Tax Cut and Jobs Act of 2017 (TCJA)

Impact on Property & Casualty Insurers

Presenters: Dan Kusaila, Crowe
Arlene Richardson, Milliman

Moderator: Stephen Koca, Milliman

Presented on: Friday September 7, 2018 at CLRS, Anaheim, CA

Overview of Topics

- General Business Provisions
- Property & Casualty / Life Overview
- Net Operating Losses
- Discounting of Loss Reserves
- Measuring Impact of TCJA on "Static" Company
- International Overview
  - Base Erosion and Anti-abuse Tax
  - Passive Foreign Investment Company
- 2018 GAAP and Statutory Accounting Considerations
- Challenges Facing the Tax Function
- Discussion and Questions
- Appendix: Tax Reform Act of 1986

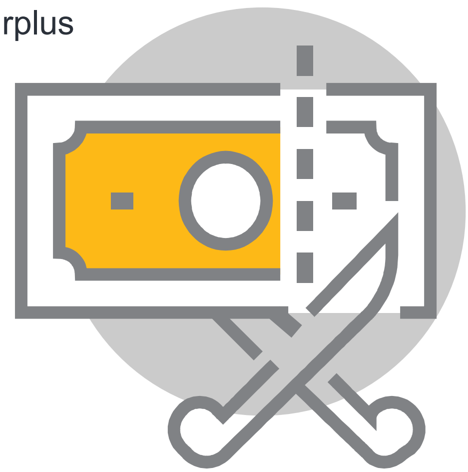
General Business Provisions

General Business Provisions

(All changes effective for the 2018 tax year unless otherwise noted)

Corporate Tax Rates

- Reduces Corporate Tax rate from 35 percent to 21 percent in 2018
  - Deferred tax asset (DTA) reduction impact P&C Industry – 1.6% Loss of Surplus
  - DTA reduction impact on Life Industry – 3.2% Loss of Surplus
- Blended rate for fiscal year filers that include the Jan 1, 2018 effective date



Alternative Minimum Tax (AMT)

- Repeals corporate AMT in 2018 and forward
- Carryforward credits available for use or refund, 50% of unused credits years 2018-2020
- Remaining credits fully refundable in 2021

Interest

- Limits net interest deduction to 30% of adjusted taxable income (general tax basis EBITDA)
- Limits net interest deduction to 30% of taxable income before interest and taxes (generally tax basis EBIT) beginning in 2022
- Disallowed net interest deductions carried forward indefinitely

General Business Provisions

Dividends Received Deduction

- Dividends received deduction rates reduced from 70 percent to 50 percent and from 80 percent to 65 percent
- Offsets effect of reduced corporate tax rate

Fixed Assets

- 100 percent expensing for new and used business assets through 2022
- Section 179 expensing limit increased to $1.0M from $0.5M, phase-out increased to $2.5M from $2.0M
- Section 179 expensing of qualified improvement property

Meals, Entertainment, & Benefits

- **<u>Fully Non-deductible</u>** under TCJA
  - Activities generally considered to be entertainment, recreation, or amusement
  - Meals related to entertainment activities
  - Social, business, pleasure, or similar club membership dues, even if the facility is used primarily for furtherance of a taxpayer's business
  - A facility used in connection with the above items
  - Qualified parking and transportation fringe benefits
  - On-premises athletic facilities
  - Meals provided for the convenience of the employer in an on site eating facility beginning in 2026
- **<u>50% Deductible</u>** under TCJA
  - Meals provided for the convenience of the employer in an on site eating facility through 2025
  - Business Meals - must be conducted in a place "conducive to business discussion," with business discussed during, and the meeting must be directly related to the taxpayer's business.
  - Waiting for IRS guidance as there is some uncertainty about the business meals deduction
- **<u>Fully Deductible</u>** under TCJA
  - Expenses incurred for employee, stockholder, board of director, and business league meetings as well as conventions remain deductible under existing guidance and limitations
  - Social or recreational expenses for the benefit of employees (holiday party, company picnic) continue to be fully deductible

P&C/Life Overview

Property and Casualty

- In the TCJA, provisions applicable to property and casualty (P&C) insurance companies:
- Proration
  - Replace 15 percent reduction with 25 percent reduction
  - Exactly offsets effect of reduced corporate tax rate
- Changes that impact the discounting of loss reserves

Life

In the TCJA, provisions applicable to life insurance companies:

- Deferred Acquisition Cost (DAC)
  - Increase DAC to 2.09 annuity, 2.45 group life, and 9.20 all other contracts
  - Lengthen the amortization period from a 120-month to a 180-month period
  - 2017 and prior amortize under old law
  - Retain 60 month amortization of first $5.0M of policy acquisition costs
- Reserves
  - Tax reserve greater of net surrender value (NSV) or 92.81% of Reserve (NAIC-Prescribed Method)
  - Run-off difference of opening balance over 8 years into income
  - No deduction for asset adequacy or deficiency reserves

