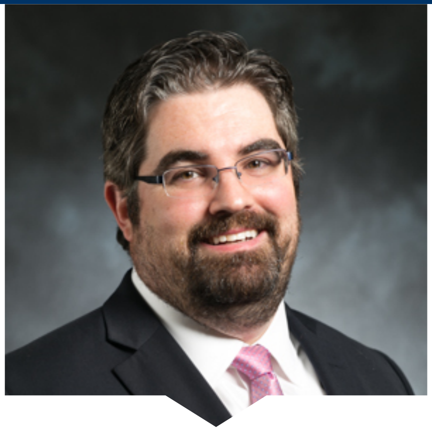
TAX REFORM AND ITS IMPACT ON CAPTIVE INSURANCE INDUSTRY

WHAT YOU NEED TO KNOW – CHANGES & IMPACT

MAZARS

TODAY'S PRESENTERS

Anthony "AJ" STRANIX



Partner - Insurance Audit

Anthony has over 15 years of experience providing audit, accounting, internal audit, and due diligence services. He has performed audits and accounting services for various insurance and reinsurance companies and captives in accordance with statutory, GAAP, and IFRS both domestically and internationally. He has also conducted audits of financial services companies and employee benefit plans.

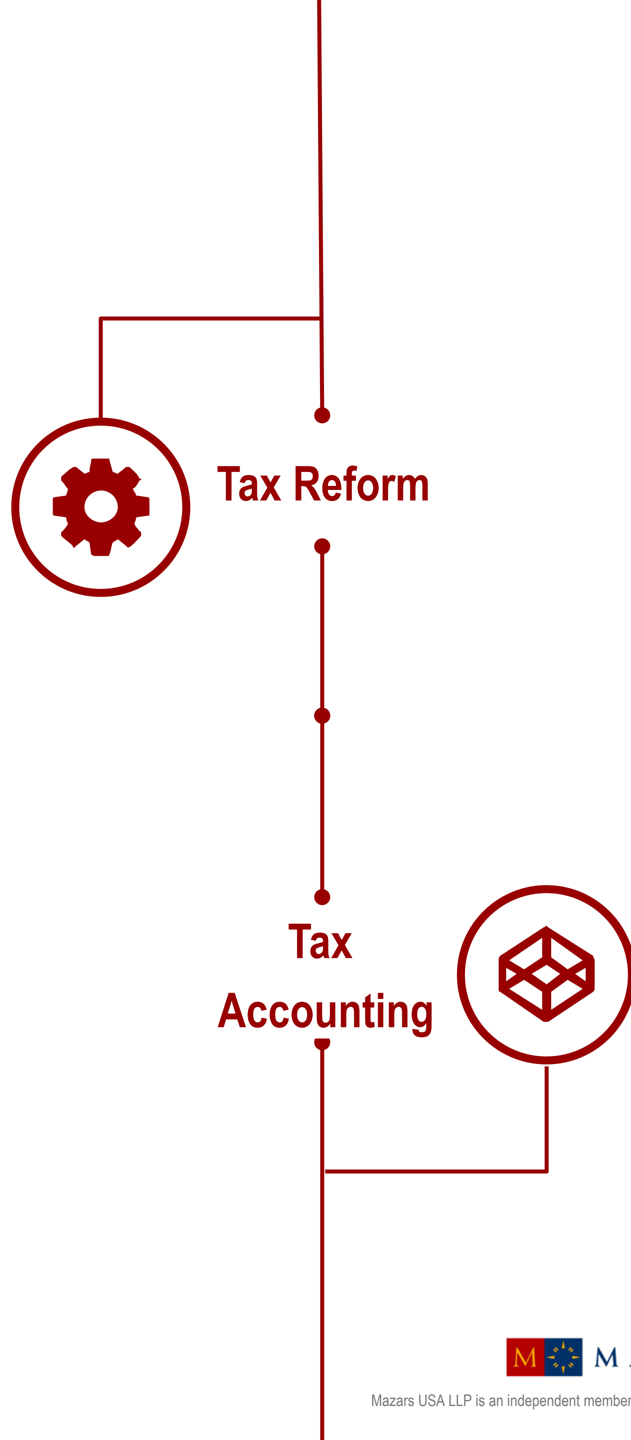
Steven Greene

Director – Insurance Tax

Steve has more than 25 years of federal and foreign insurance tax experience, including property and casualty, life, health, mortgage, financial guaranty, captive and title insurance companies.

