SUTHERLAND

LEGAL ALERT

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Ready…Aim…Fire! FY 2012 Budget Proposals (Once Again) Target Insurance Companies

On February 14, 2011, the Administration released its fiscal year 2012 budget (FY 2012 Budget). Of note, the FY 2012 Budget includes a number of tax proposals that target insurance companies or that otherwise would have a direct effect on them. Those proposals include:

- Modifying the dividends-received deduction for life insurance company separate accounts. This proposal is a modified version of a proposal that was included in the fiscal year 2010 budget (FY 2010 Budget) and the fiscal year 2011 budget (FY 2011 Budget) and is estimated to raise $2.368 billion over 5 years and $5.146 billion over 10 years.

- Disallowing the deduction for "non-taxed reinsurance premiums paid to affiliates." This proposal is a modified version of a proposal that was included in the FY 2011 Budget and is estimated to raise $1.103 billion over 5 years and $2.614 billion over 10 years.

- Extending the Subpart F "active financing" exception and "look-through" treatment for payments made between related controlled foreign corporations through December 31, 2012.

- Imposing a "financial crisis responsibility fee" on "financial institutions." This proposal is a modified version of a proposal that was included in the FY 2011 Budget and is estimated to raise $10 billion over 5 years and $30 billion over 10 years. The Administration first proposed such a fee on January 14, 2010.

- Modifying the rules that apply to sales of life insurance contracts. This proposal is a carryover from the FY 2010 Budget and the FY 2011 Budget and is estimated to raise $344 million over 5 years and $1.243 billion over 10 years.

- Requiring information reporting for "private separate accounts" of life insurance companies. This proposal is a carryover from the FY 2010 Budget and the FY 2011 Budget and is estimated to raise $9 million over 5 years and $39 million over 10 years.

- Repealing section 847 effective for taxable years beginning after December 31, 2011. This proposal is new and is expected to be revenue neutral.

We discuss these proposals below and provide a brief overview of several other relevant proposals contained in the FY 2012 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. 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 2012 Revenue Proposals (FY 2012 Green Book), the proposal 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, 2011.

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

According to the FY 2012 Green Book, under this proposal, a U.S. insurance company would be denied a deduction for certain reinsurance premiums paid to affiliated foreign reinsurance companies with respect to U.S. risks insured by the insurance company or its U.S. affiliates. Specifically, the proposal (i) would deny an insurance company a deduction for reinsurance premiums paid to affiliated foreign reinsurance companies to the extent that the foreign reinsurer (or its parent company) is not subject to U.S. income tax with respect to the premiums received; and (ii) would exclude from the U.S. insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied. This proposal also provides that the foreign corporation that is paid a premium from an affiliate that otherwise would 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 and attributable to a permanent establishment for tax treaty purposes. For foreign tax credit purposes, reinsurance income treated as effectively connected under this proposal would be treated as foreign source income and would be placed into a separate category within section 904.

Notably, the FY 2012 Budget proposal takes a markedly different (and more draconian) approach than the proposal contained in the FY 2011 Budget, which was estimated to raise $233 million over 5 years and $519 million over 10 years. The FY 2011 Budget proposal adopted a § 163(j)-like approach, pursuant to which a U.S. insurance company would not be allowed a deduction to the extent that (i) the foreign reinsurer (or its parent company) was not subject to U.S. federal income tax with respect to premiums received and (ii) the amount of reinsurance premiums (net of ceding commissions) paid to the foreign reinsurer exceeded 50% of the total direct insurance premiums received by the U.S. insurance company and its U.S. affiliates for a line of business. The FY 2012 Budget proposal also takes a different path than that followed by the bill that was reintroduced by Congressman Richard Neal in the U.S. House of Representatives on July 30, 2009 (2009 Neal Bill). In particular, the 2009 Neal Bill proposed to disallow a deduction to any company subject to the tax imposed by § 831 for any reinsurance premium paid, directly or indirectly, to an affiliated corporation (other than a controlled foreign corporation as defined under § 957) if, with respect to such affiliated corporation, such premium was neither Subpart F income (as defined under § 952) nor subject to U.S. federal income tax. As a further point of distinction in comparison to the 2009 Neal Bill, the FY 2012 Budget proposal appears to be applicable to life insurance companies as well as non-life insurance companies.

This proposal would be effective for reinsurance treaties issued in taxable years beginning after December 31, 2011. It is unclear how the proposal would affect the federal excise tax that otherwise would be payable with respect to a covered reinsurance transaction.

Extending the Subpart F “Active Financing” and “Look-Through” Exceptions

According to the FY 2012 Green Book, the Administration is proposing to extend the Subpart F “active financing” and “look-through” exceptions through December 31, 2012. Currently, these provisions apply to taxable years of foreign corporations beginning before January 1, 2012.

Imposing a “Financial Crisis Responsibility Fee”

According to the FY 2012 Green Book, the Financial Crisis Responsibility Fee 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 2012 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.

The rate of the fee applied to covered liabilities would be "approximately 7.5 basis points" (although a discount apparently 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, 2013.

Modifying the Rules that Apply to Sales of Life Insurance Contracts

According to the FY 2012 Green Book, this proposal 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 assignment of interests in life insurance policies and payments of death benefits in taxable years beginning after December 31, 2011.

Requiring Information Reporting for "Private Separate Accounts" of Life Insurance Companies

According to the FY 2012 Green Book, this proposal would require life insurance companies to report to the IRS, for 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 account, the policyholder's taxpayer identification number, the policy number, the amount of accumulated untaxed income, the total contract account value, and the portion of that value that 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, 2011.

Repealing Section 847

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

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. In addition, the additional deductions are added to a special loss discount account. In future years, as losses are paid, amounts are subtracted from the special 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 2012 Green Book, the proposal would repeal section 847, effective for taxable years beginning after December 31, 2011.

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, 2011, 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, 2011, 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, 2011. 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.

Additional Proposals of Note

In addition to the proposals discussed above, the FY 2012 Budget contains a number of proposals of more general interest. In particular, the FY 2012 Budget contains:

- A package of international tax proposals largely taken from the FY 2011 Budget that includes (i) a proposal to defer deduction of interest expense related to deferred income, (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,” and (vi) a proposal to modify the tax rules for “dual capacity taxpayers;”

- A proposal (also included in the FY 2011 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 the distribution of a dividend, as determined under section 356(a)(2); and

- A new proposal 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.

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

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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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