Life

- Proration
  - Set Company share = 70%, Policyholder share = 30%
- Small Life Insurance Company Deduction
  - Repeal the small life insurance company deduction for taxable years beginning after Dec. 31, 2017
- Reserve Changes Under Sec 807(f)
  - Adjust 10 yr. spread on re-computation of life reserves to make consistent with accounting change methodologies under Sec. 481
- Pre 1984 Policyholder Surplus Account Section 815
  - Remove Section 815
  - Take into income over 8 years starting 2018
  - Cannot offset with losses

Net Operating Losses

Net Operating Losses

- Net Operating Losses (NOLs) – TCJA
  - General
    - Repeal 2 year carryback
    - Unlimited carryforward of NOLs
    - NOLs arising in taxable years beginning after December 21, 2017 are limited in their utilization to 80 percent of taxable income. Effectively defers 80% limitation until 2019
  - Life
    - Repeal carrybacks
    - Unlimited carryforward of NOLs
    - NOLs arising in taxable years beginning after December 21, 2017 are limited in their utilization to 80 percent of taxable income. Effectively defers 80% limitation until 2019
  - P&C
    - NOL's would be subject to current law (i.e. 2 year carryback/20 year carryforward)
    - NOL's not subject to 80% limitation

Discounting of Loss Reserves

Property and Casualty: Discounting of Loss Reserves

Why do we care?

Statutory income differs from taxable income

Taxable income equals:

statutory income *less*

tax-exempt investment income (after proration) *plus*

revenue offset adjustment (20% of the change in unearned premium reserve) *plus*

other book to tax adjustment *plus*

change in amount of discount in loss reserves

Property and Casualty: Discounting of Loss Reserves

TCJA Changes that Impact Discounting

- Payment patterns
- Interest rates
- Phase-in rules

Property and Casualty: Discounting of Loss Reserves

Use of Own Payment Pattern

- Option to elect own payment patterns is repealed

- Impact for taxpayers previously using:
  - IRS payment patterns: None
  - Own payment patterns: Restate 2017 and prior accident years' discounted reserves based IRS patterns. If election was made due to faster pattern, impact is to lengthen pattern/increase discount.

Slower payment pattern → Deeper discounting → Slower recognition of deduction for incurred losses → Acceleration of federal income tax payments

Property and Casualty: Discounting of Loss Reserves

Tail Payment Patterns

- New formula generally lengthens the payment patterns
- No change for first 10 years (designated as “AY + 0” through “AY + 9”).
- Tax Reform Act of 1986:
  - Caps at 16 years
  - 6-year tail – repeat incremental “AY + 9” until 100% paid. Residual in “AY + 15” if under 100%.
- TCJA of 2017:
  - Caps at 25 years
  - Average “AY + 7”, “AY + 8”, and “AY + 9” used for “AY + 10”
  - 14-year tail – repeat incremental “AY + 10” until 100% paid. Residual in “AY + 24” if under 100%.
- Impact:

Slower payment pattern → Deeper discounting → Slower recognition of deduction for incurred losses → Acceleration of federal income tax payments

Property and Casualty: Discounting of Loss Reserves

Tail Payment Patterns – Workers Compensation

	(1)	(2)	(3)	(4)	(5)	(6)
	A.M. Best through 2015		IRS Accident Year 2017		IRS Accident Year 2018	
	Cumulative Losses Paid	Incremental Losses Paid	Cumulative Losses Paid	Incremental Losses Paid	Cumulative Losses Paid	Incremental Losses Paid
AY + 0	18.8885%	18.8885%	18.8885%	18.8885%	18.8885%	18.8885%
AY + 1	41.2063%	22.3179%	41.2063%	22.3179%	41.2063%	22.3179%
AY + 2	54.6053%	13.3989%	54.6053%	13.3989%	54.6053%	13.3989%
AY + 3	65.0211%	10.4158%	65.0211%	10.4158%	65.0211%	10.4158%
AY + 4	70.9099%	5.8888%	70.9099%	5.8888%	70.9099%	5.8888%
AY + 5	75.5957%	4.6858%	75.5957%	4.6858%	75.5957%	4.6858%
AY + 6	78.3945%	2.7987%	78.3945%	2.7987%	78.3945%	2.7987%
AY + 7	80.4084%	2.0140%	80.4084%	2.0140%	80.4084%	2.0140%
AY + 8	82.6060%	2.1976%	82.6060%	2.1976%	82.6060%	2.1976%
AY + 9	83.3419%	**0.7359%**	83.3419%	**0.7359%**	83.3419%	0.7359%
AY + 10			84.0778%	**0.7359%**	84.9911%	**1.6492%**
AY + 11			84.8137%	**0.7359%**	86.6402%	**1.6492%**
AY + 12			85.5496%	**0.7359%**	88.2894%	**1.6492%**
AY + 13			86.2855%	**0.7359%**	89.9385%	**1.6492%**
AY + 14			87.0214%	**0.7359%**	91.5877%	**1.6492%**
AY + 15			100.0000%	12.9786%	93.2368%	**1.6492%**
AY + 16		**AY + 7-9 Average**			94.8860%	**1.6492%**
AY + 17		**1.6492%**			96.5351%	**1.6492%**
AY + 18					98.1843%	**1.6492%**
AY + 19					99.8334%	**1.6492%**
AY + 20					100.0000%	0.1666%

