HOUSE AND SENATE VOTE TO ENACT THE TAX CUTS AND JOBS ACT: IMPACT ON OFFSHORE REINSURERS

On December 20, 2017, the U.S. Congress voted to enact the most sweeping tax reform bill in decades. Among other things, the Tax Cuts and Jobs Act (the "TCJA") will impose significant new restrictions on offshore reinsurers. This briefing discusses the most prominent of these restrictions, and provides some ideas for how they may be managed with careful tax planning.

OUTBOUND AFFILIATE REINSURANCE PAYMENTS

Offshore reinsurance companies with large U.S. operations could become subject to a new "base erosion and anti-abuse tax" (or "BEAT") under the TCJA. The BEAT generally imposes a minimum tax on a taxpayer's income calculated after adding back certain payments to non-U.S. affiliates that result in a deduction or other tax benefit. The rate of the minimum tax is generally 5% in 2018, 10% in 2019 through 2025, and 12.5% after 2025. The BEAT would generally tax reinsurance premiums paid by U.S. companies to non-U.S. affiliates to the extent those premium payments reduce the ceding company's taxable income beyond certain thresholds. The tax is effective for payments made in tax years ending after 2017, and appears to apply on top of the 1% reinsurance excise tax that applies under current law.

Background

The BEAT applies where an "applicable taxpayer" receives a "base erosion tax benefit" from a transaction with a non-U.S. "related party." The BEAT is calculated by applying the BEAT rate to the taxpayer's "modified taxable income," which is generally taxable income computed without regard to base erosion tax benefits and certain net operating losses attributable to base erosion tax benefits from prior years. The taxpayer is subject to the BEAT to the extent that the foregoing amount exceeds the taxpayer's regular tax liability for the year.

- Applicable taxpayer: The BEAT only applies to corporate groups with (i) average annual gross receipts for the three prior tax years that exceed $500 million (including the receipts of any U.S. group members, but only including the receipts of non-U.S. group members that are effectively connected with a

U.S. business) and with (ii) base erosion tax benefits that equal or exceed 3% of the group's total U.S. tax deductions.

- Related party: A related party generally includes a 25% owner of the applicable taxpayer, a person that is related to a 25% owner of the applicable taxpayer, an entity with greater than 50% common ownership with the applicable taxpayer, or any other person that is owned or controlled directly or indirectly by the same interests as the taxpayer. In determining stock ownership, certain constructive ownership rules apply.
- Base erosion tax benefit: Generally, any deduction arising from a payment to a non-U.S. related party and any depreciation or amortization arising from an asset purchased from a non-U.S. related party. This includes reinsurance payments that reduce the taxable income of life or property and casualty insurance companies. Certain exceptions apply to payments (and related deductions) under derivative contracts and payments for certain services.

The Takeaway

In the reinsurance industry there has been a focus on whether the BEAT applies to the full amount of reinsurance premiums paid to a related reinsurer, or whether such premiums should be offset by reinsurance recoveries from the related reinsurer and similar amounts. While the statutory language may support the application of the BEAT to gross premiums, this would result in a more punitive impact on reinsurance transactions than other transactions that could be impacted by the BEAT. Furthermore, testimony in the Senate Congressional Record suggests that the BEAT was intended to apply only to the net amount. The BEAT will have a wide-ranging impact on affiliate reinsurance transactions. We are working with a number of non-U.S. reinsurers to develop various options for restructuring these transactions in light of this new tax.

CONTROLLED FOREIGN CORPORATION STATUS

The TCJA makes certain changes to the controlled foreign corporation ("CFC") rules that will broaden the circumstances under which non-U.S. insurers and reinsurers will be treated as CFCs. If a non-U.S. corporation is treated as a CFC, shareholders that are treated as "United States shareholders" are generally required to include in income on a current basis their proportionate share of certain categories of income generated by the corporation, among other consequences.

Expanded Definition of United States Shareholder

The TCJA expands the definition of a "United States shareholder" to include shareholders that own 10% or more of the foreign corporation by vote or value. Previous rules looked only to voting power.

