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NAVIGATING BEAT FOR INSURANCE COMPANIES

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June 3, 2019

Agenda

At the end of the session, participants will be able to:

- Gain an understanding of the U.S. international tax reform items impacting the insurance industry.
- Demonstrate a working knowledge of what is included in the proposed regulations under section 59A.
- Gain an awareness of the open issues which have not been fully addressed in the section 59A guidance provided by the proposed regulations.

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Overview – U.S. International Tax Reform Impact

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U.S. International Tax Reform Impact

General Overview - Inbound

Items	Notes & Observations
Base Erosion Anti-Abuse Tax ("BEAT")	• Subjects companies to a minimum tax for certain cross-border payments made to related foreign persons that give rise to deductions. ▪ Base erosion payments explicitly includes reinsurance payments taken into account under section 803(a)(1)(B) or 832(b)(4)(A) ▪ Netting is not allowed for payments. ▪ Exclusion for Services Cost Method (SCM) costs. Only the "mark-up" component subject to BEAT. • 5% tax 2018, 10% tax 2019-2025, 12.5% tax 2026 and forward (1% increased tax rate if bank or registered securities dealer in group) • BEAT puts pressure on U.S. / non U.S. affiliated reinsurance. Unaffiliated offshore reinsurance not subject to BEAT. • Interaction between BEAT, GILTI and section 163(j) tax rules
Section 267A: Rules Regarding Certain Hybrid Arrangements	• Section 267A denies certain interest or royalty deductions involving hybrid transactions or hybrid entities. • Entities and transactions subject to the proposed section 267A regulations, include hybrid transactions, disregarded payments, branch mismatch payments and imported mismatches • Interaction between section 267A, subpart F, and GILTI tax rules
Section 163(j): Business Interest Deduction Limitation	• Deduction for business interest is limited to the sum of: (1) 30% of the adjusted taxable income (ATI) of the taxpayer, (2) business interest income (BIII), (3) floor plan financing interest (FPFI) of the taxpayer for the taxable year • Disallowed interest is carried forward indefinitely • Applies at the taxpayer level and in the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated group level. • Excess business interest expense (EBIE) allocated from a partnership to corporate partner can only be absorbed in subsequent years if excess taxable income (ETI) or excess business interest income (EBII) is allocated to partner from the same partnership

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U.S. International Tax Reform Impact

General Overview - Outbound

Items	Notes & Observations
Transition Tax	• One time transition tax on unrepatriated foreign E&P at reduced rates, with ability to pay in installments.
Global Intangible Low Taxed Income (“GILTI”)	• A new category called GILTI income includes in U.S. taxable income the low-taxed income of a CFC that is not otherwise subpart F income which exceeds a “routine” (10%) return on the U.S. tax basis in a CFC’s depreciable tangible assets. • Corporate US shareholder generally allowed a section 250 deduction for 50% of the GILTI inclusion
Foreign tax credits (“FTCs”)	• Foreign tax credits may reduce or eliminate tax on subpart F income, GILTI (subject to limitation). • New expense allocation and apportionment guidance under Proposed §§1.861-8 through 1.861-13 and 1.861-17. • Additional baskets to build out and additional analysis sourcing and characterizing income in light of the modifications to the look-through rules
Controlled Foreign Corporations (“CFCs”)	• Foreign insurance income (other than same country) and other passive subpart F income taxed at 21% under CFC rules • Expanded CFC attribution rules cause many more foreign companies to be treated as CFCs. ▪ Unexpected CFC inclusions for U.S. 10% shareholders.
Passive Foreign Investment Company (“PFIC”)	• Foreign insurers more likely to be PFICs. ▪ Changes to active insurance business exception to PFIC rules require foreign insurance companies to have insurance liabilities that constitute more than 25% of its total assets (as determined per annual filings with insurance regulators) ▪ Applicable insurance liabilities do not include unearned premiums, putting pressure on foreign P&C companies with volatile claims patterns.