Property and Casualty: Discounting of Loss Reserves

Impact of Tail Payment Pattern Change Only – Workers Compensation Discount Factors

	(1)	(2)	(3)
	Discount Factors @ 1.46%		= (2) - (1)
	AY 2017 Pattern at AY 2017 Interest Rate	AY 2018 Pattern at AY 2017 Interest Rate	Difference
AY + 0	93.6645%	93.6230%	-0.0416%
AY + 1	92.8701%	92.8119%	-0.0582%
AY + 2	92.3071%	92.2306%	-0.0765%
AY + 3	91.5487%	91.4480%	-0.1007%
AY + 4	91.2978%	91.1749%	-0.1229%
AY + 5	91.0762%	90.9276%	-0.1486%
AY + 6	91.3280%	91.1576%	-0.1703%
AY + 7	91.8322%	91.6416%	-0.1906%
AY + 8	92.2185%	92.0007%	-0.2178%
AY + 9	93.2485%	93.0177%	-0.2307%
AY + 10	94.3271%	93.6779%	-0.6493%
AY + 11	95.4609%	94.3442%	-1.1167%
AY + 12	96.6574%	95.0167%	-1.6407%
AY + 13	97.9260%	95.6953%	-2.2307%
AY + 14	99.2779%	96.3799%	-2.8980%
AY + 15	*99.2779%*	97.0700%	-2.2079%
AY + 16	*99.2779%*	97.7649%	-1.5130%
AY + 17	*99.2779%*	98.4616%	-0.8163%
AY + 18	*99.2779%*	99.1468%	-0.1311%
AY + 19	*99.2779%*	99.2779%	0.0000%

2017 AY + 15 and later set equal to AY + 15 for comparison

Property and Casualty: Discounting of Loss Reserves

Interest Rates

- Replaces interest rates based on US government securities (monthly Federal mid-term rates) with interest rates based on a corporate bond yield curve.
  - Consists of corporate bonds with varying maturities for the preceding 24-months that are in the top 3 quality levels available.
- Impact:

Corporate bond yield is higher than government bond yields → Higher interest rates → Deeper discounting → Slower recognition of deduction for incurred losses → Acceleration of federal income tax payments

- Treasury will restate interest rates for each accident year, going back 25 years.

Property and Casualty: Discounting of Loss Reserves

Phase in Rules

- Restate 12/31/17 loss reserves using new discount factors based on industry payment pattern data and corporate bond rates.
  - For most taxpayers, this will result in lower discounted reserves (higher interest rates and longer payment patterns).
- All else equal, this would have resulted in a double deduction equal to the amount of the change in 12/31/17 discounted reserves.
- However, there will be no “fresh start” like there was in 1986. Difference will be amortized over an 8-year period.

Property and Casualty: Discounting of Loss Reserves

Phase in Rules - Example

Assume steady state and no change in IRS interest rates, no tax law change:

- 12/31/17 reserves: $200M nominal, $190M discounted, $10M discount
- 12/31/18 reserves: $200M nominal, $190M discounted, $10M discount

  No change in discounted reserves therefore no adjustment to statutory income.

With tax change and “fresh start”:

- 12/31/18 reserves: $200M nominal, $170M discounted, $30M discount

  $20M change in discount reduces taxable income.

With tax change and no “fresh start” (the way law is written):

- 12/31/17 reserves restated: $200M nominal, $170M discounted, $30M discount

  $20M change in discount increases taxable income by $2.5M (one-eighth of difference in 12/31/17 under old and new law). Added back in for next 8 years. Offsets the impact of the tax law change but does not “match” actual timing.

Measuring Impact of TCJA on “Static” Company

Measuring Impact of TCJA on “Static” Company

- $125M annual WC premium; 80% loss ratio, 20% expenses
- Payout based on industry data for $100,000 WC limit – 15 year (normalized)
- Steady state $188M of reserves
- $200M capital; 2.25% return on taxable bonds
- Dividend out all after tax earnings on 1/1 of following year (approx. $6M annually in steady state after 20 years); run out for another 20 years
  - Results are not exactly the same each year since the interest rate used for discounting, promulgated by the IRS, changes annually

Measuring Impact of TCJA on “Static” Company

Balance Sheet ($000s)

	Year 2013	Year 2014	Year 2015	Year 2016	Year 2017
Cash & Invested Assets	397,105	397,107	397,107	397,105	397,104
Liabilities					
Outstanding Loss & LAE Reserve	188,200	188,200	188,200	188,200	188,200
Federal Income Taxes Payable	2,442	2,489	2,628	2,705	2,762
Total Liabilities	190,642	190,689	190,828	190,905	190,962
Initial Capital	200,000	200,000	200,000	200,000	200,000
Retained Earnings	6,463	6,418	6,279	6,200	6,142
Total Capital	206,463	206,418	206,279	206,200	206,142
Total Liabilities & Capital	397,105	397,107	397,107	397,105	397,104

Measuring Impact of TCJA on “Static” Company

Income Statement ($000s)

