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LEGAL ALERT

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New Budget Proposals Once Again Target Insurance Companies

On April 10, the Obama Administration released its fiscal year 2014 budget (FY 2014 Budget). Of note, the FY 2014 Budget includes a number of tax proposals that target insurance companies or that otherwise would have a direct effect on them. Specifically, the proposals would:

- Modify the dividends-received deduction for life insurance company separate accounts. This proposal is estimated to raise $2.459 billion over 5 years and $5.101 billion over 10 years.
- Disallow a deduction for "non-taxed reinsurance premiums paid to affiliates." This proposal is estimated to raise $2.621 billion over 5 years and $6.209 billion over 10 years.
- Modify the rules that apply to sales of life insurance contracts. This proposal is estimated to raise $257 million over 5 years and $641 million over 10 years.
- Require information reporting for "private separate accounts" established by life insurance companies. This proposal is estimated to raise $2 million over 5 years and $7 million over 10 years.
- Repeal section 847, which allows insurance companies that are required to discount unpaid losses to claim an additional deduction up to the excess of (i) undiscounted unpaid losses over (ii) related discounted unpaid losses, effective for taxable years beginning after December 31, 2013. This proposal is expected to have a negligible revenue effect.
- Impose a "financial crisis responsibility fee" on "financial institutions." This proposal is estimated to raise $21.959 billion over 5 years and $59.349 billion over 10 years.
- Provide for reciprocal reporting of information in connection with the implementation of the Foreign Account Tax Compliance Act (FATCA). This proposal is not expected to have a revenue effect.

We discuss these proposals below and provide a brief overview of several other relevant proposals contained in the FY 2014 Budget.

Modifying the Dividends-Received Deduction for Life Insurance Company Separate Accounts

In the case of a life insurance company, the dividends-received deduction (DRD) is permitted only with regard to the "company's share" of dividends received, reflecting the fact that some portion of the company's dividend income is used to fund tax-deductible reserves for its obligations to policyholders. Likewise, the net increase or net decrease in reserves is computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. The regime for computing the company's share and policyholders' share of net investment income generally is referred to as proration.

A life insurance company's separate account assets, liabilities, and income are segregated from those of the company's general account in order to support variable life insurance and variable annuity contracts.

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A company's share and policyholders' share are computed for the company's general account and separately for each separate account.

The policyholders' share equals 100% less the company's share, whereas the latter is equal to the company's share of net investment income divided by net investment income. The company's share of net investment income is the excess, if any, of net investment income over certain amounts, including "required interest," that are set aside to satisfy obligations to policyholders. Required interest with regard to an account is calculated by multiplying a specified account earnings rate by the mean of the reserves with regard to the account for the taxable year.

According to the General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (FY 2014 Green Book), the proposal, which is a carryover from the fiscal year 2013 budget (FY 2013 Budget), would repeal the existing regime for prorating investment income between the "company's share" and the "policyholders' share." The general account DRD, tax-exempt interest, and increases in certain policy cash values of a life insurance company instead would be subject to a fixed 15% proration in a manner similar to that which applies under current law to non-life insurance companies. The limitations on the DRD that apply to other corporate taxpayers would be expanded to apply explicitly to life insurance company separate account dividends in the same proportion as the mean of reserves bears to the mean of total assets of the account. Thus, under this proposal, dividends received by a separate account likely would be entitled to only a very small, if any, DRD.

This proposal would be effective for taxable years beginning after December 31, 2013.

Disallowing a Deduction for "Non-Taxed Reinsurance Premiums Paid to Affiliates"

As a general matter, insurance companies are allowed a deduction for premiums paid for reinsurance. If a reinsurance transaction results in a transfer of reserves and reserve assets to a reinsurer, the potential tax liability for the earnings associated with those assets generally is shifted to the reinsurer as well. Although the insurance income of a controlled foreign corporation generally is subject to current taxation in the U.S., insurance income of a foreign-owned foreign company that is not engaged in a U.S. trade or business generally is not subject to U.S. federal income tax. However, reinsurance policies issued by foreign reinsurers with respect to U.S. risks generally are subject to a federal excise tax equal to 1% of the premiums paid, unless waived by a tax treaty.

According to the FY 2014 Green Book, "[r]einsurance transactions with affiliates that are not subject to U.S. federal income tax on insurance income can result in substantial U.S. tax advantages over similar transactions with entities that are subject to tax in the United States." The FY 2014 Green Book also states that "[t]he excise tax on reinsurance policies issued by foreign reinsurers is not always sufficient to offset this tax advantage."