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U.S. International Tax Reform Impact

General Overview - Other

Items	Notes & Observations
Other International Taxation	• Move to worldwide hybrid minimum tax system earnings of foreign subsidiaries generally subject to current U.S. tax, but at reduced rates. • Limited categories of non taxed income, including high taxed CFC income, deemed annual 10% return on tangible property used in a business. • 100% dividends received deduction for U.S. corporations on dividends (including 1248 deemed dividends) from any 10% owned foreign corporation. • FDII is a new type of income category for US corporations for taxable years beginning after 12/31/2017
Foreign Account Tax Compliance Act ("FATCA")	• No FATCA withholding on insurance premiums, unless the insurance contract is cash-value insurance, ▪ This generally means insurance (other than indemnity reinsurance or certain term life policies) under which the holder has the right to terminate the policy and receive more than $50,000. ○ Withholding on premium payments had generally been deferred under the final regulations until 2017 for so-called offshore obligations (but was required beginning in 2017). ▪ Eliminates the administrative burden associated with the FATCA documentation
Haircut to U.S. Insurance Company Benefits	• 92.81% haircut on NAIC reserves. Changes to tax DAC, dividends received deduction. • NOL carrybacks eliminated for life companies (but not P&C). • NOL deduction limited to 80% of taxable income for life and C-Corp. companies, but no limitation for P&C companies. • P&C deductions also modified.

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U.S. International Tax Reform Impact

General Overview - Other

Items	Notes & Observations
Overall M&A Impact	• Enactment of TCJA lifted cloud of uncertainty that affected deal-making before tax reform. ▪ Initial wave of IRS guidance has arrived, but much more to come. • Increased availability of offshore earnings (after paying one-time transition tax) and ongoing after-tax earnings could be a source of M&A funding. • 21% corporate tax rate substantially improves after-tax earnings, but what of repricing? • Reduced tax headwinds for U.S. companies to acquire foreign targets – improved after-tax access to foreign earnings. • 30% of EBITDA limitation on interest deductibility (30% of EBIT after 2021) may limit tax efficiency of leveraged acquisitions. • Immediate expensing of acquired depreciable tangible property. • NOL utilization limited to 80% of income (4% “minimum tax”).

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U.S. International Regulatory Update

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U.S. International Regulatory Update

Guidance	Issued		To Be Issued
REG-104390-18	Section 951A - Global Intangible Low-Taxed Income ("GILTI")	9/13/18	Final Regulations - TBD
REG-106089-18	Section 163(j) - Limitation on Deduction for Business Interest Expense	11/26/18	Final Regulations - TBD
REG-105600-18	Foreign Tax Credit ("FTC")	11/28/18	Final Regulations - TBD
REG-104259-18	Section 59A - Base Erosion and Anti-Abuse Tax ("BEAT")	12/13/18	Final Regulations - TBD
REG-132881-17	Regulations Reducing Burden Under FATCA and Chapter 3	12/13/18	Final Regulations - TBD
REG-104352-18	Sections 245A/267A - Rules Regarding Certain Hybrid Arrangements	12/28/18	Final Regulations - TBD
TBD	Passive Foreign Investment Company ("PFIC")	TBD	Proposed Regulations - TBD
TD 9846	Final Section 965 Regulations – Transition Tax	1/15/19	N/A
REG-104464-18	Section 250 Deduction for FDII and GILTI	3/6/19	Final Regulations – TBD
TD 9857	Final Section 987 Regulations – Recognition & Deferral of Gain/Loss	5/13/19	N/A

Please visit the IRS website for additional regulatory updates at the following link: https://www.irs.gov/newsroom/tax-reform-guidance

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Base Erosion Anti-Abuse Tax (“BEAT”)

Section 59A

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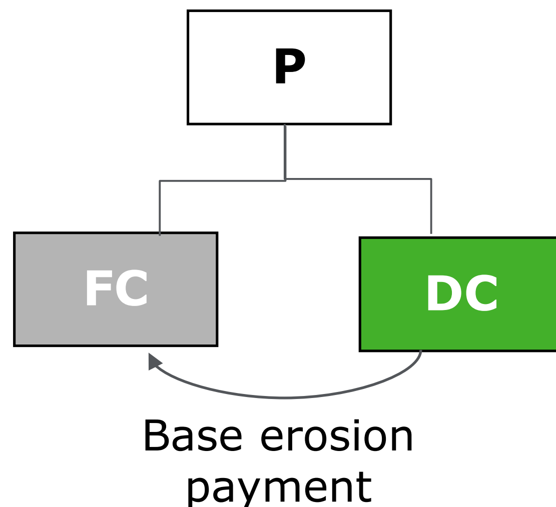
BEAT Overview



- Subjects companies to a minimum tax for certain cross-border payments made to related foreign persons that give rise to deductions.

- 5% tax 2018, 10% tax 2019-2025, 12.5% tax 2026 and forward (1% increased tax rate if bank or registered securities dealer in group)

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§59A Basic Framework

- "**Applicable taxpayer**" is taxpayer that satisfies 3 requirements:

(A) Corporation other than REIT, RIC, or S corp.

