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Tax Reform Update: Insurance Provisions – Spotlight on Property & Casualty Insurers

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Summary

The final US tax legislation includes a number of provisions that will impact the property & casualty (P&C) insurance sector, including captive insurance companies. Specific to the insurance sector are new rules for computing discounted loss reserves and a new international provision that will affect certain P&C insurers that reinsure risks with non-US affiliates. Other changes to the international rules will affect certain non-US insurance companies and persons related to those non-US insurance companies.

In Depth

Modification of Discounting Rules

P&C insurers face significant changes to the manner in which loss reserves are discounted under the new rules. In computing its taxable income, an insurance company reduces its underwriting income by losses incurred and expenses incurred. For this purpose, losses incurred include discounted unpaid losses computed under section 846. The amount of the discounted unpaid losses is the present value of the losses determined by using (1) the undiscounted unpaid loss estimates, (2) the applicable interest rate, and (3) the applicable loss payment pattern. The new rules change the applicable interest rate and the applicable loss payment pattern rules.

Prior to its amendment by the new legislation, Section 846 applied an interest rate based on the applicable midterm Applicable Federal Rate (AFR) to discount unpaid losses. The new rules apply the corporate bond yield curve (yields on investment grade corporate bonds with varying maturities), in place of the midterm AFR. Historically, the corporate bond yield curve has outperformed the midterm AFR. Accordingly, this change alone will likely result in a higher discount factor and thus lower values (*i.e.*, smaller deductions) for discounted loss reserves.

Changes to the loss payment pattern rules will also affect the computation. Under the law prior to tax reform, loss payment patterns were determined for each line of insurance business using an industry-wide historical loss payment pattern. Taxpayers, however, could elect to substitute their own historical loss payment pattern. In general, the loss payment pattern assumes that all losses are paid in in the occurrence year and the following three calendar years. For specified lines of business (auto or other liability, medical malpractice, workers' compensation, and multiple peril lines), the loss payment pattern assumes that all losses are paid in the occurrence year and the following ten calendar years. For long-tail lines (losses treated as paid in the 10th year after the accident year exceed losses treated as paid in the 9th year after the accident year), the loss payment pattern period was extended so that the losses falling into the 10th year are treated as paid in that 10th year and each subsequent year (up to 5 years) in an amount equal to the losses treated as paid in the 9th year.

Under the new rules, in certain cases, the periods for determining loss payment, patterns are extended which will result in reduced loss reserves. For lines of business eligible for the three-year rules, the loss payment pattern rules are not changed. For lines of business subject to the 10-year rules, the 10-year period is extended for a maximum of 14 more years. If the 10-year period applies, the losses that would have been treated as paid in the 10th year, will be treated as paid in the 10th year and the subsequent years in an amount equal to the average of the losses treated as paid in the 7th, 8th, and 9th years. If not treated as paid before the 24th year after the accident year, they are treated as paid in that 24th year. The special rules for long-tail lines of business have been repealed. In addition, the election to use company specific loss payment patterns has been repealed. These changes will impose consistency amongst P&C insurers; depending on particular facts and circumstances, these rules may result in increased federal taxes.

Adjustments resulting from the transition to the new rules for pre-effective date losses are spread over such year and the succeeding seven tax years.

Modification of Proration Rules

Under pre-tax reform section 832(b)(5), P&C insurance companies were required to reduce losses by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends received from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns. The final legislation amends section 832(b)(5) to adjust the factor by which the loss reserves are reduced to align to the reduction in the corporate tax rate. Under the new rules, the applicable percentage reduction is 5.25 percent divided by the highest rate in effect. Thus, if the highest rate is 35 percent, the applicable percentage is 15 percent. If the highest rate is 21 percent, the applicable percentage is 25 percent. The provision generally operates to conform the proration rules, which prohibit a deduction for losses funded with untaxed earnings, to the new corporate tax rate.

Net Operating Losses

The final legislation amended section 172 to eliminate the loss carryback provisions and to provide an unlimited carryforward period for corporations. Under the new rules, losses are available to offset only 80 percent of taxable income.