The proposal, which is a carryover from the FY 2013 Budget and is similar to a proposal that has been sponsored by Rep. Richard Neal on several previous occasions, (i) would deny an insurance company a deduction for premiums and other amounts paid to affiliated foreign companies with respect to reinsurance of property and casualty risks to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. federal income tax with respect to the premiums received; and (ii) would exclude from the insurance company's income (in the same proportion in which the premium deduction was denied) any return premiums, ceding commissions, reinsurance recovered, or other amounts received with respect to reinsurance policies for which a premium deduction is wholly or partially denied. The reinsurance transaction would remain subject to the federal excise tax, and it appears that the ceding company still would reduce its reserves by the amount ceded to the reinsurer. A foreign corporation that

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is paid a premium from an affiliate that otherwise would be denied a deduction under this proposal would be permitted to elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a U.S. trade or business and attributable to a permanent establishment for tax treaty purposes. For foreign tax credit purposes, reinsurance income treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

The proposal would be effective for policies issued in taxable years beginning after December 31, 2013.

Modifying the Rules that Apply to Sales of Life Insurance Contracts

According to the FY 2014 Green Book, this proposal, which is a carryover from the FY 2013 Budget, would require a person or entity that purchases an interest in an existing life insurance contract with a death benefit equal to or exceeding $500,000 to report the purchase price, the buyer and seller's taxpayer identification numbers (TINs), and the issuer and policy number to the IRS, to the insurance company that issued the policy, and to the seller.

This proposal also would modify the transfer-for-value rule to ensure that exceptions to that rule would not apply to buyers of policies. Upon the payment of any policy benefits to the buyer, the insurance company would be required to report the gross benefit payment, the buyer's TIN, and the insurance company's estimate of the buyer's basis to the IRS and to the payee.

This proposal would apply to sales or assignments of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2013.

Requiring Information Reporting for "Private Separate Accounts" Established by Life Insurance Companies

According to the FY 2014 Green Book, this proposal, which is a carryover from the FY 2013 Budget, would require life insurance companies to report the following information to the IRS with respect to each contract whose cash value is partially or wholly invested in a "private separate account" for any portion of the taxable year and represents at least 10% of the value of the private separate account: the policyholder's TIN, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that is (or was) invested in one or more private separate accounts. For this purpose, a private separate account would be defined as any account with respect to which a related group of persons owns policies whose cash values, in the aggregate, represent at least 10% of the value of the separate account. Whether a related group of persons owns policies whose cash values represent at least 10% of the value of the account would be determined quarterly, based on information reasonably within the issuer's possession.

This proposal would be effective for taxable years beginning after December 31, 2013.

Repealing Section 847

In general, losses incurred by an insurance company that is required to discount unpaid losses include losses paid during a taxable year (net of salvage and reinsurance recovered), plus or minus the increase or decrease in discounted unpaid losses during the taxable year. An adjustment also is made for the change in discounted estimated salvage and reinsurance recoverable.

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Unpaid losses are determined on a discounted basis to account for the time that may elapse between an insured loss event and the payment or other resolution of the claim. However, taxpayers may elect under section 847 to take an additional deduction equal to the difference between the amount of their reserves computed on a discounted basis and the amount computed on an undiscounted basis. In order to do so, a taxpayer must make a special estimated tax payment (SETP) equal to the tax benefit attributable to the additional deduction. Moreover, the additional deductions are reflected in a special loss discount account. In future years, as losses are paid, amounts are subtracted from the special loss discount account and included in gross income; the SETPs are used to offset tax generated by these income inclusions. To the extent an amount added to the special loss discount account is not subtracted within 15 years, it is automatically subtracted (and included in gross income) for the 15th year. This regime of additional deductions and SETPs is revenue neutral by design.

According to the FY 2014 Green Book, the proposal, which is a carryover from the FY 2013 Budget, would repeal section 847 effective for taxable years beginning after December 31, 2013.

Under the proposal, the entire balance of any existing special loss discount account would be included in gross income for the first taxable year beginning after December 31, 2013, and the entire amount of existing SETPs would be applied against additional tax that is due as a result of that inclusion. Any SETPs in excess of the additional tax that is due would be treated as an estimated tax payment under section 6655.

In lieu of immediate inclusion in gross income for the first taxable year beginning after December 31, 2013, taxpayers would be permitted to elect to include the balance of any existing special loss discount account in gross income ratably over a four taxable year period, beginning with the first taxable year beginning after December 31, 2013. During this period, taxpayers would be permitted to use existing SETPs to offset any additional tax that is due as a result of that inclusion. At the end of the fourth year, any remaining SETPs would be treated as an estimated tax payment under section 6655.