	Year 2013	Year 2014	Year 2015	Year 2016	Year 2017
Underwriting Income					
Net Earned Premium	125,000	125,000	125,000	125,000	125,000
Underwriting Deductions					
Loss & LAE Incurred	100,000	100,000	100,000	100,000	100,000
Total Expenses	25,000	25,000	25,000	25,000	25,000
Net Underwriting Income	0	0	0	0	0
Investment Income	8,905	8,907	8,907	8,905	8,904
Profit (Loss) Before Tax	8,905	8,907	8,907	8,905	8,904
Federal Tax					
Federal Income Tax	2,442	2,489	2,628	2,705	2,762
Net Income	6,463	6,418	6,279	6,200	6,142
Effective Tax Rate	27.4%	27.9%	29.5%	30.4%	31.0%

Measuring Impact of TCJA on "Static" Company

Discounted Loss & LAE Reserve ($000s)

		Interest Rate:	2.16%	1.79%	1.68%	1.56%	1.46%
		Accident	as of	as of	as of	as of	as of
Nominal	Maturity	Year	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017
200	168	2000	190				
500	156	2001	474	190			
1,000	144	2002	949	476	191		
1,600	132	2003	1,518	952	478	192	
2,300	120	2004	2,149	1,523	955	480	192
3,100	108	2005	2,851	2,160	1,529	959	481
4,000	96	2006	3,648	2,875	2,174	1,535	961
5,000	84	2007	4,490	3,649	2,876	2,174	1,538
7,000	72	2008	6,265	4,480	3,641	2,871	2,172
10,000	60	2009	8,962	6,265	4,480	3,641	2,871
15,000	48	2010	13,596	9,019	6,306	4,509	3,662
24,000	36	2011	22,102	13,712	9,101	6,364	4,550
41,000	24	2012	38,520	22,389	13,907	9,238	6,461
73,500	12	2013	70,437	39,109	22,771	14,166	9,419
		2014		70,937	39,417	22,971	14,302
		2015			71,087	39,509	23,031
		2016				71,252	39,611
		2017					71,391
188,200	Nominal						
		Discounted	176,151	177,736	178,913	179,861	180,642
		Amount of Discount	12,049	10,464	9,287	8,339	7,558
		Change in Amount of Discount		(1,585)	(1,177)	(948)	(781)

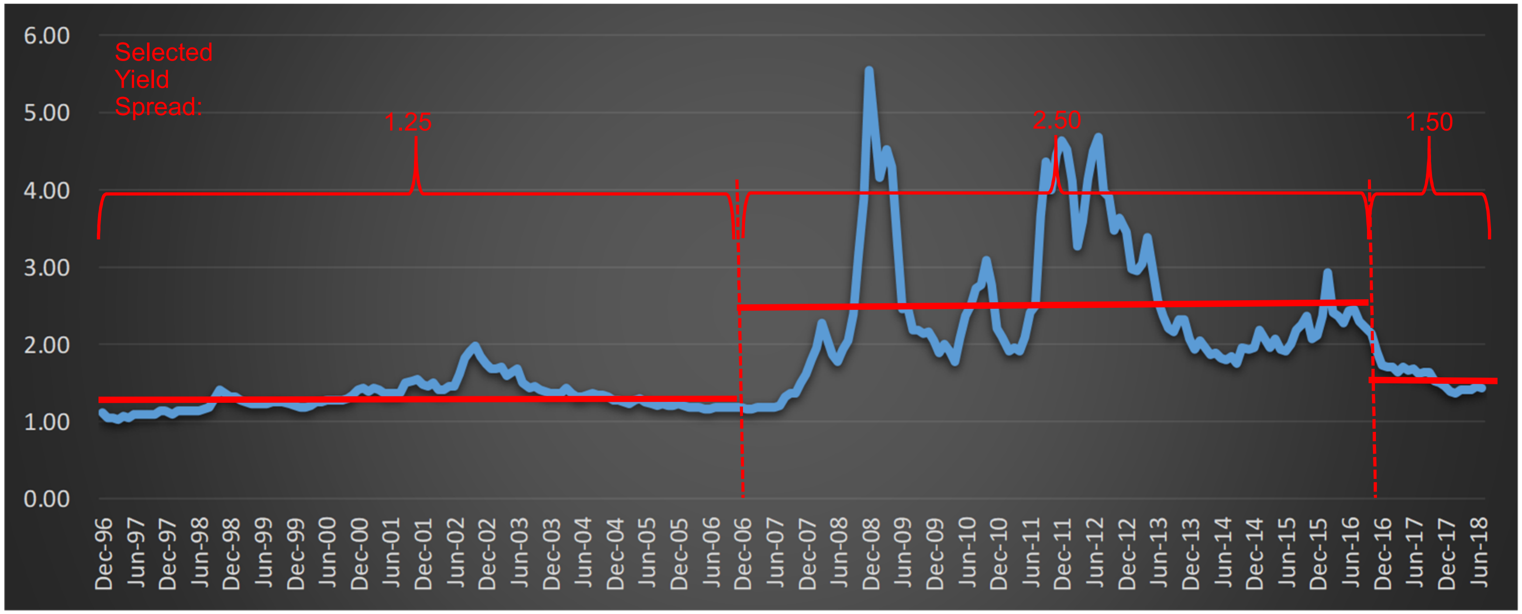
Measuring Impact of TCJA on "Static" Company