(B) **Gross Receipts Test**: Average annual gross receipts at least $500 million for the previous 3 tax years (taking into account foreign person's gross receipts only to the extent taken into account in determining ECI)

(C) **Base Erosion Percentage Test**: BE% for the tax year at least 3%, or 2% in the case of member of affiliated group that includes bank or registered securities dealer

- **Aggregation Rule**: persons treated as a ***single employer under §52(a)*** are treated as 1 person for purposes of:
    - BE% and BE% test
    - gross receipts test

- **Base Erosion Minimum Tax ("BEMTA"):** If DC is an **applicable taxpayer**, DC owes **BEAT** = **the excess, if any, of**
    - BEAT rate × **modified taxable income** (MTI) **over**
    - Regular tax liability
        - reduced by excess, if any, of
            - Tax credits allowed against regular tax liability over
            - Zero, or in tax years beginning before 2026, the sum of—

                (I) §41(a) research credit, and

                (II) portion of "applicable §38 credits" not > 80% of lesser of "applicable §38 credits" or BEAT determined without (II)

The BEAT Calculation

A Determine if taxpayer is Applicable Taxpayer

Step 1: Determine taxpayer's **aggregate group**
Step 2: Determine group's **gross receipts**
Step 3: Determine group's **base erosion percentage**
Step 4: If Applicable Taxpayer, perform the following calculation:

B Determine BEPs and related benefit

C Calculate MTI

Calculate BEMTA D

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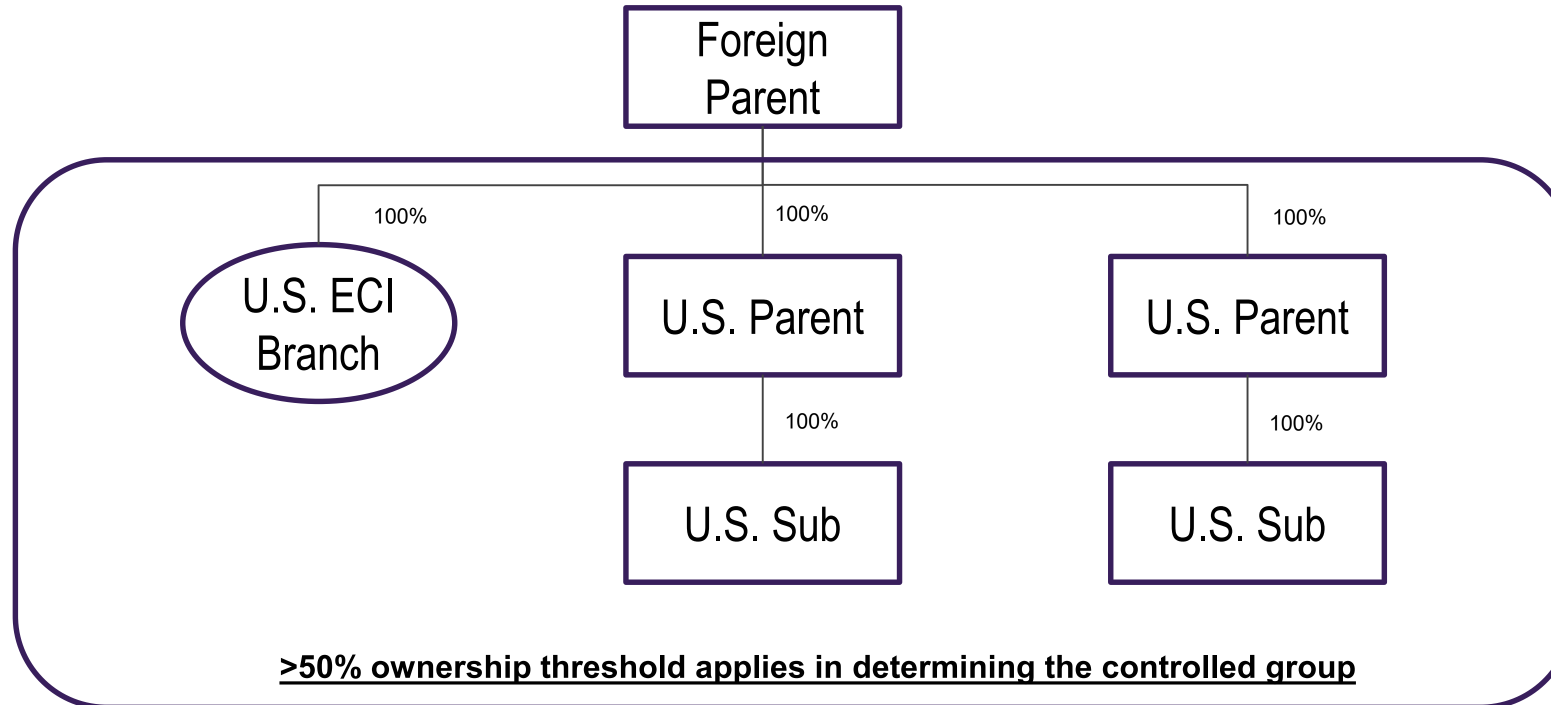
Aggregation Rule