TODAY'S AGENDA

1. Current Captive Landscape
2. Tax Cuts and Jobs Act – Tax reform act overview
3. Domestic impact
4. International impact
5. GAAP and Statutory Tax accounting
6. Parting thoughts



Current Captive Landscape

LANDSCAPE

- DE ranked #3 in US*
- Positive growth for US captives in 2017
- Over 3,000 active US captives in 30 states*
- 4th Consecutive year captives make the IRS “Dirty Dozen List”
- IRS victory in Avrahami Aug 2017
- Tax uncertainties and changes for all industries/businesses
- Industry disruption; technology, mergers, etc…

* Source – Business Insurance

CAPTIVE BENEFITS

- Improved Risk Management
- Reduction in Commercial Insurance Costs
- Supplement to Current Insurance Coverages
- Insure Losses Not Currently Covered
- Tax Benefits
  - Should NEVER be the sole reason
  - Still a benefit but reduced as a result of TCJA

TCJA Reform Overview

What TCJA means for the captive insurance industry

TAX REFORM OVERVIEW

Lower Rates, AMT Repeal, NOLs

Significant reduction in the corporate tax rate to 21% encourage economic growth and increases in number of jobs and pay. Special 20% deduction on pass-through income. Corporate AMT repealed, DRD & Proration changes

Broader Tax Base

To pay for the lower rate, TCJA includes a number of base-broadening provisions (e.g. limitations on deductions). The base-broadening extends to both business and individual taxation and will require additional guidance from Treasury for transition and application.

New International Tax System

The TCJA contains substantial changes to the international taxation principles currently in effect, bringing the US closer to a territorial-based regime and curtailing the ability to defer tax on foreign source income. Insurers need to pay particular attention to these provisions if they are part of a global organization having intercompany charges and ceded reinsurance transactions (BEAT). Other provisions include GILTI, FDII.

TAX CUTS AND JOBS ACT ("TCJA")

- TCJA timeline –
  - House of Representatives passed its version November 16
  - Senate passed its version December 2
  - Conference Agreement signed and released December 15
  - House of Representatives passed reconciled H.R. 1 on December 19/20
  - Senate passed H.R. 1 on December 20 with 51-48 vote
  - President signed into law on December 22
- Complies with required budget reconciliation rules
  - Cuts taxes by US$1.456 trillion over 10 years
  - Allows for simple majority vote rather than a 60 vote threshold in the Senate
  - However, sequestration considerations
- First major overhaul of the federal income tax since 1986 (over 30 years)

PRE & POST TAX REFORM – NO CAPTIVE

	PRETAX REFORM	
	C-Corp	*Pass-Through*
Pretax Income	$ 1,000,000	$ 1,000,000
Tax Rate	35.0%	39.6%
After-Tax Income	650,000	
Dividend Tax Rate	23.8%	
Owner's After-Tax Income	**$ 495,300**	**$ 604,000**
Marginal Tax Rate	**50.5%**	**39.6%**

	POSTTAX REFORM	
	C-Corp	*Pass-Through*
Pretax Income	$ 1,000,000	$ 1,000,000
Tax Rate	21.0%	37.0%
After-Tax Income	790,000	
Dividend Tax Rate	23.8%	
Owner's After-Tax Income	**$ 601,980**	**$ 630,000**
Marginal Tax Rate	**39.8%**	**37.0%**

* Source - March 2018 IRMI Captive Insurance Company Reports

PRE & POST TAX REFORM – 831(b) CAPTIVE WITHOUT LOSSES

	PRETAX REFORM	
	Captive	*Pass-Through*
Premium	$ 1,200,000	$ 1,200,000
Captive Operating Expenses	100,000	
Captive Claim Costs	-	-
Pretax Income	1,100,000	1,200,000
Tax Rate	23.8%	39.6%
Owner's After-Tax Income	**$ 838,200**	**$ 724,800**

	POSTTAX REFORM	
	Captive	*Pass-Through*
Premium	$ 1,200,000	$ 1,200,000
Captive Operating Expenses	100,000	
Captive Claim Costs	-	-
Pretax Income	1,100,000	1,200,000
Tax Rate	23.8%	37.0%
Owner's After-Tax Income	**$ 838,200**	**$ 756,000**

