Financial & Investment Roundtable

# Tax Reform: A Look at the Year and What's Ahead for the Future

**Doug Monska, panelist**
Assistant Vice President, Taxes, USAA Life Insurance Company

**Kim Sellers, panelist**
Senior Vice President and Chief Tax Officer, Guardian Life Insurance Company

**Regina Rose, moderator**
Senior Vice President, Taxes & Retirement Security, ACLI

March 22, 2019
San Antonio, Texas

Financial & Investment Roundtable

# Tax Reform: A Look at the Year Following Tax Reform and What's Ahead for the Future

# Tax Cuts and Jobs Act (TCJA) Recap

The 2017 tax reform legislation was developed and passed by House and Senate Republicans on a party-line basis using budget reconciliation to avoid the need for 60 votes in the Senate.

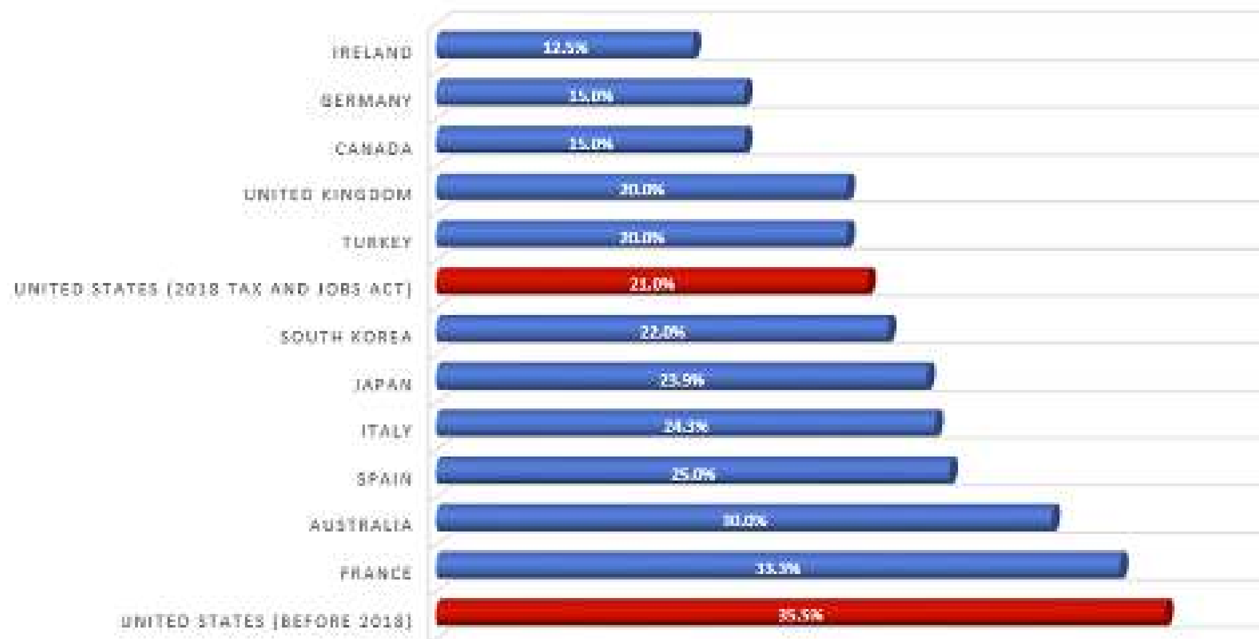
The bill moved quickly through Congress from introduction in the House Ways & Means Committee on November 2, 2017 to final passage on December 20, 2017 by the House (224-201) and Senate (51-48) of a conference bill resolving the differences between the House and Senate bills.

On December 22, 2017, President Trump signed what was formerly known as the Tax Cuts and Jobs Act (TCJA), arguably the most significant tax legislation enacted since at least 1986.

# Overview of Key TCJA Changes

- Permanently reduced the 35 percent corporate tax rate to a flat 21 percent, effective for tax years beginning after 2017.
- Repealed the corporate alternative minimum tax (AMT).
- Fundamentally changed the taxation of multinational entities by moving the U.S. from a hybrid worldwide system of taxation with deferral to a hybrid territorial system.
- Created a temporary new deduction for certain individuals, trusts, and estates for “domestic qualified business income” of passthrough entities and sole proprietorships.
- Temporarily reduced individual income tax rates, widened tax brackets, and increased and indexed the standard deduction while repealing personal exemptions and limiting certain itemized deductions (including the home mortgage interest deduction and deduction for state and local taxes).
- Temporarily doubled the estate and gift tax exclusion amount from $5 million to $10 million per individual and indexed the $10 million exclusion amount for inflation occurring after 2011.