Prior to the TCJA, structures such as voting cutbacks, as well as high-vote / low-vote stock, could be used under certain circumstances to prevent a non-U.S. insurer or reinsurer from becoming a CFC. These structures generally sought to ensure that shareholders owning more than 10% of the company by value held less than 10% of the vote. These structures will need to be revisited. Because the test for United States shareholders now looks to ownership by value, voting cutbacks and similar techniques will generally not prevent the application of the CFC rules.

Broader Attribution Rules

The TCJA further expands the scope of the CFC rules by expanding the attribution rules that apply in determining whether any person is a United States shareholder with respect to a non-U.S. corporation. As a result of these expanded attribution rules, for example, if a corporate group with a non-U.S. parent corporation has a U.S. subsidiary, such U.S. subsidiary would be treated as a United States shareholder of any non-U.S. subsidiary of the group, and each non-U.S. subsidiary would generally be treated as a CFC. As a result:

- The U.S. subsidiary would be required to report its constructive ownership of the non-U.S. subsidiaries on its annual U.S. federal income tax return, likely increasing the cost and complexity of the return.
- While the TCJA Conference Report implies that this was not Congress's intent, absent further binding guidance from the Treasury or IRS, it appears that a U.S. person that owns more than 10% by vote or value of the non-U.S. parent would be subject to income inclusions with respect to each non-U.S. subsidiary, even if such shareholder is the only U.S. person that directly or indirectly owns stock in the non-U.S. parent.

While most provisions of the TCJA begin to apply in 2018, this provision applies retroactively to taxable years beginning in 2017.

THE ACTIVE INSURANCE PFIC EXCEPTION

A non-U.S. corporation can generally avoid being treated as a passive foreign investment company (a "PFIC") if the corporation is predominantly engaged in an insurance business and such business is actively conducted (the so-called "insurance company exception" to the PFIC rules). The TCJA imposes a new bright-line requirement that a company must satisfy in order to qualify for the insurance company exception. Specifically, in order to be treated as actively engaged in the conduct of an insurance business (and therefore generally not a PFIC), a non-U.S. insurance company's "applicable insurance liabilities" must exceed 25% of its total assets, as reported on the company's last financial statements.

The term "applicable insurance liabilities" means the sum of (i) loss and loss adjustment expenses and (ii) certain reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and claims. Some practitioners have questioned whether the reference to "loss and loss adjustment expenses" could refer to paid losses as opposed to reserves based on the language used in the provision. However, the industry consensus is that the term refers to liabilities for unpaid losses (i.e., loss reserves), and the TCJA Conference Report and the structure of the provision both support this interpretation.

The provision raises various questions regarding its application. For example, presumably the test established by the provision is an annual test, but this is not specified in the provision. In addition, the provision does not address how reinsurance recoverables should impact a company's applicable insurance liabilities (i.e., whether applicable insurance liabilities should be determined net of reinsured amounts), although presumably this would follow the amounts reported on the company's balance sheet pending further guidance.

If an offshore insurance company fails the 25% test, an alternative 10% test may be available, but only if the failure to meet the 25% test is due solely to run-off-related or rating-related circumstances involving the insurance business and the company is predominantly engaged in an insurance business.

This proposal is similar to a proposal released by then-Senate Finance Committee Chairman Ron Wyden (D-Or.) in 2015. Compared to the Wyden proposal, the TCJA permits the application of the 10% test under narrower circumstances – for example, arguably under the Wyden proposal the 10% test could have applied to a company that was ramping up its business. Although the test established by the TCJA is more restrictive than had been hoped by some, we expect that the adoption of a bright-line test will provide welcome clarity to an area of the tax law where precise guidance has been sparse.

CLIFFORD CHANCE

TAX CONTACTS

Michael Seaton
Partner

T +1 212 878 3455
E michael.seaton@cliffordchance.com

David Moldenhauer
Partner

T +1 212 878 8384
E david.moldenhauer@cliffordchance.com

Alan Kravitz
Associate

T +1 212 878 3191
E alan.kravitz@cliffordchance.com

INSURANCE CONTACTS

Gary Boss
Partner

T +1 212 878 8063
E gary.boss@cliffordchance.com

Joseph Cosentino
Partner

T +1 212 878 3149
E joseph.cosentino@cliffordchance.com

Nick Williams
Partner

T +1 212 878 8010
E nick.williams@cliffordchance.com

Alice Kane
Counsel

T +1 212 878 8110
E alice.kane@cliffordchance.com