* Source - March 2018 IRMI Captive Insurance Company Reports

PRE & POST TAX REFORM – 831(b) CAPTIVE WITH LOSSES

	PRETAX REFORM			
	Captive		*Pass-Through*	
Income / Premium	$	1,200,000	$	1,200,000
Captive Operating Expenses		100,000		
Insurable Loss/Captive Claim Costs		623,000		623,000
Pretax Income		477,000		577,000
Tax Rate		23.8%		39.6%
Owner's After-Tax Income	**$**	**363,474**	**$**	**348,508**

	POSTTAX REFORM			
	Captive		*Pass-Through*	
Premium	$	1,200,000	$	1,200,000
Captive Operating Expenses		100,000		
Insurable Loss/Captive Claim Costs		623,000		623,000
Pretax Income		477,000		577,000
Tax Rate		23.8%		37.0%
Owner's After-Tax Income	**$**	**363,474**	**$**	**363,510**

* Source - March 2018 IRMI Captive Insurance Company Reports

Domestic Impact

DOMESTIC IMPACT – MICRO CAPTIVES

- PATH Act (enacted December 18, 2015);
  - PATH changed requirements for making 831(b) election
  - increases the amount of premiums that an insurance company may receive from $1,200,000 to $2,200,000 (now indexed for inflation).
  - Diversification requirements:
    - Risk Diversification Test
    - Relatedness Test (aimed at estate tax planning abuses)
  - No changes to post-PATH Act Section 831(b)
    - The Consolidated Appropriations Act of 2018, HR 1625 – Signed March 23, 2018
    - Clarifies the definition of “specified holder” and “policyholder”
  - Section 831(b) not specifically mentioned in TCJA
  - Micro-Captives likely to see an increase in their tax liability
    - prior graduated rate probably 15% versus 21%
    - changes in investment income tax treatment

DOMESTIC IMPACT – P&C CAPTIVES

- Generally…
  - No changes to Section 831(a) or insurance company qualification provisions
    - Four prong test:
      a. Insurable risk (citation)
      b. Risk shifting (citation)
      c. Risk distribution (Rev. Rul. 2005-40)
      d. Operating as insurer in commonly accepted concepts (citation)

  - Net operating losses (NOL) carryback is retained for P&C companies

  - Corporate alternative minimum tax (ATM) repealed; characterized as a refundable credit subject to sequestration.

DOMESTIC IMPACT – P&C CAPTIVES

- Modification of general corporate tax provisions
  - Corporate tax rate now at 21% (decrease from 35%, 34%, 25%)
    - Large captives – less benefit on the accelerated IBNR deductions
    - Micro-Captive – less tax benefit on premium income deferral
    - Micro-Captive Corporate Insureds
      - less tax benefit of premium deductions
      - although increase premiums could offset the decrease in tax benefit due to tax rate change
    - Micro-Captive Pass-through Insureds
      - Premium deduction still substantial as the individual rates did not decrease significantly
    - Micro-Captive owners – Preferential dividend tax rates 23.8% on captive distributions
      - state tax considerations

DOMESTIC IMPACT – P&C CAPTIVES

- Modification of general corporate tax provisions (continued)
  - Decrease in the dividend received deduction (DRD) rates – 70% to 50%; 80% to 65%
    - More taxable income to both regular and micro-captive arrangements
    - DRD "notch" calculation for micro-captives

DOMESTIC IMPACT – LARGE P&C CAPTIVES

- Modification of discounting rules
  - Phase-in of the new discounting rules
  - Requires P&C insurers to use the corporate bond yield curve as determined by the US Department of Treasury to determine the discount rate
  - 3-year period for discounting certain lines of business is not modified
  - 10-year period for certain long-tail lines is extended to a maximum of 14 years
  - Insurance companies with longer tail business (e.g. workers' compensation and medical professional liability) would be impacted more significantly
  - Election to use company-specific loss payment patterns is repealed
- Modification of proration rules
  - The reduction in loss reserve of 15% will now be 25% in 2018 and thereafter
  - Intended to keep the reduction in the reserve deduction (on a after tax basis) consistent with current law by adjusting the rate proportionately to the decrease in the corporate tax rate.
  - Loss reserve discounting proposals as well as the proration modifications will result in significant decrease in deductible loss reserves.