# Financial & Investment Roundtable




Source: Rakuten Super Logistics

# Key Implications of Tax Reform for Life Insurers

Like other corporations, life insurers will benefit from the permanent reduction (from 35 percent to 21 percent) in the federal corporate income tax rate and repeal of the corporate alternative minimum tax.

However, that benefit for life insurers was significantly reduced by both general corporate and international tax base broadeners that apply to all corporations and by several industry-specific base broadeners that apply only to life insurers.

In fact, changes to three industry-specific base broadeners alone - regarding tax deductions for **life insurance reserves**, the life company **deferred acquisition cost (DAC)** tax and **proration of dividends and tax-exempt interest** received by life insurers - were estimated by the Congressional Joint Committee on Taxation to raise approximately $23 billion over 10 years from the life insurance industry.

# TCJA Implications for Capital

Risk-Based Capital (RBC): All life insurance companies and fraternal benefit societies faced a significant increase in risk-based capital (RBC) requirements resulting from tax reform, because RBC is designed as an after-tax calculation.

- Tax reform required NAIC to adjust the tax rates in the RBC formulas to reflect the new 21% tax rate. However, the NAIC also made some offsetting technical changes other than simply changing the tax rates from 35 percent to 21 percent.
  - The tax rate change alone would have caused RBC required capital to increase approximately 21.5 percent and decreased RBC ratios approximately 18 percent.
  - The offsetting adjustments adopted by the NAIC moderated the impact of changing the tax rates and, depending upon the company, it is expected that RBC requirements will increase for companies generally from 10-15 percent. This translates into a reduction in RBC ratios from 9-13 percent.
- The NAIC also developed a document that describes the changes made to RBC as a result of the TCJA to assist state financial examiners and other state regulators in understanding significant changes in capital as a result of tax reform.
- The change in tax rate also lowered deferred tax assets for life insurers, adding to the reduction in capital.

# Tax Reform Implementation

# Status of Guidance – Investment Taxation

Notice → Proposed Regulations → Final Regulations

| Accrued Market Discount | Notice |
| --- | --- |
| Business Interest Expense | Proposed Regulations |
| NOL/Capital Loss Carrybacks | None |
| Opportunity Zones | Proposed Regulations |

# Investment Taxation

**Accrued Market Discount:** The IRS and Treasury announced (Notice 2018-80) that they will issue proposed regulations providing that accrued market discount is not includable in income under section 451(b), which was added by the Tax Cuts and Jobs Act.

**Business Interest Expense:** The IRS issued proposed regulations (REG-106089-18) which state that, for tax years beginning after December 31, 2017, the deduction for business interest expense is generally limited to the sum of a taxpayer's business interest income, 30 percent of adjusted taxable income and floor plan financing interest (see also Notice 2018-28). More importantly for life insurers, the regulations indicate that all investment income will be treated as business interest for purposes of the "net interest" determination and the "net interest" limitations will apply on a consolidated basis.

**Carrybacks:** The net operating loss carryback was removed by the TCJA, but the bill retained the capital loss carryback. Deferred tax assets supported by capital loss carrybacks may still be established to enhance life insurer capital levels for regulatory purposes. Tax planning opportunities are available to trigger investment portfolio losses that can be carried back and used against capital gains in prior years to receive a 35 percent benefit, rather than the 21 percent benefit available for capital losses in current or future years.

# Investment Taxation (continued)

**Opportunity Zones:** The opportunity zone program enacted by the TCJA is intended to encourage long-term capital investments in certain low-income communities through a new type of investment vehicle known as a Qualified Opportunity Fund (QOF).

- The IRS issued proposed regulations (REG-115420-18) for the new opportunity zone tax incentive which provide:
  - (1) requirements taxpayers must meet in order to defer the recognition of gains through QOF investments;
  - (2) rules for corporations or partnerships to self-certify as QOFs; and
  - (3) requirements for corporations or partnerships to qualify as QOFs.
- Primary benefits of opportunity zone investments:
  - Deferral of capital gain from the sale or exchange of property that is invested in a QOF until the earlier of disposition or 12/31/2026.
  - Investments made in 2019 receive a 15 percent permanent exclusion from tax.
  - Investments made in 2020-2021 receive a 10 percent permanent exclusion from tax.
  - Investments held for 10 years recognize no gain upon sale for tax purposes, if elected, of any increase in the value of the investment.