- To determine whether BEAT is applicable, the aggregation rule is used for the BE% test and gross receipts test where all persons are treated as a single employer under §52(a), excluding foreign corporations except with regard to ECI (unless not included in treaty net taxable income)
- Generally, transactions between aggregate group members are not taken into account
- If aggregate group member is a foreign corporation, transactions related to ECI or computation of net taxable income under a treaty are disregarded
- *Once you determine whether BEAT is applicable, then each taxpayer computes BEAT on an individual basis

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Applicable Taxpayer

Base Erosion Percentage Test

Base Erosion Percentage = Aggregate amount of base erosion tax benefits (BETBs) / [Aggregate amount of *allowable* deductions (including BETBs) + other BETBs that are not deductions - Deductions *allowed* under §§ 172, 245A, or 250 - Any deduction that qualifies for the SCM exception in §59A(d)(5) or the qualified derivative exception in §59A(h)]

Notable denominator inclusions

- §965(c) deduction
- "Plus" portion of payments eligible for SCM exception
- Net deduction with respect to each marked-to-market position that is not a qualified derivative payment under §59A(h)

Notable denominator exclusions

- Exchange losses on §988 transactions
- "Cost" portion of payments eligible for SCM exception
- Deductions excluded from numerator with respect to TLAC securities
- Deductions not allowed
- Deductions for transactions between members of the aggregate group

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Base Erosion Payments ("BEPs")

- Base erosion tax benefits are generally the deductions or reductions in gross income that result from base erosion payments. Base Erosion Payments include:

  - Any amount **paid or accrued** to a foreign person which is a related party

  - Any amount related to depreciation or amortization of amounts paid or accrued to a foreign related party for the acquisition of property subject to depreciation or amortization

  - Reinsurance payments taken into account under Secs. 803(a)(1)(B) or 832(b)(4)(A)

  - Amounts paid to Surrogate Foreign Corporations that became Surrogate Foreign Corps after Nov. 9, 2017 that are considered payments to reduce Gross Receipts (e.g. COGS)

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Base Erosion Payments ("BEPs")

- A loss recognized on the **transfer of property from a taxpayer to a foreign related party** is considered to be a BEP

- Amounts equivalent to deductible payments used in computing the **business profits of a permanent establishment ("PE")** resulting from treaty-based expense allocation between a home office and PE ("internal dealings") or other foreign branches may be treated as BEP.

- Deductions properly allocable to a **U.S. trade or business with ECI** are BEPs to the extent that they were paid or accrued to a foreign related party
    - The regulations trace each item of deduction to determine whether it arises as a result of a payment to a foreign related party

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BEPs - Exceptions

- Section 59(d)(5) provides that a BEP does not include amounts paid for services eligible for the services cost method ("SCM") under section 482
    - The proposed regulations make a key clarification that the services cost method exception is available if there is a markup, but that the portion of any payment that exceeds the total cost of services is not eligible for the exception and is a BEP
    - Adequate books and records most be maintained by the taxpayer to permit verification of the amount charged out for the services and the computation of the mark-up (if any) paid
- Amounts that are subject to tax as income effectively connected with a U.S. trade or business (in the hands of the recipient) are not BEPs
- Other exceptions exist for example: interest paid or accrued on TLAC securities, and qualified derivative payments

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BEPS - Tax-Free Transactions/Non-Cash Payments

- The proposed regulations clarify that a payment by a taxpayer to a foreign related party may be a BEP regardless of whether consideration is in the form of cash or non-cash items

- This may include a non-cash payment to a related party in a transaction that also qualifies under a non-recognition provision under sections 351, 332, or 368

  - Specific exceptions for these types of transactions **DO NOT** exist

- Therefore, the acquisition of property in a carryover basis transaction (i.e. a reorganization) will carry with it the consequence of BEP status for the resulting depreciation or amortization amounts.