Imposing a "Financial Crisis Responsibility Fee"

According to the FY 2014 Green Book, the financial crisis responsibility fee, which is a carryover from the FY 2013 Budget, is intended to recoup the costs of the TARP program, "as well as discourage excessive risk-taking, as the combination of high levels of risky assets and less stable sources of funding were key contributors to the financial crisis."

As provided in the FY 2014 Green Book, the fee generally would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers, companies that control certain broker-dealers, and insured depository institutions. U.S. companies owning and controlling these types of entities as of January 14, 2010, also would be subject to the fee. Firms with worldwide consolidated assets of less than $50 billion would not be subject to the fee for the period when their assets are below this threshold. U.S. subsidiaries of foreign firms that fall into these categories and that have assets in excess of $50 billion also would be covered.

The fee would be based on the covered liabilities of a financial firm. Covered liabilities generally are the consolidated risk-weighted assets of a financial firm, less its capital, insured deposits, and certain loans to small business. These amounts would be computed using information filed with the appropriate federal or state regulators. For insurance companies, certain policy reserves and other policyholder obligations also would be deducted in computing covered liabilities. In addition, adjustments would be provided to prevent avoidance of the fee.

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The rate of the fee applied to covered liabilities would be 17 basis points, and a 50% discount would apply to more stable sources of funding, including long-term liabilities. The fee would be deductible in computing corporate income tax.

The fee would be effective as of January 1, 2015.

Providing for Reciprocal Reporting of Information in Connection with the Implementation of FATCA

In many cases, foreign law may prevent foreign financial institutions from complying with FATCA by reporting information about U.S. accounts to the IRS. To date, such legal impediments have been addressed through intergovernmental agreements under which the relevant foreign government has agreed to provide the information required by FATCA to the IRS. According to the FY 2014 Budget, requiring U.S. financial institutions to report similar information to the IRS with respect to nonresident accounts would facilitate such intergovernmental cooperation by enabling the IRS to reciprocate in appropriate circumstances by exchanging similar information with cooperative foreign governments to support their efforts to address tax evasion by their residents.

The proposal would provide Treasury with authority to promulgate regulations that would require reporting of information with respect to nonresident alien individuals, entities that are not U.S. persons, and certain U.S. entities held in substantial part by non-U.S. owners, including information regarding account balances and payments made with respect to accounts held by such persons and entities.

Additional Proposals of Note

In addition to the proposals discussed above, the FY 2014 Budget contains a number of proposals that have a broader application to corporate taxpayers. In particular, the FY 2014 Budget contains:

- A package of international tax proposals largely taken from the FY 2013 Budget that includes (i) a proposal to defer deduction of interest expense related to deferred income of foreign subsidiaries, (ii) a proposal to require the determination of the foreign tax credit on a pooling basis, (iii) a proposal to tax currently “excess returns” associated with transfers of intangibles offshore, (iv) a proposal to limit shifting of income through intangible property transfers, (v) a proposal to limit earnings stripping by “expatriated entities,” (vi) a proposal to modify the tax rules for “dual capacity taxpayers,” (vii) a proposal to tax gain from the sale of a partnership interest on a look-through basis, (viii) a proposal to prevent the use of leveraged distributions from related foreign corporations to avoid dividend treatment, (ix) a proposal to extend section 338(h)(16) to certain asset acquisitions, and (x) a proposal to remove foreign taxes from a section 902 corporation’s foreign tax pool when earnings are eliminated;

- A proposal (also included in the FY 2013 Budget) to repeal the “boot-within-gain” limitation of current law in the case of any reorganization transaction if the exchange has the effect of a distribution of a dividend, as determined under section 356(a)(2);

- A proposal (also included in the FY 2013 Budget) to repeal the “non-qualified preferred stock” provision of section 351(g) and the cross-referencing provisions of the Internal Revenue Code that treat non-qualified preferred stock as boot;

- A new proposal to repeal the rules under section 708 concerning technical terminations of partnerships; and

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- A new proposal to repeal the anti-churning rules under section 197.

Also of note is that the FY 2014 Budget does not contain a proposal to extend either the controlled foreign corporation "look-through" rule or the "active financing" exception under Subpart F. The absence of such proposals may reflect the fact that those provisions remain in effect until the end of 2013.

We will continue to monitor the status of these proposals and keep you updated on any significant developments as they occur.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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