- Testing impact on after tax income (shareholder dividend)
  - going concern and runoff
  - nominal and present value at 5%

- Variables
  - Tax Rate – old, new
  - Payment Patterns – own, IRS old tail, IRS new tail
  - Interest Rates – estimated based on historical yield spread

Measuring Impact of TCJA on "Static" Company

Relative Yield Spreads of Treasury vs Corporate Bonds



Measuring Impact of TCJA on "Static" Company

Shareholder Dividends 2018-2037 ($000s)

	Going Concern Cumulative				**Run-off** Cumulative			
Scenario	Present Value of Shareholder Dividends at 5.0%	% Change Relative to Scenario 1	Nominal Value of Shareholder Dividends	% Change Relative to Scenario 1	Present Value of Shareholder Dividends at 5.0%	% Change Relative to Scenario 1	Nominal Value of Shareholder Dividends	% Change Relative to Scenario 1
1. No Change	73,674		118,019		45,848		69,865	
2. New Tax Rate	88,037	19.49%	141,156	19.60%	53,644	17.00%	82,249	17.73%
	Incremental Change - Relative to Scenario 1				Incremental Change - Relative to Scenario 1			
	14,363		23,137		7,796		12,384	

Shareholder dividends equal to after tax income earned in a year (and paid on 1/1 the following year)

Scenario	Description
1	Interest Rate: Current; Patterns: Own; Tax Rate: Old
2	Interest Rate: Current; Patterns: Own; Tax Rate: New

Measuring Impact of TCJA on “Static” Company

- Focusing on the nominal run-off scenario, why does the value of shareholder dividends increase $12.384M or 17.7%?
  - expected impact 19.7% (0.79/0.66-1.0)
  - $7.588M = amount of discount; expect “loss” of 13% of this amount (34% less 21%) or $982,540.

- The going concern scenario has the same result but it is masked by the impact of continuing to write business; it becomes a permanent timing difference.

Measuring Impact of TCJA on "Static" Company

- Next we tested the impact of the following incrementally:
  - own payment pattern to IRS payment pattern as previously calculated (old tail)
  - old tail to new tail
  - old interest rates to an estimate of the new interest rate

- As the chart and graphs that follow show, the biggest impact by far was the change in tax rate.

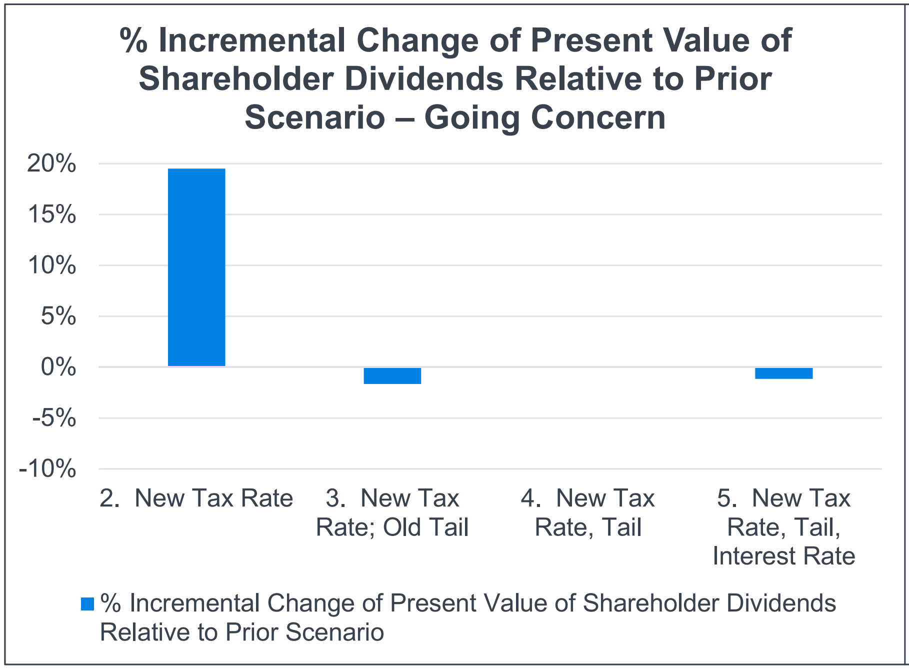
Measuring Impact of TCJA on "Static" Company