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Partnership Rules

- Partnerships are not included in the definition of an "applicable taxpayer"
- The proposed regulations generally apply an aggregate approach when determining gross receipts for evaluating whether a corporation is an applicable taxpayer, and also when addressing the treatment of payments made by a partnership or received by a partnership
- Amounts paid or accrued by the partnership are treated as paid by each partner to the extent allocable to the partner under section 704
    - Amounts paid to or accrued to a partnership are treated as received by the partner to the extent allocable under section 704
- A de minimis exception applies to partners with small ownership interests

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BEAT Proposed Regulations

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BEAT Proposed Regulations

- On Dec. 13, the IRS released proposed regulations (REG-104259-18) resolving many threshold questions surrounding the BEAT regime brought about by the Tax Cuts and Jobs Act (TCJA)
- The package contains nearly 200 pages of regulations and preamble
- The proposed regulations apply to taxable years beginning after December 31, 2017 (however, if not finalized by June 22, the IRS generally expects the regulations to be effective for tax years ending on or after December 17, 2018)
- In light of the retroactive effective date, taxpayers should carefully assess how the proposed regulations impact their specific tax circumstances.
- The proposed regulations were released under Sections 59A, 383, 1502, 6038A, 6038C, and 6655

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Initial Takeaways

The proposed regulations provide critical guidance in a number of areas, and resolved a number of issues favorable for taxpayers. Notable aspects of the proposed regulations include:

- An exception from the definition of BEP for amounts that are subject to tax as income effectively connected with the conduct of a U.S. trade or business

- Favorable transition rules addressing BEPs and net operating losses (NOLs) originating before the effective date

- Clarification that the services cost method exception is available if there is a markup, but that the portion of any payment that exceeds the cost of services is not eligible for the exception and is a BEP

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Insurance Takeaways

Other notable aspects of the proposed regulations are:

- Absence of a so-called “netting” exception for taxpayers hoping to offset corresponding income items against BEPs for BEAT purposes. The IRS has requested comments addressing whether for purposes of determining whether netting should apply, a distinction should be made between reinsurance and non-reinsurance contracts.

- The IRS has requested comments on the appropriate treatment of payments of claims from a domestic reinsurance company to a foreign insurance company.

- Registered dealer de minimis exception: dealer gross revenue < 2% of US aggregate group gross revenue
  - How may this apply in the context of a corporate partner that owns a disregarded dealer?

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Insurance Takeaways (cont.)

- 953(d) companies are treated as U.S. corporations under BEAT
- Gross Receipts Test - No reduction in gross receipts for reinsurance premiums paid or accrued by an insurance company.
- Qualified Derivative Payments (QDPs) do not include insurance contracts for the special rule under § 59A(h).
- De Minimis Exception - The higher rate is applied to any member of an aggregate group, including an insurance company, that has a bank or registered securities dealer that is a member of the affiliated group, but would exclude all the members of an aggregate group or affiliated group if the gross receipts of the bank or dealer are less than 2% of the group's receipts.
- Life versus Nonlife company treatment for base erosion benefits

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BEAT – Planning and Scenario Modeling

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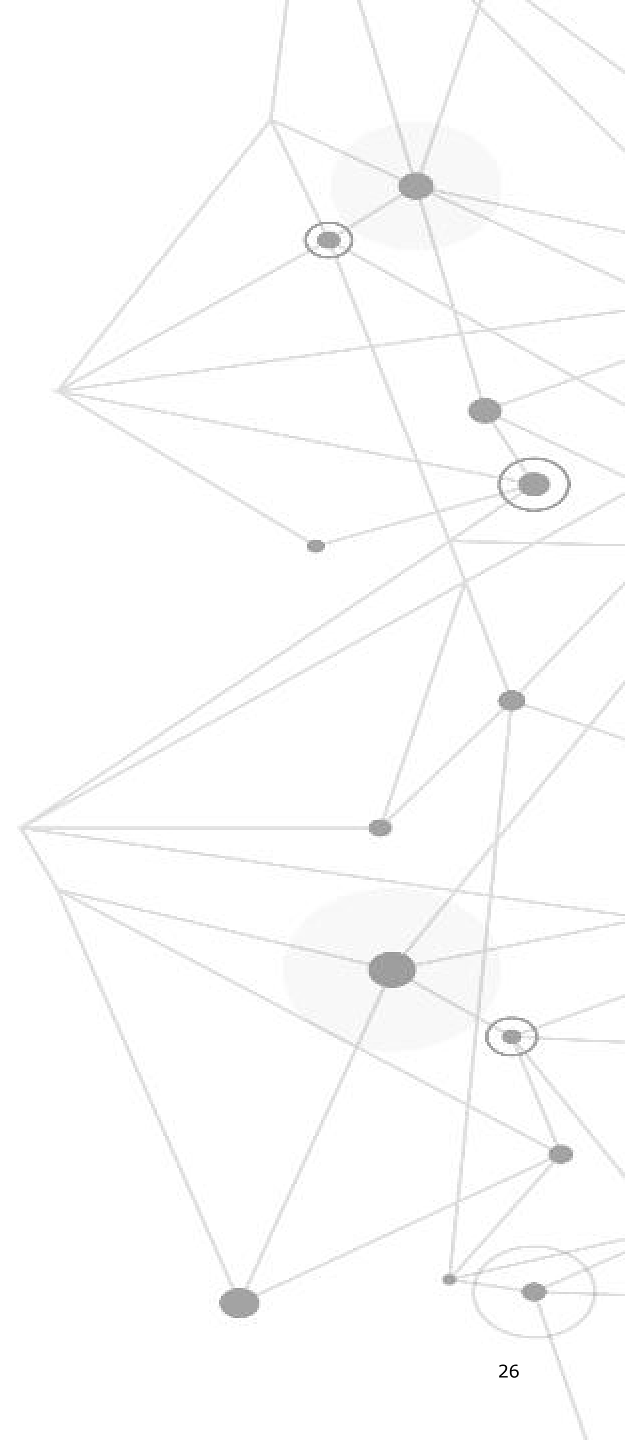
BEAT Planning and Modeling

