Potential tax implications for the insurance industry
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Introduction

On 20 January 2017, Donald Trump was sworn as the 45th President of the United States, capping a surprising sweep by Republicans of the House, Senate and White House. President Trump, House Speaker Paul Ryan (R-WI) and Senate Majority Leader Mitch McConnell (R-KY) have each declared that comprehensive tax reform legislation is a high priority in 2017. With a unified Republican government, they have a good chance of making that priority a reality, if not this year, by early 2018. However, the legislative path forward and the ultimate design and details of the final legislation are far from clear. Republican leaders in Congress and the Trump Administration, trying to recover from their failure to gain agreement among Congressional Republicans on how to address their first priority, “repeal and replace” of the Affordable Care Act (ACA), are now grappling with how best to move forward with tax reform legislation and how to address some tax reform proposals that have already become quite controversial. While the unanimity of purpose among Republicans coupled with their ability to drive the legislative agenda elevates the prospects for broad tax reform legislation, the political difficulties inherent in a major rewrite of the tax code will make the tax reform legislative process precarious and unpredictable.

As the Constitution requires revenue bills to originate in the House, and House Republican leaders kicked off the process of designing a tax reform bill last June when they released the House Republican Blueprint on comprehensive tax reform (the Blueprint)¹, House Ways and Means Committee Chairman Kevin Brady (R-TX), Republican members of the House tax writing committee, and their staffs have been working to turn that aspirational document into hundreds of pages of legislative language. The assumption and expectation has been that the House will act first, using the Blueprint as its starting point; the Senate would follow with its own bill, which might be quite different from the House bill, and a final bill will be hammered out later this year in a House-Senate conference committee. The centerpiece of the House starting point will undoubtedly be a broad-based reduction in tax rates, an important policy objective shared by both the Congressional Republicans and President Trump.

However, the path forward on tax reform is murkier since the health care legislation stalled. House leaders and the President decided on 24 March to put the Affordable Care Act “repeal and replace” bill aside. Democrats were prepared to vote no on any such legislation, and there appeared to be insufficient support among Republicans to pass the bill in the House. That development put the focus squarely on tax reform, which was next in the queue of priorities, but also raised awareness of the difficulty of advancing a major bill on a partisan basis. Importantly, the health bill was largely designed by Congressional Republican leaders, and the White House has indicated they want to move in a different way with tax reform and take a larger role at the outset in developing the framework for tax reform legislation. “When you see tax reform for the first time, it will be the President’s plan and we will drive the debate on that,” White House budget director Mick Mulvaney said on 24 March. Administration officials have made clear they are developing their own plan. “You can expect that we are going to come out with a plan pretty soon,” Secretary Mnuchin said the same day, seemingly making it harder for the House to get started on tax reform until the administration puts out its plan.

Administration officials have been examining the Blueprint, which contains some new and controversial tax reform ideas, while borrowing from prior tax reform legislative efforts, most notably a plan developed by former House Ways and Means Committee Chairman Dave Camp (R-MI) earlier this decade. Additionally, the initial failure of the Republican-only health care effort so early in the new Congress and the new Presidency of Donald Trump makes it riskier to pursue some of the more controversial proposals included in the Blueprint, the most significant of which are proposals to “border adjust” the corporate income tax and deny the deduction for net interest expense. Ways and Means Committee Republicans are trying to redesign the border adjustability proposal to win additional support, but the concept has been described as involving a degree of uncertainty, and there may be less tolerance for that now. President Trump has expressed support for the goals of the border adjustability component, but Secretary Mnuchin said the Administration will not embrace the proposal “as-is.” They are focused on approaches that are simple and sure to work, he said.

The health care bill was unveiled with limited vetting among Republicans in the House or outside groups. The White House could try to build more support for tax reform proposals before announcing a tax plan that the President would then champion. This could involve input from the Senate, where Republicans have not aligned behind a tax reform plan but have been investigating options; a number of GOP senators oppose border adjustability. In light of the difficulty of winning a consensus among a sufficient number of Congressional Republicans, it remains unclear whether the President will continue to pursue tax reform on an all-GOP basis, or try to rally some Democratic support, perhaps with a tie-in to infrastructure investment.

With all these options on the table, and the likelihood that tax reform legislation will move quickly in Congress once the White House and Congressional Republicans align on a plan, it is appropriate for insurance professionals to carefully review and consider prior iterations of tax legislation, since they are a likely and readily available source for current proposals.

¹ This document was published by the House of Representatives Republican Tax Reform Task Force on 24 June 2016, under the title A Better Way — Our Vision for a Confident America and can be found at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.
The House Republican Blueprint for tax reform

While not a legislative draft, the Blueprint outlines a revenue-neutral approach to tax reform that is intended to spur economic growth. Not surprisingly, the most significant aspect of the Blueprint is a broad-based reduction in tax rates. The Blueprint pays for this rate reduction by eliminating “targeted” tax deductions, credits and exclusions, but provides very little details on what those might be. In addition, the Blueprint raises significant revenue by moving the US business tax regime toward a cash-flow destination-based tax in part by implementing a border tax adjustment mechanism in which revenues from exports are not subject to the business income tax, while revenues and expenses relating to imports are subject to tax.

Broadly speaking, the Blueprint calls for a reduction in the top corporate tax rate from 35% to 20%. Individuals would also see a significant reduction in rates. Under the Blueprint, individuals would be subject to tax rates of 12%, 25% and 33%, depending on their income level. Active income received from pass-through vehicles and sole proprietorships would be subject to a maximum 25% tax rate. Passive investment income (e.g., net capital gains, dividends and interest) would qualify for a 50% exclusion, meaning that individuals would be taxed on such income at graduated tax rates of 6%, 12.5% and 16.5%.

The changes proposed by the Blueprint go beyond just tax rates. Of particular importance, the Blueprint calls for a potentially significant tax benefit in the form of full and immediate business expensing of investments in all tangible, intangible and real property (other than land). At the same time, the Blueprint proposes to eliminate deductibility of net interest expense, which would constitute a repeal of a very significant business tax benefit. The Blueprint also contains other noteworthy proposals that should be monitored. For example, the Blueprint proposes to eliminate the Alternative Minimum Tax (AMT) for corporations (as well as for individuals) and would allow net operating losses (NOLs) to be carried forward indefinitely (subject to certain adjustments and limitations), increased by an interest factor, while NOL carrybacks would not be allowed.

On the international front, the Blueprint would move to a territorial tax system by providing a 100% exemption for dividends paid from the future active earnings of foreign subsidiaries. As a transition to the territorial system, an 8.75% tax rate would be imposed on previously untaxed accumulated foreign cash or cash-equivalent earnings, and a 3.50% tax rate would apply to all other accumulated foreign earnings, payable over eight years. The Blueprint would dramatically scale back the anti-deferral tax rules embodied in Subpart F of the Internal Revenue Code (IRC), but would currently leave in place the foreign personal holding company rules that generally tax “passive income,” including interest. However, those rules include a notable exception for the active financial services income of banks, insurance companies, finance companies and similar businesses. It is presumed that the active financial services exception rules to Subpart F would be retained. The Blueprint also outlines a destination-based system in which export sales would be exempt from tax and imported “inputs” would not be deductible. Unofficial estimates project that this border adjustment mechanism may raise up to $1.2 trillion in additional revenues over a 10-year period, which will be a key ingredient to pay for tax rate reduction while maintaining revenue neutrality. While many countries use border adjustments in connection with their value-added taxes, the World Trade Organization prohibits such adjustments as part of an income tax regime – meaning that if enacted, this proposal could be subject to challenge.