DOMESTIC IMPACT – LIFE CAPTIVES

- Computation of life insurance tax reserves
  - The method of computing reserves under Section 807(d) is modified so that the amount of the life insurance reserve for any contract would be the greater of the new surrender value of the contract of 92.81% of the tax reserve method applicable to the contract
  - For variable insurance contracts, the tax reserve would be the greater of:
    1. the net surrender value; or
    2. the portion of the reserve that is separately accounted for under Section 817, plus 92.81% of the excess (if any) of the tax reserve method, over the net surrender value.
  - The Act requires a recalculation of reserves held on contracts issued before the effective date using the new reserve computation method. The difference between the reserves computed using the old method and the new method would then be taken into account over the subsequent eight years.
  - Effective for tax years after 2017.

DOMESTIC IMPACT – LIFE CAPTIVES

- Deferred policy acquisition (DAC) costs
  - Retains the 180-month period by which specified policy acquisition expenses are amortized under Section 848, retained the three categories of specified insurance contracts as in current law, and increases the DAC percentages.
  - The increased DAC percentages in the Act are as follows:
    - For annuity contracts, 2.09%;
    - For group life insurance contracts, 2.45%; and
    - For all other specified insurance contracts, 9.20%.
  - Effective for tax years beginning after 2017.

DOMESTIC IMPACT – LIFE CAPTIVES

- Modification of rules of life insurance proration
  - The Act amends and significantly simplifies Section 812 so that, for purposes of the life insurance company proration rules, for both the separate and general accounts, the company's share is 70% and the policyholder's share is 30%
  - Effective for tax years beginning after 2017
- Adjustment for change in computing reserves
  - The Act reduces 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 to a four-year period
  - Effective for tax years after 2017

DOMESTIC IMPACT – LIFE CAPTIVES

- NOL deductions
  - The Act repeals the special carryforward period of 15 years and carryback period of 3 years for NOLs of life insurance companies. As such, NOLs of life insurance companies would be subject to the same rules as all other corporations under Section 172
  - This proposal applies to NOLs arising in tax years after 2017
- Repeal of small life insurance company deduction
  - The Act repeals the special deduction that allows insurance companies with assets below US$500 million to deduct 60% of their first US$30 million in income related to life insurance
  - Effective for tax years beginning after 2017

DOMESTIC IMPACT – LIFE CAPTIVES

- Current reserves and associated cumulative temporary differences
  - Current owners of life captives should assess the new legislation and its impact on:
    - Current reserving methodologies
    - Deferred balances carried
    - Potential new life and Accident & Health products placed with a captive
    - Impact of small life insurance company deduction repeal
  - Future life captive owners should consider revising previously prepared models and feasibility studies for the impact of the new legislation

International Impact

INTERNATIONAL IMPACT

- Provisions impacting outbound/inbound captives
  - Territorial tax system
    - 100% dividend exemption
    - One-time transition tax (toll charge), repatriation
  - Anti-base erosion
    - Controlled foreign corporation (CFC) updates
    - The Base Erosion and Anti-Abuse Tax (BEAT)
  - Modification of insurance business exception to passive foreign investment company (PFIC) rules
  - No change to Section 953(d) itself in tax reform, but 953(d) entities will need to adhere to domestic taxable income modifications
  - Dividend payments by a US captive to foreign parent remain subject to Fixed, Determinable, Annual or Periodic (FDAP) withholding and Foreign Account Tax Compliance Act (FATCA) rules
  - Payments by a domestic captive to a foreign affiliate may be subject to the BEAT provisions

INTERNATIONAL IMPACT – TERRITORIAL SYSTEM

100% Exemption for Foreign-Source Dividends

- Applies to any US corporation that owns
    - At least a 10% stake in a foreign corporation
    - Subject to a one-year holding period
    - Does not apply to a PFIC that is not also a CFC
- Effective for distributions made after 31 December 2017
- Note: Subpart F provisions remain, resulting in US owners of offshore captives that are CFCs continuing to be subject to current taxation in many cases
- In cases where a CFC captive's income is 100% Subpart F, distributions to its US parent are distributions of previously taxed income, and not subject to tax under current law.

INTERNATIONAL IMPACT – TERRITORIAL SYSTEM

Mandatory Toll Charge on Tax-Deferred Foreign Earnings

- One-time transitional tax on a US 10% shareholder's pro rata share of the foreign corporations' post-1986 tax-deferred earnings
- Tax rate
    - 15.5% for accumulated earnings held in cash, cash equivalents or certain other liquid assets; or
    - 8% for accumulated earnings invested in illiquid assets (e.g. Property, Plant & Equipment)
- Allows accumulated earnings deficits of any foreign corporation to offset tax-deferred earnings of other foreign corporations
- This might not be applicable for offshore CFCs whose income in 100% Subpart F.