Potential Planning:

- Move from quota share to XOL
- Use of US Branch of foreign insurer
- Use of IRC 953(d) election
- BEP% denominator diligence
- BEP% can be reduced in the following ways:
  - Reducing the total aggregate base erosion tax benefits in the numerator; and
  - Increasing the number of allowable deductions in the denominator

Modeling:

- Scenario modeling is critical with data quality at a sufficient granularity to update quickly
  - For example:
    - forecasts in early 2019 could reflect sufficient regular tax > BEAT tax
    - Q32019 heavy catastrophes occur so now regular tax < BEAT tax
      - Or now expecting 2019 NOL – opportunity to INCREASE base erosion payments?
      - But what about capital/surplus considerations?
- Foreign tax credit utilization given not creditable for BEAT



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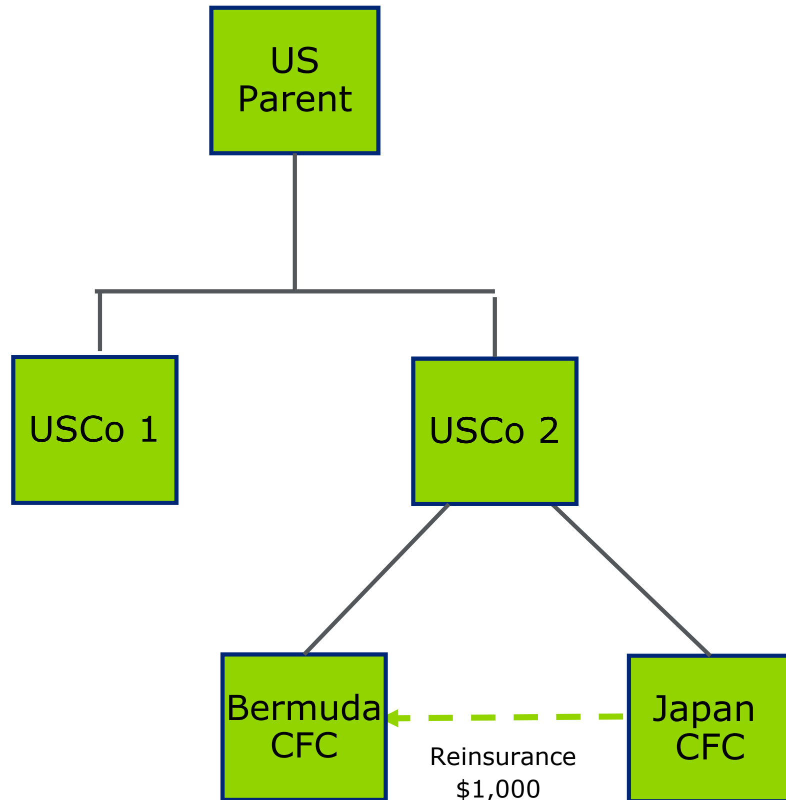
BEAT Planning:

Foreign to Foreign Reinsurance



BEAT

- There are other reinsurance opportunities to consider when dealing with CFCs located in countries paying high-tax (more than U.S. @21%).
- **US Parent** has a direct ownership interest in **USCo 1** and **USCo 2,** which has a direct ownership interest in **Japan CFC** and **Bermuda CFC.**
- **Japan CFC** would reinsure its risks to **Bermuda CFC,** a related foreign reinsurance company located in a different jurisdiction.
  - Japan currently has a blended corporate income tax rate of about 31%. Bermuda currently has no corporate income tax.
  - BEAT would not apply as no payments made from US to foreign related party.
  - **Japan CFC** would still be subject to subpart F income, but would receive a tax rates benefit of about 10% (Japan @31% v. US @21%)