No revenue estimates were included with the Blueprint. It is, however, intended to be both pro-growth and revenue-neutral (i.e., not increase the deficit). To arrive at this position, the Blueprint relies on several key revenue assumptions in measuring the overall neutrality of the tax reform legislation.

*Current policy revenue baseline:* in measuring the revenue neutrality of comprehensive tax reform legislation, it is necessary for some type of reference baseline to be used. The Blueprint uses a “current policy” baseline, which assumes that Congress will continue to extend current tax policies and that temporary tax expenditures will be permanently extended. Thus, when the 2015 tax extenders legislation, which made permanent a number of business and individual tax provisions and temporarily extended other provisions, was signed into law last year by President Obama, there was an accompanying reduction in federal revenue over a 10-year budget window. Under a current policy baseline, this revenue effect gets incorporated into the Congressional Budget Office’s future budget projections and may reduce the base-broadening that is needed to achieve revenue neutrality.

The Blueprint raises significant revenue by moving the US business tax regime toward a cash-flow destination-based tax, in part by implementing a border tax adjustment mechanism in which revenues from exports are not subject to the business income tax while revenues and expenses relating to imports are subject to tax.

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2 This is a very high-level estimate considering US imports are approximately 15% of GDP and exports are approximately 12% of GDP. The net 3% trade imbalance at the Blueprint’s 20% corporate tax rate equals 0.6% GDP (3 times 20%). 0.6% of GDP is roughly $120 billion a year (totaling $1.2 trillion over 10 years).
The Blueprint also includes positive revenue effects that its drafters assume will arise from the economic growth they expect from this change in tax policy. This “dynamic” score will be provided by the staff of the Joint Committee on Taxation. Proposals such as 100% expensing and the reduction in individual tax rates will be modeled as producing increased economic growth that will generate additional revenue, but it remains unclear how significant that additional revenue will be.

Finally, the Blueprint assumed that all the tax increases that were part of the Affordable Care Act, such as the individual shared responsibility tax (also known as the “individual mandate”), the employer shared responsibility tax (also known as the “employer mandate”), the 3.8% tax on net investment income, the 0.9% payroll tax, the medical device excise tax, the Section 9010 health insurer fee, the Section 162(m)(6) compensation deduction disallowance and other industry-specific tax increases would have been repealed as part of a separate health care bill. In all, the tax provisions in the ACA account for approximately $1 trillion in tax revenues over 10 years, and the legislation on health care would have repealed those taxes, fully offsetting the cost with other ACA changes, mainly from cuts in Medicaid spending. Following the cancellation of the March 24 House vote on the American Health Care Act, the fate of these taxes remains unclear. Speaker Ryan initially declared the ACA tax provisions will not be repealed as part of tax reform efforts, but instead will be retained as part of the ACA. To repeal these taxes as part of tax reform and keep the tax reform bill from dramatically increasing the federal budget deficit, they would have to be offset by other tax increases.

### Proposal House Republican Blueprint

<table>
<thead>
<tr>
<th>Proposal</th>
<th>House Republican Blueprint</th>
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<tbody>
<tr>
<td><strong>Top corporate tax rate (now 35%)</strong></td>
<td>20%, corporate AMT eliminated</td>
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<tr>
<td><strong>Top pass-through tax rate (now 39.6%)</strong></td>
<td>25% top rate for active business income passed-through to individuals</td>
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<tr>
<td><strong>Taxation of future foreign earnings</strong></td>
<td>Territorial tax system with 100% exemption for dividends from foreign subsidiaries; border adjustments (exempts exports, taxes imports)</td>
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<tr>
<td><strong>Mandatory tax on previously untaxed accumulated foreign earnings</strong></td>
<td>8.75% for cash/cash equivalents, 3.5% otherwise, payable over eight years</td>
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<tr>
<td><strong>Cost recovery</strong></td>
<td>100% expensing: tangible, intangible assets (does not apply to land)</td>
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<tr>
<td><strong>Interest expense</strong></td>
<td>No current deduction will be allowed for net interest expense</td>
</tr>
<tr>
<td><strong>Other business tax preferences</strong></td>
<td>Calls for them to generally be eliminated, except for R&amp;E credit and LIFO</td>
</tr>
<tr>
<td><strong>Individual tax rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)</strong></td>
<td>12%, 25%, 33%</td>
</tr>
<tr>
<td><strong>Capital gains and dividends</strong></td>
<td>50% deduction for capital gains, dividends and interest, leading to basic rates of 6%, 12.5% and 16.5%</td>
</tr>
<tr>
<td><strong>Carried interest</strong></td>
<td>(Not addressed)</td>
</tr>
<tr>
<td><strong>Estate tax (now 40% rate, $5.45 million exemption)</strong></td>
<td>Repealed</td>
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<tr>
<td><strong>State tax deduction</strong></td>
<td>Eliminated</td>
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<tr>
<td><strong>Charitable contribution deduction</strong></td>
<td>Retained, but could be modified</td>
</tr>
<tr>
<td><strong>Mortgage interest deduction</strong></td>
<td>Retained, but could be modified</td>
</tr>
<tr>
<td><strong>Personal exemption phase-out (PEP), Pease deduction limitation</strong></td>
<td>(Not addressed)</td>
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<tr>
<td><strong>Life insurance build-up</strong></td>
<td>(Not addressed)</td>
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The Camp Plan: a precursor to the Blueprint

In February 2014, then-House Ways and Means Committee Chairman Camp released as a discussion draft a comprehensive proposal for tax reform (the Camp Plan)3 that also would have dramatically reduced tax rates, paid for with elimination or limitations on most individual and business tax preferences. That draft was later introduced as a bill, without further changes. When it was released, the Camp Plan was the product of three-plus years of work from the Chairman and his staff and, like the Blueprint, embraced the many trade-offs necessary to significantly lower tax rates, a critical component of realizing economic growth associated with tax reform.

Given the similarity of their policy objectives, many believe the Camp Plan to be a precursor of the Blueprint and a ready source of potential tax reform proposals and legislative language. However, the Blueprint raises significant revenue from its border adjustment mechanism, which is quite controversial. House Republican leaders have suggested that a selling point of border adjustment is that the revenue it raises will negate the need to utilize many of the revenue raisers in the Camp Plan in order to retain revenue-neutrality. Conversely, they argue that if the border adjustment mechanism is dropped as the legislative process moves forward, it will be necessary to include the Camp Plan revenue raisers.

Insurance company proposals in the Camp Plan

The Camp Plan proposed a number of substantive changes to the international tax regime. With respect to the Subpart F regimes for insurance companies, the Camp Plan retained the active financing exceptions from Subpart F for insurance premium income and investment income under current IRC Sections 953(e) and 954(i). The Camp Plan, however, added an additional requirement that investment income could qualify for deferral under Section 954(i) only if it is subject to an effective foreign income tax rate of at least 50 percent of the maximum US corporate rate in effect under the statute.

