CARe Reinsurance Seminar 2019
C-22: Tax Reform One Year Later

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June 4, 2019

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Key provisions

Tax rate

The corporate income tax rate lowered from 35% to 21% effective 1/1/18 with immediate impact on deferred tax asset (DTA) and deferred tax liability (DTL) accounts.

Alternative Minimum Tax (AMT)

Corporate alternative minimum tax (AMT) has been eliminated.

Net Operating Losses (NOLs)

P&C insurers retain NOLs for a two year carryback and forward 20 years.

Loss reserve discounting

Payment pattern extended and discount rate based on higher corporate yield curve.

Proration and Dividends Received Deduction (DRD)

Effective tax rate on muni bond income and equity dividends unchanged. Corporate bond income reflects lower 21% tax rate.

Territorial tax system

Change from worldwide tax system to a territorial system with 100% deduction for dividends received from foreign affiliates.

Base Erosion Anti-abuse Tax (BEAT)

A minimum tax reflecting items such as ceded premiums to offshore affiliates. BEAT rate is 5% in 2018 and 10% thereafter.

Passive Foreign Investment Company (PFIC)

Initial determination of insurance company status based on insurance liabilities (excluding UPR) ratio to assets > 25%.

Earning impacts

- Lower statutory tax
  - Corporate tax rate lowered to 21% (from 35%)
  - Corporate AMT eliminated
- Increased importance of underwriting income
  - UW income subject to full tax rate
  - Companies with higher UW contribution to earning will benefit more under lower tax rate
- Value of reinsurance
  - UW gains *and* losses have amplified impact
  - Risk in both current AY as well as prior year development have greater impact
  - Companies will need to re-evaluate their risk tolerances (after-tax) and reinsurance strategy

Balance sheet impacts

- Deferred tax assets (DTA) and liabilities (DTL)
  - Lower tax rate impacts DTA (negative impact) and DTL (positive impact)
    - DTA arise from loss reserve discounting for tax purposes – larger impact for casualty writers
    - DTA also arise from NOL carryforwards – larger impact for companies with past losses
    - Most common DTL reflects unrealized gains
- Net operating loss (NOL) carryforwards
  - US P&C industry retained it's NOL carryback provision of 2 years & NOL carryforward provision of 20 years
  - Special treatment not even afforded Life insurers

Investment impacts

- Decreased advantage of “tax-advantaged” investments
  - Certain investments are afforded lower tax rates
    - Municipal bond income
    - Unaffiliated stock dividends
  - The Proration and Dividend Received provisions will change so that the effective tax rate on these investments will remain basically unchanged
- Investment allocation
  - While tax advantaged income is unchanged taxes on other investment income reflects lower rate
  - Municipal bond yields will likely adjust (rise) to match higher after tax returns of other investments
  - If not, may see change in allocation strategies

Risk and capital management impact

- Lower tax rate magnifies the impact the UW results
  - Increases the risk premium and reserve leverage pose to company's financial position
    - Higher risk for same level of writings / reserves
  - Re-evaluate Risk Tolerance and reinsurance
    - Increased after tax net PML for same risk profile
- Regulatory and rating agency capital models
  - DTA/DTL adjustments to surplus
  - After tax adjustments (bond MV, UPR/DAC equity)
  - BCAR cat risk is pre-tax (stress test after-tax)
- Offshore group reinsurance and capital support
  - BEAT tax will reduce off-shore support possibly increasing capital requirement for US operations

Global reinsurance market impact

- A change to a territorial tax system
  - 100% deduction for foreign affiliate dividends
  - Effectively foreign income not subject to US tax
  - May encourage US based incorporation and M&A
- Base Erosion Anti-Abuse Tax (BEAT Tax)
  - Additional tax on “base erosion” payments
    - Base erosion is cross border payments to affiliates which reduce US taxable base income
    - Exempt if company < $500m in gross premiums
- Passive Foreign Investment Company (PFIC)
  - Stricter threshold for determining insurance company
  - Insurance liabilities (x UPR) ratio to assets > 25%
  - May require “hedge fund Re” to write more risk

Global reinsurance market impact

BEAT Tax Considerations

- BEAT tax is the excess of 10% of “modified taxable income” _over_ regular tax
  - BEAT tax was 5% in 2018, 12.5% after 2025
- Modified taxable income includes base erosion payments added to regular taxable income
- Includes ceded premiums to offshore affiliates
  - No offset to for ceded losses or commissions
- Can make cessions to offshore affiliates uneconomic:
  - 10% on ceded premium compared to
  - 21% on retaining otherwise ceded profit
- Consider cession if regular tax enough to not trigger BEAT, or if ceded margin > 50% (10%/50%< 21%)
- In 2018, CWP to affiliates reduced by 60% to $23B

Global reinsurance market impact

BEAT Tax Calculation

- Simplistic scenario with 21% tax rate and %10 BEAT tax

$1000 premium, 20% profit margin, and 50% offshore QS

- Regular taxable income = $100, tax = $21
- Modified taxable income = $100 + $500 = $600 (added $500 of ceded premium to offshore affiliate)
- BEAT Tax = ($600 x 10%) - $21 = $39
- Total Tax = $21 + $39 = $60
- Tax without QS would have been $200 x 21% = $42
- Need to reduce QS to 10% to make economic

BEAT tax implications depend on the following:

- Tax rate before BEAT
- Income before BEAT
- Ceded premium offshore
- Ceded margin offshore

Benefits from past affiliated QS arrangement
(before new U.S. Tax Law)

Tax management

- Effectively reduced group tax rate
- New lower U.S. tax rate makes tax benefits less relevant

Capital management

- More efficient global allocation of capital
- Facilitated global aggregation of risk
  - Diversification benefits
  - Enabled global group reinsurance programs

Asset management

- Efficiently manage assets

Global reinsurance market impact

BEAT Tax – Offshore Strategies

- Reduce affiliated offshore cessions
  - Potentially increases US taxes and required capital
- Maintain offshore arrangement where makes sense
  - Portfolios with low ratios, e.g. mortgage
- Utilize affiliated Stop Loss instead of QS
  - Significantly less ceded premium
  - Lower expected ceded loss ratios
  - Difficulty assessing capital benefit & transfer pricing
- Use Controlled Foreign Corporation (CFC or 953d entity)
  - Offshore subsidiary deemed a US taxpayer
  - Subject to foreign capital requirements
  - Useful for group internal reinsurance arrangements
- Increased use of 3rd party reinsurance

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