Treasury jointly issued a Priority Guidance Plan outlining guidance it intends to work on during the 2014-2015 year. The plan continues to focus more on life than property and casualty insurance companies. The following insurance-specific projects were listed as priority items. Many carried over from last year's plan, including:

- Final regulations under §72 on the exchange of property for an annuity contract. Proposed regulations were published on October 18, 2006.
- Guidance on annuity contracts with a long-term care insurance feature under §§72 and 7702B.
- Guidance clarifying whether the Conditional Tail Expectation Amount computed under AG 43 should be taken into account for purposes of the Reserve Ratio Test under §816(a) and the Statutory Reserve Cap under §807(d)(6).
- Guidance on exchanges under §1035 of annuities for long-term care insurance contracts.
- Regulations under §7702 defining cash surrender value.
- Guidance providing de minimis relief under §833.
- Guidance relating to captive insurance companies.

It remains uncertain how many items will be completed by June 30, which is the end of the guidance plan year.

### **Implications**

- There is a good deal of bipartisan agreement on the merits of tax reform legislation, and Congressional leaders are attempting to meet an aggressive timeline for action this year. Accordingly, insurers should closely monitor developments in order to respond to any legislative changes.
- Insurers should closely monitor legislative developments pertaining to taxation of overseas profits, and depending on what transpires, re-evaluate their incentives to shift and leave profits offshore.
- Even in the absence of comprehensive Tax Reform, the Obama Administration's budget proposals include several possible revenue-increase measures specific to insurance companies, and life products in particular. Insurers will need to stay abreast of the status of these measures both in order to address them internally and educate their policyholders on their potential implications.
- In addition to guidance that is promised on the 2014-2015 Priority Guidance Plan, insurers should monitor longer-term trends, including the adoption of Life PBR, the IRS's response to the Rent-A-Center and Securitas cases, and the ongoing appeal of the *Validus* case.

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