Most notably for property/casualty insurance companies, the Camp Plan denied the deduction of reinsurance premiums paid to affiliated corporations that are not subject to US tax on the premiums (either as income of the affiliate or as a Subpart F inclusion to a US shareholder of the affiliate).4 For purposes of this provision, there was a 50% or more ownership requirement to be an affiliated corporation. The Camp Plan also excluded from a US insurance company’s income any ceding commission, return premium, reinsurance recovered or other amount received by the insurance company with respect to reinsurance policies for which a premium deduction is denied to the extent the item is properly allocable to the premium. However, if the taxpayer demonstrated to the Internal Revenue Service (IRS) that the recipient of the reinsurance premiums was resident in a foreign jurisdiction that taxes those premiums at a rate as high as or higher than the US corporate rate, the deduction for reinsurance premiums would have been allowed. Further, the proposal provided an election for an affiliated foreign reinsurer to be subject to US tax on premiums and net investment income that is attributable to the reinsurance transaction that is subject to the proposal. The election was intended to provide another option so that these foreign affiliates are not treated less favorably than US reinsurers. Under the election, the deduction disallowance for reinsurance premiums and additional amounts with respect to such reinsurance does not apply, and the exclusion for return premiums, ceding commissions, reinsurance recovered or other amounts received with respect to such reinsurance does not apply.

The Camp Plan also proposed changes that would significantly affect the federal income taxes of life, property/casualty and health insurance companies. Some of the most significant insurance tax items in the Camp Plan included: (i) changing the calculation of tax reserves for both life and property/casualty companies; (ii) modifying the deferred acquisition costs (DAC) rules for life insurance companies; (iii) eliminating most of the benefit of the dividends received deduction (DRD) for life insurance company separate accounts; (iv) further reducing the deductions of interest relating to corporate-owned life insurance (COLI) policies; and (v) eliminating the special benefits available to certain Blue Cross and Blue Shield organizations, among several other tax proposals directly impacting the insurance industry. For a complete listing of all the Camp Plan insurance tax proposals, please see Appendix A on pages 13 and 14 of this publication.

All of the insurance proposals in the Camp Plan were scored as revenue raisers by the Joint Committee on Taxation, with the largest revenue being generated from the changes in the tax reserve calculations for life and property/casualty companies. In all, the Camp Plan insurance tax proposals would have increased taxes on insurers by more than $76 billion over a 10-year period and are potentially at risk of being included in the comprehensive tax reform legislation.

3 David Camp, then in his role as House Ways and Means Committee Chairman, released this document on 26 February 2014, as a discussion draft for comprehensive tax reform. Camp subsequently introduced the document as a legislative bill, H.R. 1, the Tax Reform Act of 2014, on 11 December 2014.

4 This provision applied to reinsurance of risks other than life insurance, annuity, or non-cancelable accident and health insurance risks.
The Trump Campaign Tax Plan: an evolving perspective

Over the course of the presidential campaign, President Trump offered a brief perspective on what tax reform might look like if he were to become president (the Trump Plan). From a high-level policy perspective, the Trump Plan is consistent with the Blueprint and the Camp Plan insofar as the most significant aspect of the Trump Plan is a reduction in tax rates, coupled with the elimination of more targeted deductions and credits. Under the most recent Trump Plan, announced on 8 August 2016, individual income tax rates would be 12%, 25% and 33%, the same as those proposed by the Blueprint. The Trump Plan differs from the Blueprint, however, with respect to the tax rate applicable to corporations and on income from pass-through entities. In each such instance, the Trump Plan calls for a 15% tax rate, which is lower than the rate proposed under the Blueprint or the Camp Plan. The Trump Plan also calls for repeal of the AMT for corporations and individuals. Although the Trump Plan calls for the repeal of the estate tax, Trump has proposed that unrealized capital gains of more than $10 million that are held at death would be subject to tax, although it is unclear under the Trump Plan when or how that tax would ultimately be assessed and collected.

With respect to immediate expensing for investment in business assets and interest deductibility, the Trump position is less well-defined. Initially, candidate Trump did not propose anything specific regarding immediate expensing. In fact, it wasn’t until the release of the last version of his tax plan that Trump indicated support for immediate expensing, which, unlike under the Blueprint, would be elective and limited to manufacturers; for those manufacturers making this election, the deduction for corporate interest expense would be lost. In terms of changes to the international tax regime, the Trump Plan suggests support for repealing deferral and applying the 15% corporate rate to the worldwide income of US companies. Trump and his staff have expressed support for a 10% tax rate on the deemed repatriation of previously untaxed foreign earnings of US companies.

The Blueprint is silent on the treatment of inside build-up on life insurance policies. However, Trump’s first tax plan (released in 2015) proposed to “phase out the tax exemption on life insurance interest for high-income earners.” The Trump Plan, announced on 8 August 2016, was significantly lighter on details than his first tax plan. The Trump Plan, consistent with the Blueprint, was silent on the tax treatment of inside build-up on life insurance. It is unclear whether President Trump continues to support taxing inside build-up on “high earners.” What is clear, however, is there is generally very broad support in Congress for not taxing inside build-up.

Beginning with Congress enacting the Revenue Act of 1913, inside build-up has never been taxed. Worthy of note is the fact that the Joint Committee on Taxation no longer includes inside build-up of life insurance products as a tax expenditure. The industry successfully lobbied to remove inside build-up from the tax expenditures list on the basis that inside build-up is not a tax expenditure. It is unclear whether removal from the expenditures list will prevent life insurance policies from being targeted again as a revenue generator in comprehensive tax reform legislation.

Administration officials are actively discussing tax reform legislation with House and Senate Republicans, as well as private sector stakeholders, and appear to be working toward more concrete positions on various key tax reform design issues. However, it remains unclear when the Administration itself will put forward its own plan, or whether it will wait to detail its positions. The Administration will become a much bigger player in the tax reform debate as White House officials solidify their positions on key issues, including a more firm and consistent view on border adjustability.
Considerations and questions for the insurance industry

Ambitious tax rate reduction is a common objective of the Blueprint, the Camp Plan and the Trump Plan. Broadening the tax base to partially or fully offset these rates cuts is also likely to be a critical and controversial component of tax reform legislation. However, Republicans differ on whether the cost of rates cuts should be fully paid for with offsetting tax increases. Both Ryan and Brady have spoken publicly about their desire to keep tax reform budget neutral, and some Administration officials have echoed this desire. However, after the health care legislation was pulled from the House floor on March 24, the tenor of this debate over budget neutrality has shifted and some policymakers have indicated that the bill could potentially not be fully offset with revenue raisers that would come from significantly curtailing tax credits, deductions and other preferences. Moreover, the Blueprint anticipates significant revenue raised through the border adjustment proposal that would allow House tax writers to make a deeper cut in the corporate tax rate than was included in the Camp Plan while dispensing with or trimming back some of the so-called tax base-broadeners that Camp utilized to pay for the rate cut. However, the border adjustment plan has become increasingly more controversial, and so it is not clear whether it can be depended on to ensure the tax bill is fully offset. The border adjustment mechanism has many opponents as well as supporters. If there are significant changes to that proposal that either carves it back or eliminates it completely, it could necessitate a search for substitute revenues. Moreover, it remains unclear which revenue raising proposals that were included in the Camp Plan will also be included in a White House plan or in the House legislation, and this will remain unclear until the House starting point is unveiled by Ways and Means Committee Chairman Kevin Brady (R-TX) later in the spring.

The legislation will likely evolve through compromise as it moves through the House to the Senate and then to the White House, and insurance companies should take time now to identify and consider those tax reform proposals that may affect their industry. Below are several insurance-specific issues to consider.