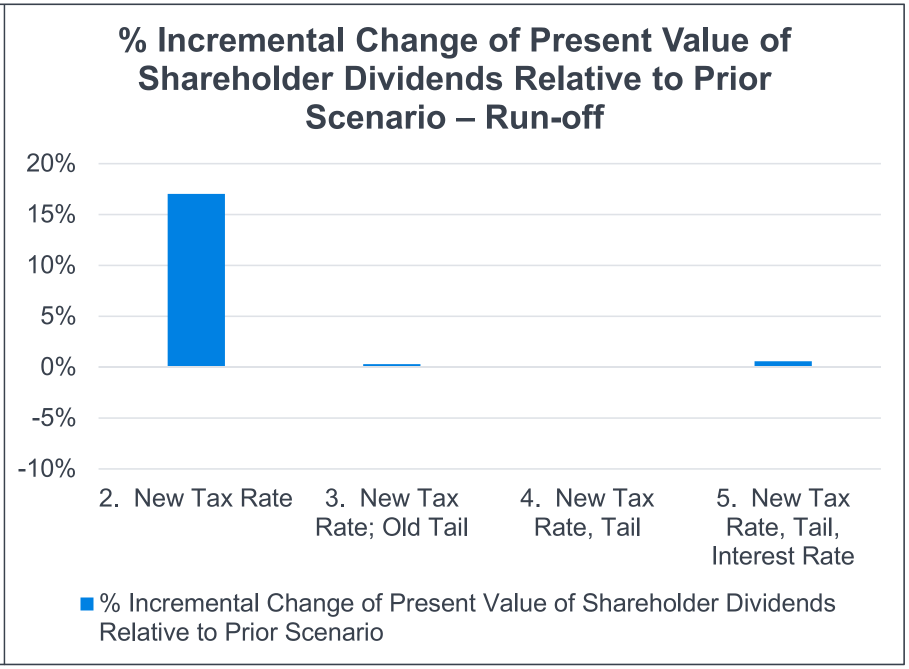
Shareholder Dividends 2018-2037 ($000s)

	Going Concern Cumulative				**Run-off** Cumulative			
Scenario	Present Value of Shareholder Dividends at 5.0%	% Change Relative to Scenario 1	Nominal Value of Shareholder Dividends	% Change Relative to Scenario 1	Present Value of Shareholder Dividends at 5.0%	% Change Relative to Scenario 1	Nominal Value of Shareholder Dividends	% Change Relative to Scenario 1
1. No Change	73,674		118,019		45,848		69,865	
2. New Tax Rate	88,037	19.49%	141,156	19.60%	53,644	17.00%	82,249	17.73%
3. New Tax Rate; Old Tail	86,805	17.82%	139,580	18.27%	53,778	17.30%	82,246	17.72%
4. New Tax Rate, Tail	86,775	17.78%	139,542	18.24%	53,780	17.30%	82,248	17.72%
5. New Tax Rate, Tail, Interest Rate	85,925	16.63%	138,256	17.15%	54,047	17.88%	82,247	17.72%
	Incremental Change - Relative to Scenario X-1				Incremental Change - Relative to Scenario X-1			
2	14,363		23,137		7,796		12,384	
3	(1,232)	-1.67%	(1,576)	-1.34%	134	0.29%	(3)	0.00%
4	(29)	-0.04%	(38)	-0.03%	2	0.00%	2	0.00%
5	(850)	-1.15%	(1,286)	-1.09%	267	0.58%	(1)	0.00%

Shareholder dividends equal to after tax income earned in a year (and paid on 1/1 the following year)

Measuring Impact of TCJA on “Static” Company





International Overview

International Overview

- Modifying the current worldwide taxation system:
  - Dividends received by US corporations from foreign corporate subsidiaries paid from foreign earnings are exempt from U.S. tax
  - Tax potentially significant amounts of foreign income on a current basis under anti-base erosion provisions and modifications to Subpart F

Base Erosion and Anti-Abuse Tax (BEAT)

- Minimum tax equal to 10%* imposed on base erosion payments paid or accrued by a taxpayer to a foreign related party
  - Minimum tax imposed on taxpayers that are (i) C corporations, with (ii) average annual gross receipts of at least $500M for the 3 taxable years ending with the preceding taxable year, and (iii) which have a base erosion percentage of 3% or higher for the taxable year
- Base erosion payments are amounts paid to a foreign related person to which a deduction is allowable
  - Includes any amount paid in connection with the acquisition of depreciable or amortizable property
  - Includes interest, rents, royalties, services, and tangible/intangible property purchases used in a trade or business
  - Does not apply to purchases of inventory (cost of goods sold) in a typical cross-border supply chain structure
- TCJA specifically includes any premium or other consideration paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer for any reinsurance payments taken into account under sections 803(a)(1)(B) or 832(b)(4)(A)
- Additional reporting requirements under section 6038A after December 31, 2024
- Effective date: amounts paid or incurred after December 31, 2017

*Transition Rule: 5% rate applies for one year for base erosion payments paid or accrued in taxable years after December 31, 2017. Minimum tax rate is increased to 12.5% for taxable years beginning after December 31, 2025

BEAT Examples

- Example 1: For tax year 2019, U.S. Insurer receives $1,000 in premium, cedes $800 to offshore reinsurer, and has $100 in other U.S. deductions.

Regular Tax Liability	BEAT	Total Tax (after BEAT)
U.S. Taxable Income = $1,000 - $800 - $100 = **$100** U.S. Regular Tax = $100 x 21% = **$21**	Base Erosion Payments = **$800** MTI = $100 + $800 = **$900**	BEAT = ($900 x 10%) - $21 = **$69** Total U.S. Tax Liability = $21 + $69 = **$90**

- Example 2: For tax year 2019, U.S. Insurer receives $1,000 in premium, cedes $100 to offshore reinsurer, and has $800 in other U.S. deductions.