The final legislation includes a favorable special rule applicable to P&C insurance companies. Specifically, despite the amendments to section 172, a P&C insurance company is allowed to carry losses back for 2 years and forward for 20 years and to apply losses against 100 percent of taxable income.

The changes are effective for losses arising in taxable years ending after December 31, 2017.

Capitalization of Certain Policy Acquisition Expenses

Certain types of policies are subject to rules requiring capitalization of a portion of policy acquisition expenses. Under pre-tax reform law, these expenses were capitalized and amortized over a 120-month period. Policies covered by these rules are annuity contracts, group life insurance contracts and other group contracts covering a group of connected individuals, such as by employment or membership in an organization. These policies are typically issued by life insurance carriers but multi-line P&C carriers with life portfolios also may be affected by these provisions.

Under the new rules the amortization period is lengthened from 120 months to 180 months. In addition, the percentage of expenses subject to the capitalization rules is increased. For annuity contracts, the percentage is 2.1 percent (formerly 1.75 percent); for group life insurance contracts, the percentage is 2.46 percent (formerly 2.05 percent); and, for all other specified insurance contracts, the percentage is 9.24 percent (formerly 7.7 percent).

The provisions that increased these amortization periods and capitalization percentages were scored as significant revenue raisers.

Other Provisions Impacting P&C Insurers

New section 59A, the Base Erosion Anti-Abuse Tax (BEAT) imposes a minimum tax on certain U.S. and non-US corporations that reduce US income tax liability by deducting "base erosion payments." The BEAT rules apply to any corporation (US or non-US) that has average annual gross receipts over a three-year look-back period of at least $500,000,000 and which has a "base erosion percentage" of three percent or higher. In general, the "base erosion percentage" is the percentage of the taxpayer's overall deductions for the taxable year consisting of base erosion tax benefits (*e.g.*, deductions from payments to non-US related persons). The BEAT tax equals the excess of (1) 10 percent (5 percent for tax year 2018, and 12.5 percent for tax years after 2025) of the taxpayer's taxable income, calculated without regard to any "base erosion tax benefit" or net operating loss deduction attributable to any base erosion payment over (2) the taxpayer's regular tax liability reduced by allowable tax credits. Particularly relevant to P&C companies, base erosion payments include any premium or other consideration paid by a taxpayer to a foreign person which is a related party of the taxpayer for any reinsurance payments taken into account by the taxpayer in computing premiums earned under section 832(b)(4). Thus, a reinsurance premium paid by a US insurer to a non-US insurance affiliate is a base erosion payment. In addition, a direct insurance premium paid by a US corporation that is not itself an insurance company to a non-US insurance affiliate is a base erosion payment.

Last, primarily applicable in the captive insurance sector, new rules change the active insurance business exclusion from passive income for purposes of the passive foreign investment company (PFIC) provisions. These changes finally implement measures proposed from time to time over the past several years to address a perceived abuse involving certain offshore insurance companies owned by managed investment funds. Congress and Treasury were concerned with arrangements that could operate to defer income recognition and convert ordinary income to capital gains. Under the new rules, the active insurance exception is available only to insurance companies (within the meaning of pre-existing law) with specified levels of active insurance assets—loss and loss adjustment expenses, and certain reserves must constitute more than 25 percent of the insurance company's total assets. The Conference Report clarifies that applicable insurance liabilities include loss reserves for P&C contracts and, further, that applicable insurance liabilities excludes unearned premium reserves with respect to any type of risk.

A special rule reduces the percentage from 25 percent to 10 percent if the entity is in run-off and issuing existing assets to pay claims or on application to the insurance company of specific requirements with respect to capital and surplus relating to insurance liabilities imposed by a ratings agency as a condition of obtaining a rating necessary to write new business for the current year.

Conclusion

A number of provisions in the final legislation will impact P&C carriers, including captive insurance companies. These amendments are largely expected to result in an increase to taxable income due to changes in the proration rules and in the rules for discounting loss reserves. Transition rules should ease the burden from these computational changes. In addition, certain changes to the international tax rules may affect P&C carriers. US P&C carriers that reinsure with non-US affiliates may be subject to the minimum tax imposed by the new BEAT provisions. US shareholders of non-US P&C insurers, including captive reinsurers, should consider the impact of the new PFIC test to their investment in shares.