Blueprint’s move toward a cash-flow tax on business activity:

Since 1921, insurance companies have been afforded special tax treatment in the IRC. The long history of special tax treatment primarily relates to the income-first nature of the insurance business. The Tax Court Opinion rendered by Judge Dawson in Bituminous Casualty Corp. v. Commissioner concisely stated, “If the premiums were to be taxed as received and the deductions allowed only as they later became fixed, the result would be to tax very large sums of money as income when in fact those amounts will never really become income because they will have to be paid out to policyholders and other claimants.”

The Blueprint’s “move toward a cash-flow tax approach” could affect the unique insurance tax provisions within Subchapter L of the IRC. However, that move to a cash-flow approach is largely embodied in the proposals to allow for 100% expensing and the attempt to tax cross-border cash flows through the border adjustment proposal. To the extent there are changes to Subchapter L, insurance companies will need to take appropriate action — including, among other things, revising product pricing models.

Border adjustments

The Blueprint outlines a border adjustment proposal under which export sales would be exempt from tax and imported “inputs” would not be deductible. Combined with the movement toward a territorial system for taxing the earnings of foreign subsidiaries of US companies, the Blueprint seeks to transform the US tax system into a destination-based system. A critical motivation for the border adjustment proposal is to reduce the role of tax and transfer pricing in determining business location decisions. As such, it acts as an important anti-base erosion measure in conjunction with the move to a territorial system, with the intention of making US businesses largely indifferent as to whether they export from the US or sell to foreign customers through foreign subsidiaries.

From a US manufacturer’s perspective, border adjustments are relatively easily understood — that is, the gross revenue generated from exports are not taxed, while their domestic costs of goods sold would be deductible. On the import side, the costs associated with imports are not deductible. Border adjustability would also apply to services. The manner in which cross-border financial services and financial transactions,

The border adjustment mechanism is very controversial and has many opponents as well as supporters, and significant changes to that proposal that either carves it back or eliminates it completely could necessitate a search for substitute revenues.

including insurance/reinsurance contracts, would be treated under a border adjustability regime is very unclear. To the extent it is unclear whether a transaction is an import or an export, it makes the application of a border adjustment mechanism problematic.

Assuming border adjustments are included in final tax reform legislation, there are two macro-level questions facing the insurance industry:

1. Will cross-border insurance transactions be subject to border adjustments (i.e., is insurance a service or a financial instrument)?
2. Is an outbound insurance transaction considered an import or an export and conversely, is an inbound insurance/reinsurance transaction an import or export?

While there are arguments on either side of the two questions above, this publication will not attempt to provide answers to those questions. However, exploring the issues and considerations with respect to these two questions should be helpful to the insurance tax practitioner.

**Is insurance a service or financial instrument?**

To the extent insurance is deemed to be providing a service, it is likely to be included in the border adjustment regime. Conversely, if insurance is considered a financial instrument, it may be exempt from border adjustments. Neither the IRC nor the Treasury Regulations define the term “insurance” or “insurance contract.” As a result, more than 75 years of tax case law has emerged on this topic. Importantly, none of the tax case law directly opines on whether an insurance contract is a service or a financial instrument.

In recent years, several commentators noted that the boundaries between insurance and other financial instruments may not be clear. Financial innovation, investor sophistication and capital markets liquidity have all contributed to the line of demarcation being blurred at times. For example, credit protection was traditionally only available through bond insurance. That protection is now offered by counterparties of financial instruments, such as credit-linked notes, credit default swaps and credit options. The risk of a natural disaster has historically been borne by only insurance companies; now it is assumed by the holders of catastrophe, weather bonds and derivatives. Conversely, investment returns have historically only been available through conventional stocks, bonds, mutual funds and other financial instruments. Now, investment returns are readily available through whole-life and variable life insurance products, residual value, finite, retroactive and retrospectively rated insurance policies.7

So, is insurance a service or a financial instrument? The decision will ultimately need to be made by the tax writers in the House and the Senate should the border adjustment proposal prove successful in the House-Senate conference committee.

**Import view**

The import view is that the foreign insurer is providing the US cedant a service and that service is being “imported.” If this view prevails, the reinsurance premium paid to the offshore reinsurer may be disallowed, as costs associated with imports are not deductible under the House border adjustment mechanism. Whether the outbound premium paid can be netted against the ceding commission in determining taxable income is unclear.

While the import view is detrimental toward outbound reinsurance transactions, it is beneficial for inbound transactions. Simply put, if an outbound transaction is an import, then an inbound transaction is an export, and the House border adjustment mechanism favors exports. Thus, the inbound premium received by the US insurance company may not be taxable. Again, it is unclear whether the ceding commission would be netted against the nontaxable premium or if it would generate a current tax deduction.

There are a number of specific questions and issues relating to the import view, such as:

- How will claim payments be taxed?
- Is the federal excise tax under Section 4371 still applicable?
- Will the additional tax burden on outbound reinsurance transactions cause capacity or surplus issues for US companies?
- Will a ceding commission be netted against the premium to determine taxable income?
- How will global reinsurance pricing be affected?
- Would the US become a tax-favored jurisdiction to pool insurance risk?
- Will existing outbound reinsurance treaties be grandfathered from border adjustments?
- Will individual treaties need to be renegotiated to accommodate border adjustments?
- How will different forms of reinsurance (e.g., funds withheld coinsurance) be treated under the border adjustment mechanism?

Export view

The export view, in an outbound transaction, is that the insurance risk is being exported offshore, or shifted/transferred to a foreign country. This view is favorable toward outbound reinsurance transactions and detrimental for inbound transactions. As the House border adjustment mechanism favors exports, the outbound premium payment would be deductible and the ceding commission received may not be taxable. Again, it is unclear whether the ceding commission would be netted. An inbound insurance transaction under the export view would yield the inverse result such that the inbound premium received would be taxable and the ceding commission may not be deductible.

The specific questions and issues relating to the export view include the following:

- How will claim payments be taxed?
- Is the federal excise tax under Section 4371 still applicable?
- Will a ceding commission be netted against the premium to determine taxable income?
- Will existing inbound reinsurance treaties be grandfathered from border adjustments?
- Will individual treaties need to be renegotiated to accommodate border adjustments?
- How will different forms of reinsurance (e.g., funds withheld coinsurance) be treated under the border adjustment mechanism?

Rate reduction impact on insurance company investments

The US insurance industry is a major institutional investor in the $3.7 trillion municipal securities market. Property/casualty companies have traditionally invested more heavily in the municipal bond market compared to life companies due to the more favorable tax treatment in most instances.8 A significant reduction in tax rates would affect the tax-equivalent yield9 associated with municipal bonds, which could make municipal bonds a less attractive investment, causing insurance companies to rethink their investment strategies. However, a lower tax-equivalent yield will impact the value of current municipal bond holdings and may result in significant losses if municipal bonds are liquidated. In fact, municipal market prices have already declined since the November 8 elections, given the likely prospects of lower tax rates.

Camp Plan insurance tax base-broadeners

Base-broadening revenue raisers will be critical to achieving a lower 15% or 20% corporate tax rate as part of a comprehensive tax reform package, because lowering the corporate tax rate is expensive. A 1% reduction in the corporate tax rate costs approximately $110 billion over 10 years.10 The insurance industry revenue raising proposals in the Camp Plan may be used to broaden the corporate tax base for insurers to help pay for rate reduction. In all, the Camp Plan insurance tax proposals would have increased taxes on insurers by more than $76 billion over a 10-year period. Whether the Camp Plan insurance tax revenue raisers will be included in a new comprehensive tax reform bill may, in part, be contingent on the outcome of the border adjustment proposal. As previously mentioned, the Blueprint’s border adjustment mechanism may raise more than $1.2 trillion in revenues (unofficial estimate), and if it is successfully included in the final tax reform bill, the need for additional industry-specific base-broadening proposals may be reduced.