INTERNATIONAL IMPACT – BEAT

- BEAT applies to corporations subject to US income tax with three-year average annual gross receipts of at least $500 million **and** that have made related party deductible payments totally 3% or more of the corporation's total deductions for the year. (Gross premiums specifically covered)

- A corporation subject to the tax generally determines the amount of tax owed under the provision (if any) by adding back to its adjusted taxable income for the year all deductible payments made to a foreign affiliate (base erosion payments) fro the year (the modified taxable income). The excess of 10% of the corporation's modified taxable income over its regular tax liability for the year is the base erosion minimum tax owned.

BEAT STEPS

Template

1. Determine if the company is subject to BEAT due to $500m average receipts and 3% foreign affiliated payments thresholds.
2. Compute regular tax of US Sub under general tax rules with certain modifications
3. Compute modified taxable income by eliminating certain deductible payments made to non-US affiliates
4. Apply 10% tax rate to modified taxable income to arrive at BEAT tax amount
5. Compare regular tax liability to BEAT tax US Sub must pay higher of BEAT tax or regular tax.

INTERNATIONAL IMPACT – PFIC EXCEPTION

- A PFIC is a foreign company that, in any year, has more than 70 percent passive income or that holds more than 50 percent of the company's assets to generate passive income. Many captives currently would meet the 50 percent asset test.
  - A US owner of stock in a PFIC must either include its pro rata share of the PFIC's income on a current basis, or pay a large interest amount when it receives a distribution
- Insurance companies generally hold assets that produce passive income, resulting in them being at risk of being classified as PFICs.
  - Prior to TCJA, offshore captives met the active insurance trade or business exemption ("predominately" in the insurance business)
  - After TCJA, passive income for PFICs does not include income derived in the active trade or business of an insurance business by a corporation that:
    - (1) would be subject to tax as an insurance company if it were a domestic company; and
    - (2) insurance liabilities (as defined) constitute more than 25 percent of its total assets
- As a result of common ownership structures and the related party insurance income rules, most captives will be considered CFCs, rather than PFICs

INTERNATIONAL IMPACT – OTHER PROVISIONS

- Effective 1/1/2018, for determining CFC status, a U.S. shareholder would include U.S. persons that owned 10% of more of the voting power or value of stock of a foreign corporation.
- The TCJA permits intangible income from Foreign-Derived Intangible Income ("FDII") to be taxed at 13.125% (the effective tax rate of 13.125% is arrived at by computing a FDII deduction). The FDII deduction can only be made if the income derived is not from a low-taxed jurisdiction.
- US shareholders of CFCs are required to include in income their "global intangible low-taxed income" ("GILTI"). The mechanism for taxing such amounts would be similar to Subpart F. That is, a shareholder's GILTI, generally equal to the excess of the shareholder's CFC net income over a routine or ordinary return would be currently taxable and subsequently increase the shareholder's basis in its CFC stock.

Tax Accounting

ASC 740: CHANGES IN TAX LAWS OR RATES

- The effects of a change in tax laws or rates shall be recognized at the date of enactment.
  - For TCJA , the Enactment date is 22 December 2017

- Effects on the deferred tax balances
  - Re-measure the deferred tax balance at the 21% tax rate
    - DTA balance results in tax expense (DTL results in tax benefit)
  - Tax rate change impact on deferred tax recorded as a component of tax expenses relating to continuing operations (not an extraordinary item)
  - On February 14, 2018, the FASB issued ASU No. 2018-2 which allows companies the ability to reclassify to retained earnings of tax effects of items remaining within accumulated OCI resulting from the TCJA. This would alleviate the potential effects of previously established deferred taxes on unrealized gains/losses at the old 35/34% rate while reversals are occurring at the lower 21%, thus "stranding" deferred taxes in OCI.