Regular Tax Liability	BEAT	Total Tax (after BEAT)
U.S. Taxable Income = $1,000 - $100 - $800 = **$100** U.S. Regular Tax = $100 x 21% = **$21**	Base Erosion Payments = **$100** MTI = $100 + $100 = **$200**	BEAT = ($200 x 10%) - $21 = **$-1** Total U.S. Tax Liability = maximum of $21 + $-1 = **$20** and **$21**

Passive Foreign Investment Company

- Restriction on insurance business exception to Passive Foreign Investment Company (PFIC) rules
  - Foreign corporation is generally not a PFIC if it is predominantly engaged in the active conduct of an insurance business and would be taxed as an insurance company were it a U.S. corporation
  - Bill amends exception to apply only if the foreign corporation would
    - be taxed as an insurance company were it a U.S. corporation AND
    - if loss and loss adjustment expenses and certain reserves constitute more than 25% of its total assets (or 10% if due solely to run-off-related or rating-related circumstances involving the insurance business)

*Statute does not include annuities when defining life insurance reserves. Senate explanation makes specific mention of life and annuity reserves. Regulations will make it clear annuity reserves are included in the above definition.

2018 GAAP and Statutory Accounting Considerations

2018 GAAP and Statutory Accounting Considerations

- Staff Accounting Bulletin No. 118 currently in effect
  - Complete
  - Incomplete, can be reasonably estimated
  - Incomplete, cannot be reasonably estimated

Items originally disclosed as incomplete must be resolved within one year of the 12-22-2017 enactment date

- ASU 2018-02
  - TCJA – driven remeasurement of deferred taxes originally established through accumulated other comprehensive income (AOCI) must be charged to Continuing Operations
  - ASU 2018-02 allows reclassification to retained earnings of tax effects “Stranded” in other comprehensive income (OCI) due to TCJA remeasurement
  - Effective for fiscal years beginning after Dec. 15, 2018 and related interim periods; early adoption permitted
  - Whereas adoption of ASU 2018-02 and its various disclosures is required, reclassification of stranded tax effects is optional
- Federal budget “sequestration reduction” of AMT Credit Refunds
  - Confirmed in IR-2018-99
  - 6.2% for AMT refunds processed by IRS between 10/01/2018 and 9/30/2019
  - Potential permanent reduction to Deferred Tax Assets
- Implementation of TCJA

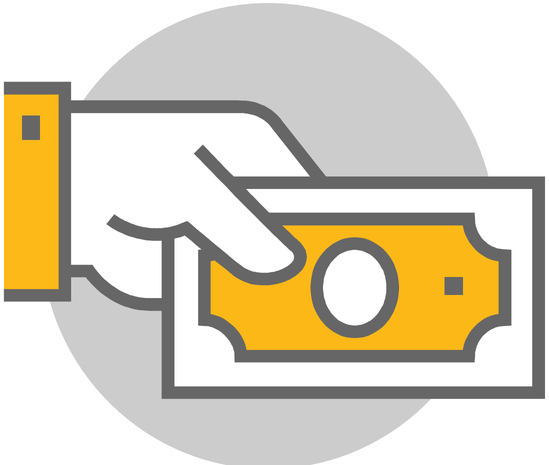
Challenges Facing the Tax Function

Challenges the Tax Function Faces under the TCJA

- Current Strain on Tax Department
  - Statutory accounting rather than tax preparers first to face implementation of changes under TCJA
  - Additional Tax Department Inputs
  - Modeling
    - BEAT/GILTI/Foreign Repatriation
    - Changes to insurance provisions
      - Life Reserves
      - P&C Reserves
      - DAC
      - Life Insurance Proration
    - Meals & Entertainment and Fringe Benefits
    - Fixed Asset
    - Life/non-life/non-insurance NOL interplay
    - Admissibility
- Remaining TCJA Uncertainties
- Role of Technology

How is Industry Responding

- Insurance Trends:
  - Investment Strategy Changes
  - Investment of Additional Surplus
  - Mergers and Acquisitions



Discussion and Questions

Stephen Koca
stephen.koca@milliman.com

Dan Kusalia
daniel.kusaila@crowe.com

Arlene Richardson
arlene.richardson@milliman.com

Appendix: Tax Reform Act of 1986

Tax Reform Act of 1986

- Marginal Tax Rates and NOL’s (All Taxpayers)
- Revenue Offset
- Proration
- Discounting of Loss Reserves
  - Interest Rates
  - Payment Patterns
  - Strategies
- Alternative Minimum Tax (All Taxpayers) (“AMT”)
  - Strategies

Tax Reform Act of 1986

Marginal Tax Rates and NOL's (All Taxpayers)

- A net operating loss (NOL) could be used to recoup taxes paid in prior years (carryback) or in future years (carryforwards).

Pre-1987	Post-1987
Marginal Tax Rate	
46%	35%
NOL's	
Few restrictions on how many years carrybacks and carryforwards are limited to	Carrybacks limited to 2 years and carryforwards limited to 20 years

- Also, only 90% of taxable income could be offset by NOLs, making the minimum marginal tax rate 2.0% (i.e., 20% AMT rate x 10% that cannot be offset by NOLs).