If the Camp Plan insurance tax base-broadeners are used to help pay for tax rate reduction, below are just a few of the questions that insurance companies should consider:

- Will transitional rules allow the base-broadeners to be phased in over time, as in the Camp Plan?
- Will the phase-in period for base-broadeners be consistent with the tax reduction phase-in period, if any, to minimize an immediate significant increase in taxable income?
- Will certain Camp Plan base-broadeners continue to be a viable option in conjunction with specific Blueprint proposals? For example, the Blueprint’s proposal for immediate expensing of intangible assets may not comport with the Section 848 Tax DAC changes enumerated in the Camp Plan.

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8 Property/casualty tax exempt earnings are subject to a 15% proration adjustment. A life insurance company’s tax exempt earnings are subject to proration via the policyholders’ share of a life insurance company’s income, which in many instances exceeds 15%.
9 Tax-Equivalent Yield = Tax-Free Municipal Bond Yield / (1 - Tax Rate).
10 Joint Committee on Taxation memorandum, Revenue Estimates, 27 October 2011.
Potential surplus and income statement impacts

Insurance companies should begin to model the potential surplus impacts of the Blueprint. A significant reduction in tax rates will reduce the value of net admitted deferred tax assets (DTAs), negatively impacting surplus. Depending on a company’s specific facts and contingent on what base-broadeners are included in the tax reform legislation, as well as how rate reduction is phased in, a lower statutory rate may reduce current tax expense, which could positively impact surplus relative to the current tax system. However, insurance tax practitioners need to be diligent, as back-of-the-envelope calculations may not be sufficient to adequately determine the various outcomes. We strongly urge insurance companies to build a tax reform model using various assumptions (e.g., tax rates, border adjustments, Camp Plan base-broadeners, etc.) so that management can be better informed on the potential impacts and share those findings with relevant stakeholders. The results from modeling can demonstrate how a company’s tax liability under the Blueprint could bear no resemblance to its current tax liability, particularly if border adjustments apply to cross-border insurance transactions.

The first component of the admissibility test, SSAP No. 101 paragraph 11.a., ties the hypothetical loss carryback to correspond with the IRC loss carryback provisions, not to exceed three years. The adjusted gross DTA admitted under paragraph 11.a. equals the amount of “federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years.” Under current law, ordinary losses for non-life companies can be carried back two years,11 and for life companies, ordinary losses can be carried back three years.12 Capital losses for both non-life and life companies can be carried back three years.13

Page 26 of the Blueprint states: “Net operating losses (NOLs) will be allowed to be carried forward indefinitely and will be increased by an interest factor that compensates for inflation and a real return on capital to maintain the value of amounts that are carried forward. Carrybacks of net operating losses will not be permitted and the deduction allowed with respect to an NOL carryforward in any year will be limited to 90% of the net taxable amount for such year determined without regard to the carryforward.” If tax reform legislation is enacted that precludes NOLs carrybacks, SSAP No. 101 paragraph 11.a. will be largely irrelevant.14 Because SSAP No. 101 paragraph 11.a. links the hypothetical loss carryback to the IRC carryback provisions, any tax law change to those provisions will directly affect the first component of the admissibility test. To the extent paragraph 11.a. is largely irrelevant, paragraph 11.b. in the admissibility test would take on greater importance for determining an insurance company’s net admitted DTA, and insurance companies should begin to consider what impact, if any, this would have on their net admitted DTA.15

For US GAAP purposes, insurance companies may experience a significant income statement impact due to a lower federal tax rate. Pursuant to ASC 740-10-45-15, the effects of changes in tax rates and laws on deferred tax balances are recognized in the period in which the new legislation is enacted. In the case of US federal income taxes, the enactment date is the date the bill becomes law (i.e., upon presidential signature). The total effect of tax law changes on deferred tax balances is recorded as a component of tax expense related to continuing operations for the period in which the law is enacted. To the extent an insurance company has a significant net deferred tax liability under US GAAP, a lower statutory rate will result in an income statement benefit. If an insurance company has a net DTA, a lower statutory rate will result in an income statement expense.16

The results from modeling can demonstrate how a company’s tax liability under the Blueprint could bear no resemblance to its current tax liability, particularly if border adjustments apply to cross-border insurance transactions.

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11 IRC Section 172.
12 IRC Section 810.
13 IRC Section 1212.
14 The Blueprint is silent on capital loss carrybacks. To the extent capital loss carrybacks continue to be permitted, paragraph 11.a. would not be entirely irrelevant.
15 For more information, see 15 March 2017 EY Tax Alert, “US tax reform may affect an insurance company’s surplus under SSAP No. 101.”
16 For more guidance on accounting for changes in tax laws and rates under ASC 740, please see Section B of EY’s Financial Reporting Developments, Income Taxes, revised October 2016.
Life insurance inside build-up

Both the Blueprint and Trump’s latest tax plan are silent on the treatment of inside build-up on life insurance policies. However, Trump’s first tax plan (released in 2015) proposed to “phase out the tax exemption on life insurance interest for high-income earners.” It is unclear whether President Trump continues to support taxing inside build-up on “high earners.” To the extent inside build-up is taxed on “high earners,” life insurance and annuity policyholder ownership would decrease, perhaps substantially. However, there are very strong policy reasons and very broad support in Congress for not taxing inside build-up.

Impact of territorial tax regime and Subpart F insurance rules

On the international front, moving to a territorial tax system along with a lower corporate tax rate should remove restrictions on the movement of capital by eliminating the “lock-out” effect that disincentivizes repatriation of cash to the US. It should also put US-based multinationals on more equal footing with non-US-based competitors that have not had to operate under a worldwide tax system. Nonetheless, insurance companies should begin taking into account the one-time transition tax in the taxable year before the implementation of the territorial tax system. This may require modeling the amount of earnings that will be subject to the 8.75% rate versus the 3.50% rate and the impact of tax attributes (e.g., deficits) on the earnings. As foreign tax credits will have less importance under a territorial tax system, it will also be important to consider whether any foreign tax credit carryforwards will expire, potential valuation allowances on the credits and planning to lessen the impact of any such credits expiring. Although the Blueprint would dramatically scale back the anti-deferral tax rules embodied in Subpart F, it is likely that a future Subpart F regime will still apply foreign personal holding company rules that generally tax “passive income,” including dividends and interest. Further, it is presumed that the active financing exception rules to Subpart F would be retained.

A key function of the border adjustment mechanism in the Blueprint is to act as an anti-base erosion mechanism as the United States shifts to a more territorial tax system, and a dividend exemption. If the border adjustment proposal is dropped, some other mechanism to prevent erosion of the US tax base will be necessary; otherwise, the territorial system will be scored by revenue estimators as a significant revenue loser. Policymakers may, therefore, take another look at options included in prior international tax reform proposals, including proposals to impose a minimum tax on earnings of foreign subsidiaries of US companies to the extent those earnings are taxed locally at a relatively low rate. Minimum tax proposals would thus impose US tax currently on some portion of the earnings of controlled foreign corporations with relatively low effective tax rates. Some proposals, including the proposal in the Camp Plan, only imposed the minimum tax if the earnings related to non-tangible assets, posing a risk for financial services companies that their earnings would meet this definition even though such income qualified under the active financing rules. Further, some proposals in the Camp Plan would modify sections 953(e) and 954(i) by imposing specific minimum tax thresholds on insurance income and investment income of an insurance company controlled foreign corporation.