# Status of Guidance – International Taxation

Notice → Proposed Regulations → Final Regulations

| | |
|---|---|
| Base Erosion | Proposed Regulations |
| Business Interest Expense | Proposed Regulations |
| Foreign Tax Credit | Proposed Regulations |
| GILTI | Proposed Regulations |
| Investment of Earnings | Proposed Regulations |
| Transition Tax | Final Regulations |

# International Taxation

**Base Erosion:** The IRS issued proposed regulations (REG-104259-18) to implement the Base Erosion Anti-abuse Tax (BEAT) rules under section 59A which impose a minimum 10 percent tax on corporations that make foreign-party payments deemed to be base-eroding equal to at least 3 percent of their total deductions.

**Business Interest Expense:** Proposed regulations (REG-106089-18) on business interest expense limitations include sections specific to the calculation of interest expense for controlled foreign corporations. The regs provide for an election to apply an alternative method that would limit the amount of business interest expense of a controlled foreign corporation (CFC) group member subject to the section 163(j) limitation to the amount of the CFC group member's allocable share of the CFC group's applicable net business interest expense. In addition, the regs provide special carveout rules for “financial services groups” which were not part of the statute and to which life insurers are opposed, and subjects interest paid by a CFC to U.S. affiliates to the interest expense limitations.

**Foreign Tax Credit:** The IRS issued proposed regulations (REG-105600-18) relating to the determination of the foreign tax credit. The regulations provide some relief for companies by lowering the GILTI tax liability through a 50 percent expense allocation rule which requires companies to allocate half, instead of all, of certain domestic expenses to foreign subsidiaries.

# International Taxation (continued)

**GILTI:** The IRS released proposed regulations (REG-104390-18) to implement the new Global Intangible Low Tax Income (GILTI) tax by providing guidance on determining the GILTI inclusion amount for a US shareholder of any controlled foreign corporation.

**Investment of Earnings:** The IRS issued proposed regulations (REG-114540-18) under section 956, which concerns investment of earnings in US property, to address a disparity created by the TCJA.

**Transition Tax:** The IRS issued final regulations (REG-104226-18) related to foreign tax credits to implement the new international tax regime enacted by the TCJA in section 965. The final regulations follow the basic approach and structure of the proposed regulations (REG-104226-18) and provide additional guidance described in four notices (Notice 2018-7, Notice 2018-13, Notice 2018-26, and Notice 2018-78). In addition:

- Notice 2018-78 allowed taxpayers additional time to determine their basis election for the transition tax.
- PMTA 2018-16 supports the FAQ # 14 conclusion on installment payments under section 965(h).

# Status of Guidance – Other Insurance Items

Notice → Proposed Regulations → Final Regulations

| Section 807 Project | Priority Guidance Plan projects |
|---|---|
| Life Insurer Reserve Basis Changes | Revenue Procedure |
| Unpaid Losses | Proposed Regulations |
| Reportable Policy Sales | Notice |
| Tax Accounting | Ref #2018-01 |

# Other Items of Interest

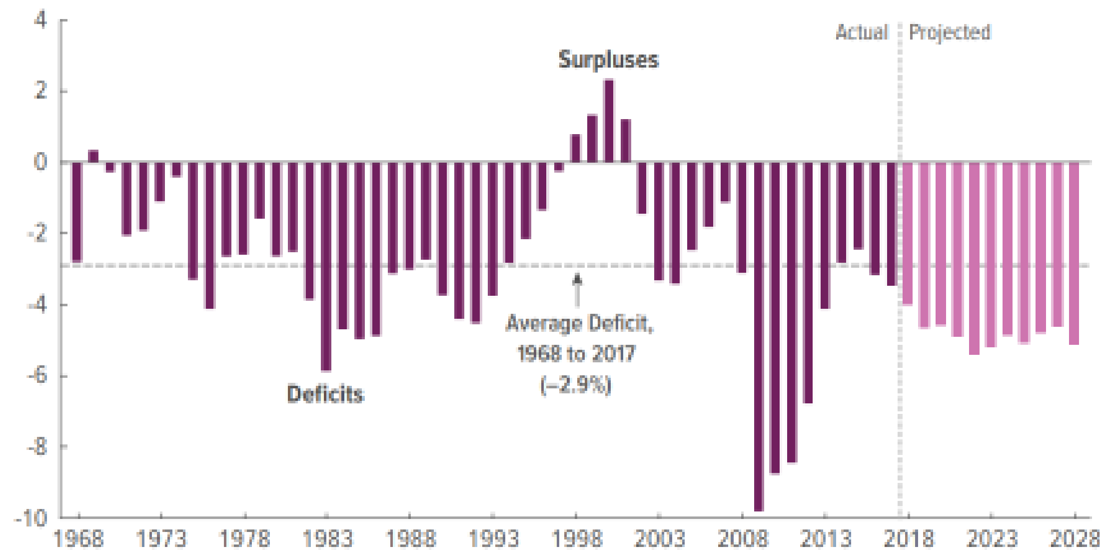
**AMT Credits:** The Office of Management and Budget (OMB) determined that corporations with alternative minimum tax credits are entitled to full refunds under the TCJA, reversing the IRS's position that the refunds are subject to sequestration.