Tax Reform Act of 1986

Revenue Offset

- Statutory accounting treats all prepaid acquisition costs as expenses when paid, the main one being agents' commissions. This accelerates the recognition of expenses relative to GAAP.
- Treasury recognized this and introduced an adjustment that assumed that 20% of unearned premium was a proxy for prepaid expenses.
  - Revenue offset requires that 20% of the change in unearned premium be added to statutory income in determining taxable income.
- Example: $100 policy written at December 31, with 20% paid to the agent on that day.

Revenue Offset	Earned Premium	Expenses	Income
No	$0	$20	($20)
Yes	$0	$20	$0

Tax Reform Act of 1986

Proration

- Prior to 1987, P&C insurers were investing heavily in tax-exempt bonds and dividend paying equities.
  - Tax-exempt bonds were 100% exempt from federal income taxes.
  - Dividends from unaffiliated equities (defined as less than 20% owned by the taxpayer) were 70% tax exempt.
- Proration changed this by adding 15% of these previously tax-exempt items to statutory income.
- Using a marginal tax rate of 35%, the marginal rates are:
  - Tax-exempt income rate = 35% x 15% = 5.25%
  - Unaffiliated dividends = 35% x (30% + 15% x 70%) = 14.175%

Tax Reform Act of 1986

Discounting of Loss Reserves

- Prior to 1987, loss & LAE reserves were not discounted in determining taxable income.
- Discounting was introduced for tax years beginning after December 31,1986.
- Taxpayers needed interest rates and payment patterns to determine the amount of discount in their reserves.
- Once reserves are restated to a discounted basis, the deduction for incurred losses was the usual formula for calculating calendar year incurred losses, but with discounted reserves substituted for undiscounted reserves.
  - paid losses + the change in discounted reserves (i.e., current year end reserve level less prior year end reserve level).

Tax Reform Act of 1986

Discounting of Loss Reserves – Payment Patterns

- Taxpayers were given the option to elect either of the following:
  - Their own payment patterns (by annual statement line of business); or
  - Insurance industry patterns provided by Treasury.
    - Based on insurance industry annual statement data two years prior to the tax year, and which remained in effect for 5 tax years. For example, 2010 annual statement data is used for accident years 2012 through 2016.
    - Also included a formula for smoothing out the “tail” and extending it to as much as 15 years.
- The election was to be made every 5 years and created an opportunity to influence the timing of recognition of their taxable income.
- Strategies could then be devised to optimize after tax income.

Tax Reform Act of 1986

Discounting of Loss Reserves – Strategies

- Treasury gave P&C companies a break by introducing discounting on a “fresh start” basis.
  - So for tax year 1987, year end 1986 reserves were restated to a discounted basis, with no corresponding adjustment/offset.
  - This created a “double deduction” equal to the amount of discount embedded in the 1986 reserves, and led to strategies to optimize after tax income.
- Example:
  - Claim reserved at year end 1986 at $100; $100 taken as an expense (deduction) for losses in 1986.
  - Claim still reserved at $100 at year end 1987 with no payments.
    - Statutory accounting shows no incremental change in the value of the loss.
    - “Fresh start”, however, applies discount to reserves at each year end.
  - Assume discount factors for 1986 and 1987 are .85 and .90, respectively. The resulting taxable incurred loss in 1987 is $5 (paid of $0 plus the change in discounted reserve of $5).
  - Claim settled in 1988 at $100; calendar year taxable incurred loss is another $10 (paid of $100 plus change in discounted reserve of -$90).
  - Overall, the company deducted $115 for this claim; $100 in 1986 and $15 over the next two years.

Tax Reform Act of 1986

Alternative Minimum Tax (All Taxpayers) (AMT)

- Introduction of Alternative Minimum Taxable Income (AMTI).
- Applied a 20% marginal tax rate to AMTI.
- Taxpayer was responsible for larger of "regular tax" or AMT.
- Certain tax-exempt income items, called "preference items", are added to regular taxable income at 75% to arrive at AMTI. For P&C insurers, this was primarily tax-exempt interest and dividends.
- Calculation of Marginal Tax Rates:
  - Recall that 15% of tax-exempt interest and dividends are already in taxable income.
    - Tax-exempt interest: 20% x (15% + 75% x 85%) = 20% x 78.75% = 15.75%
    - Unaffiliated dividends: 20% x [(30% + 15% x 70%) + 75% x (1 – (30% + 15% x 70%))] = 20% x 85.125% = 17.025%

Tax Reform Act of 1986

Alternative Minimum Tax (All Taxpayers) – Strategies

- AMT created an opportunity for P&C insurers to change their investment portfolios to maximize after tax income.
- There is an optimal mix of taxable and tax-exempt bonds to maximize after tax income, based on:
  1. The relative yield spreads between taxable and tax-exempt bonds; and
  2. The insurer's underwriting results.
- This occurs where the mix of bonds produces the same amount of federal tax under each of the formulas for regular tax and AMT.