Elimination of net interest deduction

The Blueprint denies a current deduction for net interest expense, and disallowed amounts may be carried forward indefinitely. It is unlikely that insurance companies would have net interest expense given the nature of their business and investments. However, the Blueprint states: “[T]he Committee on Ways and Means will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance and leasing, that will take into account the role of interest income and interest expense in their business models.” It is unclear what these rules may contain and thus whether the drafters of the Blueprint intended such special rules to be favorable to insurance companies or more restrictive. For example, query whether investments that generate interest income and fund deductible insurance reserves could be viewed as providing a double benefit (i.e., the investments fund deductible insurance reserves and offset interest expense such that there is no net interest expense).

Insurance companies are significant investors in the corporate bond market due to their investment-grade quality and the regular principal and interest payments can be matched against expected claim payments. Several analysts have commented that eliminating the deductibility of net interest expense could reduce the size of the US corporate bond market. If so, insurance companies may be forced to consider alternative investments to back their reserves.

Many of these insurance-specific issues are under active consideration, and the insurance industry should be actively engaged with policymakers as the legislative process moves forward in 2017. The foregoing list is a very small sample of some of the specific questions and issues arising from the various tax reform proposals. What is clear, however, is that the answer to any of these questions (as well as other discrete questions not presented) will significantly affect the insurance industry. Accordingly, professionals in the insurance industry should be mindful of the various provisions and keep a close tab on developments as the legislative process moves forward.
Insurance industry

Legislative process and potential timing in 2017

The legislative process has already begun. House Ways and Means Committee members, led by Chairman Brady, have been working behind the scenes to put the meat on the bones of the Blueprint and turn it into what eventually will be hundreds of pages of legislative text. However, the failure of the Republican health care initiative has changed the dynamics around whether this plan will be the starting point for House action on tax reform. As the Trump Administration further develops its views on various elements of reform, Congressional Republicans will have to take those views into consideration as well; it is no longer a foregone conclusion that the Blueprint will be the starting point for House action. Once a bill is put before the Ways and Means Committee, it will be open for debate and amendment by Committee members, and that amended bill, once approved by the Committee, will go to the House floor for consideration. Assuming it passes the House, the bill will be sent to the Senate. In the Senate, the Finance Committee could draft its own bill, taking what it likes from the House bill but making its own design decisions on key issues. The Senate will be less beholden to the concepts in the Blueprint and more focused on crafting a bill that can pass the Senate. That bill will have to go to the Senate floor and be passed, possibly with the inclusion of more changes. The differences between the House and Senate bills would have to be ironed out in a House-Senate conference committee; that final bill would then have to go back to the House and Senate floors to be passed before, ultimately, being signed by the President.

Given the disparate views and the need to have 60 Senate votes, rather than a simple majority of 51 votes, to move legislation of any consequence through the Senate floor, the Republicans are planning to use the budget reconciliation process to pass tax reform legislation (see Appendix B for a detailed overview of the budget reconciliation process). While the reconciliation process may be a path of lesser resistance than regular order, 51 votes are still required in the Senate in order to pass the bill (or 50 votes with Vice President Pence breaking the tie). In other words, the bill drafted by the Senate Finance Committee could focus on the design decisions and details necessary to pass the Senate with a very thin Republican majority.

Also important are the protections that come with using the budget reconciliation process, the most important of which is the necessity that the bill not add to the deficit over the long term. This could require that aspects of the legislation “sunset” after the first 10 years.

The timing of the tax legislative process will depend on numerous factors, and it is tremendously fluid. While some Republican leaders have expressed a desire to complete tax reform legislation by August, the tax legislative process could very well take much longer, particularly if Senate deliberations on tax reform legislation produce a bill significantly different than a House-passed bill. This would then require a House-Senate conference committee to negotiate a final bill that will then have to be approved by both chambers before being sent to the President for his signature. It should therefore come as no surprise that this entire process may take the better part of 2017, if not longer.

It is no longer a foregone conclusion that the Blueprint will be the starting point for House action.

Timeline of actions and activities:

1. Now
   - The Blueprint is being drafted into legislative text
     - Working with issues resolution counsel and JCT staff
     - Ways and Means is leading staff in filling in the gaps, creating legislative text that could be 1,000 pages
     - Chairman Brady works with members to make design decisions, incorporate their views
     - Stakeholder input is also incorporated

2. Vetting
   - The draft bill is further vetted behind the scenes with members
     - Creates opportunity for additional stakeholder involvement
     - Last opportunity before bill made public
     - Owners of what’s in, what’s out, will create confusion

3. Unveiling
   - Chairman Brady releases bill shortly before committee action

4. Committee action
   - Ways and Means Committee holds “markup”
     - Works with amendments, some incorporated, some not
     - Committee will agree on its own bill, as amended

5. House floor
   - House votes on Ways and Means product
     - Tax links on the House floor are usually not open for amendment

6. Senate process begins
   - Senate Finance Committee Action
     - Senate focus will be crafting a bill that can get 51 votes on the floor
       - Potential for bill to add to deficit, potentially dramatically, in the Finance Committee
       - Chairman Hatch will produce his own bill (conceptual, not legislative text)
       - Senate Finance Committee will move into markup stage
       - Amendments to both bills will be considered, floor agreed
       - Finance Committee is the starting point, but the bill will be further shaped through Senate floor amendments

7. House-senate conference committee
   - Where the final bill is written
     - Any pluses minus, Senate tax committee chairman (Sen. Ron Wyden, D-Ore.)
     - Includes, again, on bill that can get 51 votes on the Senate floor
     - Final bill likely will more closely resemble the Senate passed rather than House-passed bill

8. Bill released
   - Release of final bill – conference report

9. Approvals
   - Final Congressional approval (both to the House and Senate floors for final passage)

10. President
    - President signs bill
Conclusion

Ambitious tax rate reduction combined with broadening the tax base is the common objective of the Blueprint, the Camp Plan and the Trump Plan, but the devil is in the details and those details remain quite fluid as the Administration develops its tax reform proposals and asserts more control over the design of tax reform legislation. The legislation will certainly evolve through compromise as it moves through the House, to the Senate and then to the White House. Insurance companies should closely monitor the debate and model the potential effects of the leading tax reform proposals. Tax reform appears to be next on the legislative agenda. Companies that understand the concepts behind the Blueprint and other approaches to tax reform and that engage with policymakers now will be better positioned as the final product takes shape.
The following provides additional background for each of the insurance tax base-broadeners included in the Camp Plan, including the related Joint Committee on Taxation (JCT) revenue score assigned to each proposal over a 10-year period. Whether these insurance tax revenue raisers will be included in a new comprehensive tax reform bill may, in part, be contingent on the outcome of the border adjustment proposal.