**Forms:** The IRS updated the Form 1120-L, "U.S. Life Insurance Company Income Tax Return," to incorporate TCJA changes.

**Principle Based Reserves (PBR):** During 2017, the IRS resolved the tax treatment of principles-based AG-43 reserves for pre-2017 taxable years and life PBR for tax for companies adopting PBR in 2017.

- The industry pursued an Industry Issue Resolution (IIR) project on the treatment of PBR-type reserves for taxable years prior to 2018.
- On August 24, 2018, the industry received IRS guidance in the form of an Industry Director's Directive (IDD) which allowed a deduction for 96 percent of the principle-based components of life PBR for 2017 and for all post-2010 reserves for variable annuities, in addition to the deduction for the full formulaic component of the pre-2018 reserves computed using principle-based methodologies.
- Additionally, the IDD allowed companies to recompute some tax reserves for products with guaranteed living benefits for pre-2010 years and allow the same 96 percent deduction of the PBR components plus the full formulaic reserve for those contracts.

# Looking Ahead




Deficits as a percentage of gross domestic product are projected to increase over the next few years and then largely stabilize. They exceed their 50-year average throughout the 2018–2028 period.

# Items to Watch

- TCJA regulations not yet issued (Priority Guidance Plan)
- Finalizing proposed regulations
- State conformity with federal taxation
- Financial reporting for all TCJA requirements
- Changes to life/non-life regulations
- Partnership audit regulations

# Potential Life Insurance Simplification Opportunities

Life/non-life consolidated returns

Ordinary vs. capital treatment of assets

- While investment assets of insurers are used in the ordinary course of business, they are classified as capital assets for tax purposes.
- This creates a tax character mismatch because the losses generated from those assets cannot offset the ordinary income which arises from earnings on those assets.
- This mismatch between liabilities and assets causes an inability to properly offset income and losses since capital loss rules are more restrictive than those for ordinary losses, which ultimately means that a loss may go unrecognized for tax purposes.
- Provisions have been included in previous proposed derivatives legislation to treat debt instruments held by insurers as ordinary, rather than capital assets.

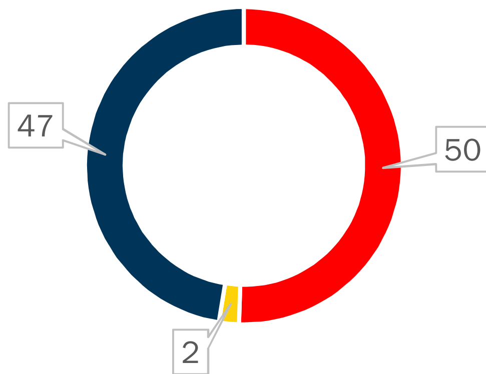
# Political Considerations – 2018 Elections

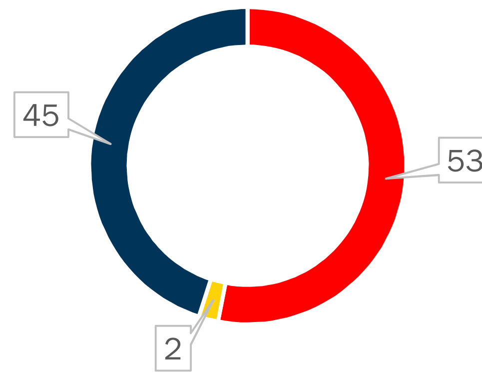
In the 2018 mid-term elections, Democrats took control of the House of Representatives. Republicans retained control of the Senate, splitting the Congress.