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BEAT – Unanswered Questions

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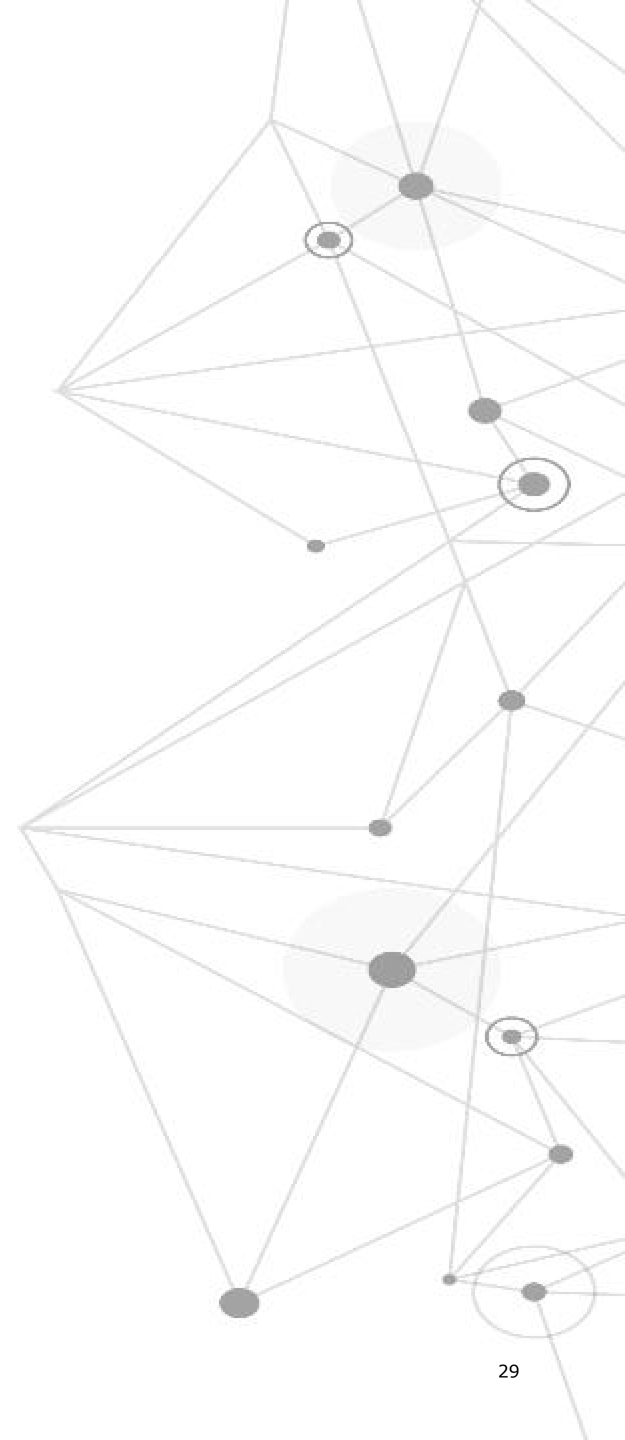
BEAT Unanswered Questions

- Claims Payments
- Ceding Commissions
- Netting/ModCo
- Treatment of NOLs
- Whether life and nonlife insurance companies should or should not be treated the same when it comes to reinsuring foreign risk
- OECD/BEPS response to BEAT