Life insurance tax proposals

Computation of life insurance tax reserves:
Amend Section 807(c) to replace the current interest rate used to calculate life insurance reserves (i.e., the greater of the “applicable federal rate” or the prevailing state assumed rate) with an interest rate that equals the applicable federal rate, plus 3.5%. By increasing the interest rate used to calculate life insurance reserves, the proposal seeks to decrease deductible life insurance reserves to amounts deemed to better reflect economic reality. (Camp Plan, Section 3504)

> JCT revenue score: Increase of $24.5 billion over 10 years

Deferred policy acquisition costs:
Update the proxy DAC rules of Section 848 to reflect current expense ratios for insurance products. Currently, insurance companies must deduct over 10 years their expenses associated with earning a stream of premium income and calculate the expenses that are spread based on a specific percentage of net premiums received on annuity contracts (1.75%), group life insurance contracts (2.05%) and other specified insurance contracts (7.70%). This proposal would reduce the categories of insurance contracts subject to the DAC rules from three to two – namely, group contracts and all other specified contracts – and would increase the capitalization rate to 5% for group contracts and 12% for other specified contracts. (Camp Plan, Section 3512)

> JCT revenue score: Increase of $11.7 billion over 10 years

Life insurance proration of DRD:
Change the life insurance company proration rules under Section 812 to limit the DRD attributable to dividends earned by separate account assets, which generally support reserve liabilities for variable contracts, to a company share percentage that reflects the ratio of separate account assets in excess of reserve liabilities to all separate account assets. This would significantly limit the ability of a life insurance company to obtain the benefit of the DRD attributable to separate account assets. (Camp Plan, Section 3506)

> JCT revenue score: Increase of $4.5 billion over 10 years

Adjustment for change in computing reserves:
Repeal the 10-year period provided under Section 807(f) for including income or taking deductions for changes in life insurance reserves attributable to a change in the method of computing the reserve and subject those life insurance reserve changes to the accounting method change rules under section 481. (Camp Plan, Section 3505)

> JCT revenue score: Increase of $2.5 billion over 10 years

Repeal of small life insurance company deduction:
Repeal the “small life insurance company deduction” under Section 806, which provides a life insurer with assets worth less than $500 million and taxable income (determined without the small life insurance company deduction) of less than $15 million a deduction equal to 60% of the first $3 million of taxable income, reduced by 15% of taxable income exceeding $3 million. (Camp Plan, Section 3503)

> JCT revenue score: Increase of $0.3 billion over 10 years

Operations loss deductions:
Conform the operations loss deduction carryback/carryover rules for life insurance companies to the rules applicable to NOLs of non-life insurance companies, thereby reducing the carryback period available to life insurers from 3 years to 2 and increasing the available carryforward period from 15 years to 20 years. (Camp Plan, Section 3502)

> JCT revenue score: Increase of $0.3 billion over 10 years

Rule for distributions from policyholders’ surplus accounts:
Repeal Section 815, subjecting life insurers in existence before 1984 to tax on “Phase III” income, which is measured by reference to certain deemed distributions from amounts accumulated in “policyholders’ surplus accounts,” amounts that ceased accumulating after changes in the tax rules applicable to life insurers in 1984. Any remaining “Phase III” balance as of December 31, 2014, would be included in taxable income ratably over eight years beginning in 2015. (Camp Plan, Section 3507)

> JCT revenue score: Increase of $50 million over 10 years
Property/casualty insurance tax proposals

Loss reserve discounting:
Change the discount rate rules applicable to unpaid loss reserve deductions to require property/casualty companies to use Treasury’s corporate bond yield curve to determine the discount. In addition, the special rule under current law that extends loss payment pattern periods for long-tail lines of business would apply similarly to all lines of business for consistency. Lastly, the election to use company-specific, rather than industry-wide, historical loss payment patterns would be repealed. (Camp Plan, Section 3510)

- JCT revenue score: Increase of $17.9 billion over 10 years

Blue Cross and Blue Shield provisions:
Repeal the special rules in Section 833 for Blue Cross and Blue Shield (BCBS) organizations adopted when these organizations became taxable under Section 832 in 1986. These special rules provide BCBS organizations in existence in 1986 (and certain “other organizations” deemed to be operating in the same manner) with a “special deduction” equal to the amount by which 25% of losses and claims incurred, plus expenses, on insurance and “cost-plus” contracts exceeds the company’s “adjusted surplus” and excludes these organizations from the rule under Section 832 requiring current inclusion in income of 20% of unearned premiums. (Camp Plan, Section 3509)

- JCT revenue score: Increase of $4.0 billion over 10 years

Proration for property/casualty insurance companies:
Change the property/casualty proration rules to require them to reduce reserve deductions by a percentage equal to the ratio of the company’s tax-exempt assets to all of its assets. This proposal would remove the current proration rule, which requires a property/casualty insurer to reduce its loss reserve deduction by an amount equal to 15% of the sum of its tax-exempt income, its DRD and any increase in cash value of life insurance or annuity contracts owned by insurer. (Camp Plan, Section 3508)

- JCT revenue score: Increase of $2.9 billion over 10 years

Special estimated tax payments:
Repeal the elective deduction available to insurance companies under Section 847, equal to the difference between a company’s reserves computed on a discounted basis and reserves computed on an undiscounted basis. Currently, companies that make this election must make a special estimated tax payment equal to the tax benefit attributable to the deduction. (Camp Plan, Section 3511)

- JCT revenue score: Increase of less than $50 million over 10 years

Life insurance product tax proposals

COLI interest expense disallowance:
Amend Section 264(f)(4) to reduce the number of life insurance policies that qualify for the exception to the pro rata interest disallowance rule for COLI policies. Current law generally reduces business interest deductions to the extent the interest is allocable to “unborrowed” insurance policy cash values, except for policies insuring the lives of officers, directors, employees, or 20%-owners of the business. The proposal would limit this exception to policies covering 20% owners, i.e., “arrangements that are more likely to reflect business succession planning strategies,” according to an explanation released with the Camp Plan. (Camp Plan, Section 3501)

- JCT revenue score: Increase of $7.3 billion over 10 years

Various information reporting items:
Require information reporting by the acquirer of an interest in an existing life insurance contract with a death benefit of $500,000 or more. The acquirer would be required to report information disclosing the purchase price and date; the identities of the buyer, seller and issuer; and the policy number to the IRS, the seller and the issuer (although there is no requirement to report the purchase price to the issuer). Upon receiving the report (or notice of the transfer of a life insurance contract to a foreign person), the issuer of the policy would be required to report to the IRS the seller’s (or transferor’s) identification and investment in the contract and the policy number of the contract. When any policy benefits are paid to the buyer of a previously issued life insurance contract, the insurance company would be required to report the gross benefit payment, the buyer’s identity and the insurance company’s estimate of the buyer’s basis to the IRS and the payee. The proposal would retroactively repeal the ruling of the IRS in Revenue Ruling 2009-13 that the seller’s investment in the contract must be reduced by the cost of insurance levied against policy values. Finally, the proposal provides that the exceptions to the transfer for value rules under Section 101(a) do not apply to a reportable policy sale, which means that some or all of the death benefits could be includible in taxable income. (Camp Plan, Sections 3513–3515)

- JCT revenue score: Increase of $0.2 billion over 10 years

Total JCT revenue scores:
Increase of $76.2 billion over 10 years
Appendix B: Budget reconciliation overview

The Republicans intend to pass a FY 2018 budget resolution later this year so that tax reform legislation can advance under budget reconciliation. In fact, Speaker Ryan has stated several times that budget reconciliation will be the legislative vehicle for enacting tax reform. Therefore, understanding the budget reconciliation process, and related “Byrd rules,” will be useful.