This new political reality has implications on many issues of importance to the life insurance industry, from tax and retirement security to financial services, trade, and more.

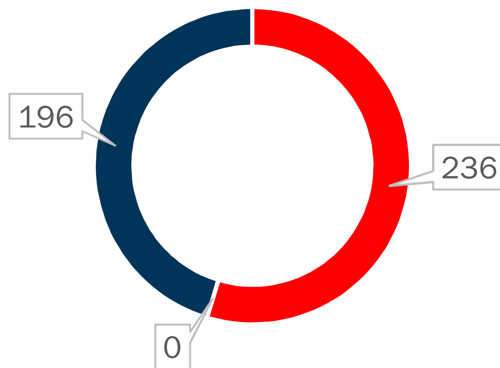
Significant legislative activity is unlikely to occur in the next two years. However, messaging and positioning through legislative proposals is expected regularly by both parties prior to the 2020 election.

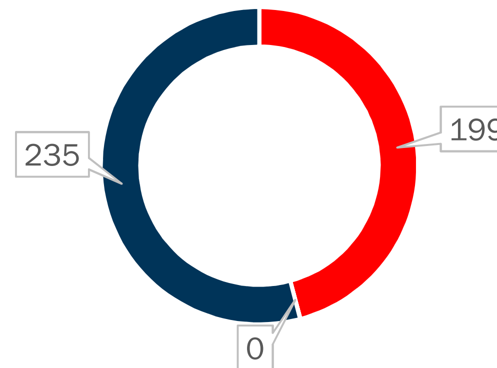
# Election Results: Senate



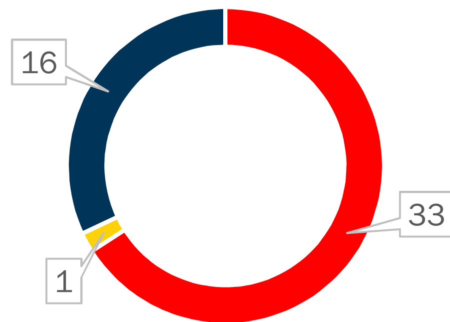
# Election Results: House



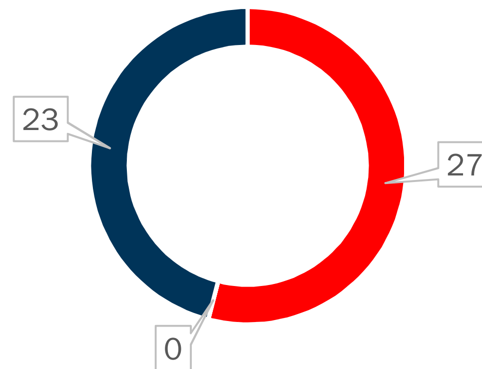



# Election Results: Governors

Pre-Election




Post-Election




■ Republicans ■ Independents ■ Democrats ■ Republicans ■ Independents ■ Democrats

# Political Considerations: Senate Leadership

**Chambers and committees with tax jurisdiction**

Because Republicans retained the Senate, chamber leadership did not change.

Senate Majority Leader Mitch McConnell (R-KY) retained his position.

Senate Minority Leader Chuck Schumer (D-NT) retained his position.

Orrin Hatch (R-UT) retired, and Chuck Grassley (R-IA) became chairman, for the second time, of the Senate Finance Committee; Ron Wyden (D-OR) remains ranking member.

# Political Considerations: House Leadership

Chambers and committees with tax jurisdiction

Due to the change in House control, leadership positions switched parties.

Nancy Pelosi (D-CA), previously House Minority Leader, became Speaker of the House following the election.

Kevin McCarthy (R-CA) became House Minority Leader (previously Nancy Pelosi (D-CA)) following Paul Ryan's (R-WI) retirement.

Richard Neal (D-MA) became chairman of the House Ways & Means Committee; Kevin Brady (R-TX), the previous chairman, became ranking member.

# Implications of Political Control in Congress

- Outcomes of 2020 elections could have significant tax implications for life insurers
- How will the elections, combined with continued budget shortfalls, impact the potential for a corporate tax rate increase?

# Questions?