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Q&A

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Presenter Bio

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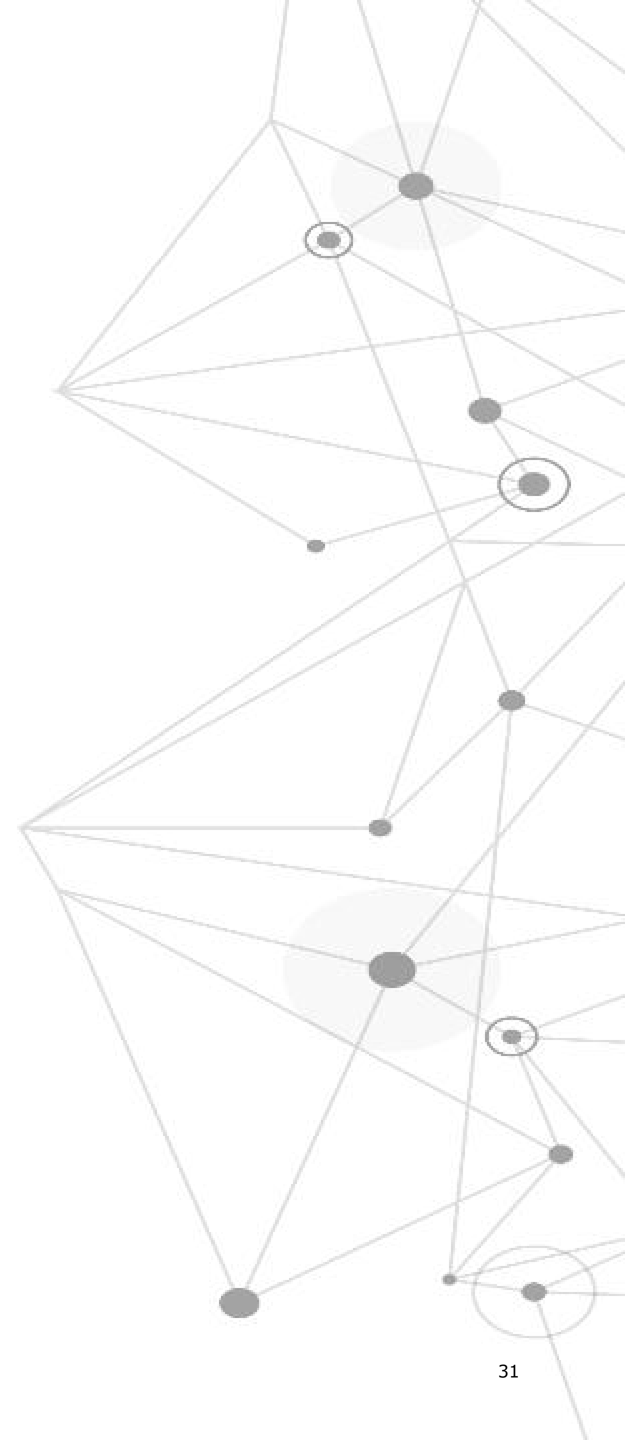
Jason is a principal in the international tax group. He acts as a trusted tax advisor to financial institutions clients in the insurance, reinsurance, investment fund, asset management and banking sectors.

His work frequently involves international tax planning and advice relating to inbound and outbound investment structures and business transactions.

Prior to joining Deloitte Tax LLP, Jason was a tax partner at Hogan Lovells US LLP.



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Appendix

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BEAT General Example

Base Erosion Tax Benefits Payments:

1) Reinsurance Payment to related non-US Reinsurance Company
2) Ceding Commission to Related Party CFC
3) Losses/Claims paid on related claims (to CFC or related party)
4) Overhead Allocation

Regular Taxable Income		
Gross Premiums Written 3rd party	1,000	Represent 2 year contract
Gross Premiums Written Related Party	200	
Reinsurance to related party	-500	50% Quota Share
Reinsurance to third party	-100	
Net Premiums Written	600	
Change in provision for gross unearned premiums	240	
Earned Premiums-For Tax	360	Net premiums less unearned premiums
Direct Losses Paid	-100	
Related Losses Paid	-50	
Ceded Losses Paid	50	
Net Losses Paid	-100	
Overhead to Foreign Parent	-100	
Ceding Commission Income	50	
Ceding Commission Expense	-40	
Taxable Income	170	Premiums + Ceding Commision
US Tax-Regular Tax Liability	35.7	Tax at 21%
Foreign Tax Credits	-5	
R&E	-10	
Section 38 Credits	-10	
Total Regular Tax	10.7	

Modified Taxable Income	
Taxable Income	170
Base Erosion Tax Benefits with Respect to Base Erosion Payments	
Reinsurance payment to related party	500
Related Party Claims Paid	50
Related Party Ceding Commision Expense	40
OH Allocation Markup	100
Total Base Erosion Payments	690
Modified Taxable Income (MTI)	860
MTI Rate	10%
MTI * MTI Rate (§59A(b)(1)(A))	86
Regular Tax Liability	35.7
Allowable Chapter 1 Credits	25
§41 Research Credit	10
Applicable §38 Credit	10
BEMTA Determined Without Regard to §38 Credits	25.7
80% of Applicable §38 Credit or BEMTA under §59A(b)(1)(B)(ii)(I)	8
Excess of Allowable Credits over Sum of §41 and §38 Credits	7
Regular Tax Liability Reduced by the Excess	28.7
Base Erosion Minimum Tax Amount (Excess of MTI over RTL)	57.3

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