Budget reconciliation process

The Republican majority will have two basic process options on moving comprehensive tax reform legislation: (1) obtain sufficient votes to move a bill under regular order and attempt to invoke cloture\(^{18}\) to cut off unlimited debate; or (2) utilize the budget reconciliation process. Both options will present substantial challenges. The key question is whether comprehensive tax reform will be a bipartisan effort, as it is unlikely enough Democrats will be willing to support comprehensive tax reform that includes reducing taxes for higher income taxpayers.

Regular order requires a vote of 60 Senators to invoke cloture and cut off unlimited debate. In contrast, a budget reconciliation bill provides for time limits on debate and requires only a simple majority vote for passage in the Senate. While on its face, this would appear to be an attractive approach for Senate Republicans to follow, reconciliation’s procedural advantages come with tight restrictions on the specific policy changes that can be considered using the reconciliation process. The following summarizes the components of the budget reconciliation process, including key constraints, as it most likely will significantly influence the manner in which comprehensive tax reform is enacted.

Regular order – unlimited debate and amendments

When legislation is considered in the Senate under the normal process, known as “regular order,” Senate rules favor protecting the debate and amendment rights of individual Senators. Absent an agreement by all Senators (known as a “unanimous consent agreement”) to expedite the process, bills considered under regular order are subject to unlimited debate and amendments, and members can offer non-germane amendments. Any individual Senator or group of Senators can delay a vote on final passage of a bill by threatening a filibuster – i.e., prolonging the debate by continually speaking or offering multiple amendments.

Senate Majority Leader McConnell has the ability to shut off unlimited debate and place a hard limit on amendments by “invoking cloture,” which leads to a procedural vote requiring 60 votes for passage. Thus, bills considered in the Senate under regular order generally need 60 votes in order to move to a vote to final passage.

Budget reconciliation – expedited procedures and simple majority vote

Reconciliation is a congressional term given to the relevant provisions in the Congressional Budget Act of 1974, the legislation that instituted a formal detailed procedure used by Congress to produce the federal government’s budget for the coming fiscal year.

The annual budget process begins with the development of a budget resolution that serves as a “blueprint” of tax and spending targets for the federal government for the upcoming fiscal year and beyond. The budget resolution may provide for use of the reconciliation process, under which one or more committees are given instructions to report out bills that change spending levels on programs under their jurisdiction or, in the case of the tax-writing committees, make changes to federal revenues. Committees may also be instructed to produce a particular amount of deficit reduction (allowing the tax-writing Committees to include a combination of tax and spending provisions) or to increase the debt limit by a particular amount. The reconciliation instructions cannot constrain how the Committees meet their instructions; however, budget resolutions often include language describing which programs and policies Congress intends for the Committees to address in order to meet their instructions. These individual bills are then sent to the respective Budget Committees in each chamber, where they are combined into one overall budget reconciliation bill.

In the Senate, the time for debate and voting on a reconciliation bill is limited to 20 hours and amendments must be germane. Most important from a legislative strategy perspective is the fact that reconciliation bills require only a simple majority vote in the Senate for passage. However, these procedural benefits also come with significant procedural limitations.

\(^{18}\) Cloture is the way to stop a filibuster. Under the cloture rule, debate can be brought to a close with the affirmative vote of a supermajority, three-fifths (or 60 votes), of the Senate.
The “Byrd rule”

The procedural protections given to a reconciliation bill are designed to bolster the chances of passing legislation to achieve the budgetary targets outlined in the budget resolution – which has the added benefit of making it easier to achieve the politically difficult goal of reducing the federal deficit by either cutting spending or raising taxes or a combination of the two. In order to prevent abuse of the reconciliation process, the Senate added certain tests designed to prevent the Senate from considering “extraneous” provisions as part of a budget reconciliation bill or conference report that have little or no fiscal impact – for example, trying to impose a ban on handguns as part of a reconciliation bill. These six tests, collectively known as the “Byrd rule,” are named for their author, former Senator Robert C. Byrd (D-WV). The Byrd rule prevents reconciliation bills from being used as the vehicle for carrying controversial policy changes that have little or no budget impact.

Specifically, the Byrd rule would label any provision as extraneous to the reconciliation bill that:

- Does not produce a change in outlays or revenues
- Produces a change in outlays or revenues that are merely incidental to the non-budgetary components of the provision
- Is outside the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure
- Increases outlays or decreases revenues if the provision’s title, as a whole, fails to achieve the Senate reporting committee’s reconciliation instructions
- Increases net outlays or decreases revenues during a fiscal year after the years covered by the reconciliation bill unless the provision’s title, as a whole, remains budget neutral
- Contains recommendations regarding the OASDI (Social Security) trust funds

Under the reconciliation process, a point of order lies against any provision that violates the Byrd rule. If a point of order is raised and sustained by the Chair, the provision is stricken from the bill. The Senate parliamentarian makes the final determination of which provisions violate the Byrd rule. The point of order can only be waived by an affirmative vote of three-fifths (60) of the Senate.

This listing shows that four of the last five US presidents enacted legislation containing significant tax changes within a year of taking office. Interestingly, three of those bills used budget reconciliation as the vehicle to pass legislation in the Senate.

<table>
<thead>
<tr>
<th>President</th>
<th>Action Taken</th>
<th>Enacted Date</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>George W. Bush</td>
<td>Economic Growth and Tax Relief Reconciliation Act of 2001</td>
<td>7 June 2001</td>
<td>The “Bush tax cuts” reduced individual rates, estate tax</td>
</tr>
<tr>
<td>Bill Clinton</td>
<td>Omnibus Budget Reconciliation Act of 1993</td>
<td>10 August 1993</td>
<td>Increased individual, corporate taxes</td>
</tr>
<tr>
<td>George H. W. Bush</td>
<td>Omnibus Budget Reconciliation Act of 1990</td>
<td>5 November 1990</td>
<td>Increased individual taxes despite “no new tax” pledge</td>
</tr>
</tbody>
</table>
The major complication that the Byrd rule poses for comprehensive tax reform is the fact that a reconciliation bill cannot increase the federal budget deficit during “a fiscal year after the years covered by the reconciliation bill unless the provision’s title, as a whole, remains budget neutral.” It is widely expected that Congress will pass a FY 2018 budget resolution that provides for a tax reform reconciliation bill to cover the 10-year budget period from 2018 to 2027. This means that, unless tax reform as whole remains budget-neutral, the net effect of the bill’s provisions cannot result in an increase in the federal budget deficit after FY 2027. The Byrd rule, therefore, could play a vital role in determining to what extent tax rates are reduced and what items are included as base-broadeners and what remains in the final bill should the Republican majority decide to employ reconciliation procedures for consideration of tax reform legislation. Alternatively, the Republican majority may choose to sunset key provisions of the tax reform bill at the end of the ten-year window in order to stay in compliance with the Byrd rule – a tactic that was used in 2001 for the Economic Growth and Tax Relief Reconciliation Act (also known as the “Bush tax cuts.”)

Lastly, there may be certain sections of the bill that play an important part in the overall tax reform plan. However, if they do not comport with the Byrd rule, these sections could be summarily dropped from the bill unless supporters can achieve the 60 votes necessary to waive the rule. For example, proposed changes to the IRS under the Blueprint may not comport with the Byrd rule.

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ED None

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