- Financial statement disclosure
  - Disclose effect of adjustments on deferred tax amounts

SSAP 101

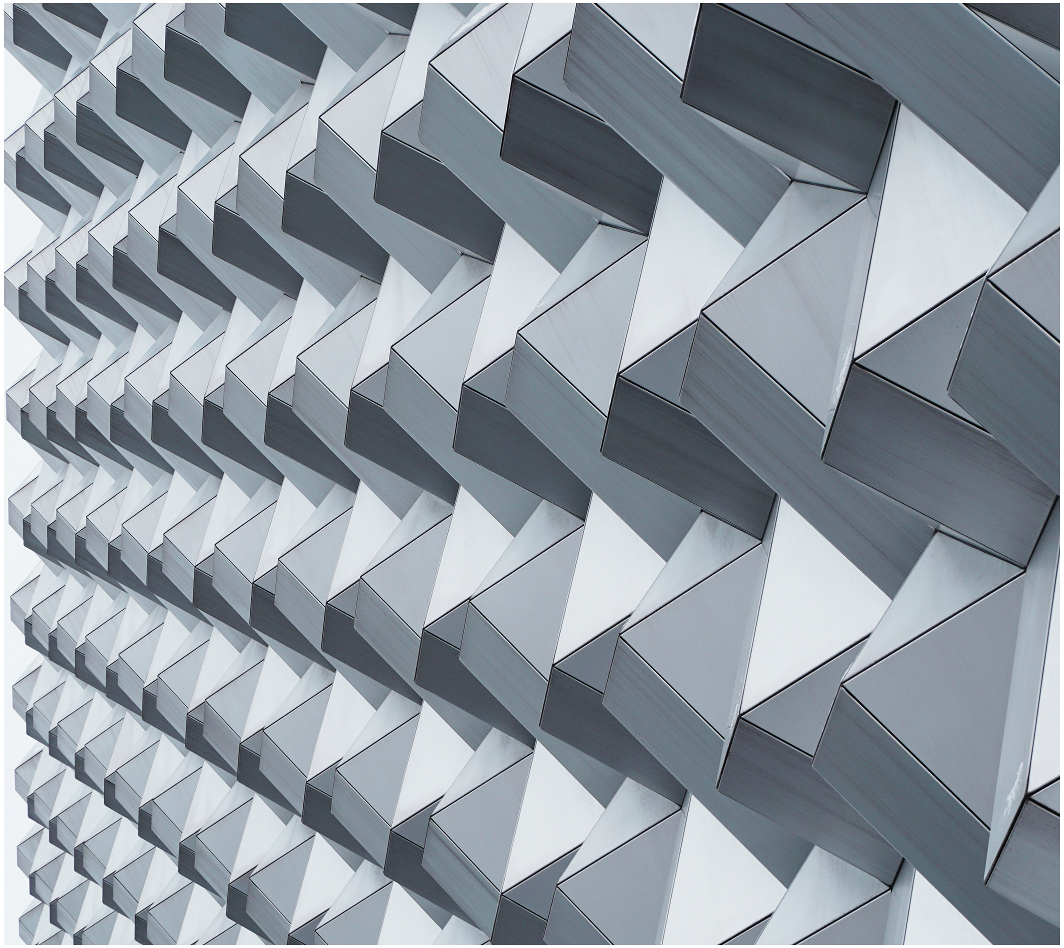
For those captives that prepare their Audited Financial Statements and domicile annual statements on statutory basis:

- Effect on deferred tax balances
  - Re-measure the deferred tax balance at the 21% tax rate
    - DTA balance results in tax expense (DTL results in tax benefit)
  - Deferred tax impact recorded as a component of surplus. (see SAPWG INT 18-01)
    - This change in net deferred tax, excluding any change reflected in unrealized capital gains, and excluding any change in nonadmitted DTAs is to be reflected in the “Change in Deferred Income Tax” line in changes in capital and surplus. Tax effects previously reflected in unrealized capital gains (to present unrealized gains (losses) as “net of tax” shall be updated in the “Change in Net Unrealized Capital Gains (Losses) less Capital Gains Tax” line in changes in capital and surplus.
- Changes to NOL carryback/carryforward rules and rate reduction may impact admissibility and potential valuation allowance considerations
- Financial statement disclosure

Parting Thoughts

PARTING THOUGHTS

- Review and update current feasibility studies
- Determine and/or revisit domicile viability
- Many areas of the TCJA need further clarification
  - As such, monitor future guidance, rulings and regulations and advise appropriately.
- Consider all other corporate aspects of the TCJA (Depreciation, M&E, Business interest deduction)
- 2018 estimated tax payments
  - Repeal of AMT and AMT refunds
  - Safe harbor of PY liability may not be appropriate



THANK YOU

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