Tax Changes and Implications for the Insurance Market

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With you Today

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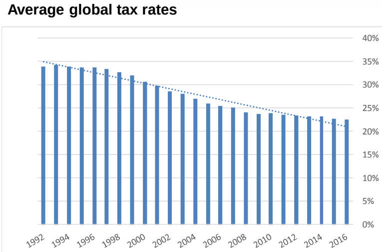
Agenda

- Corporate Taxation: The US and The World
- Proposed Tax Reform in 2017
- Property Casualty Taxation:
  Overview and Potential Implications of Reform
- International Tax Overview
- Tax Planning
- Questions?

Corporate Taxation: The US and The World

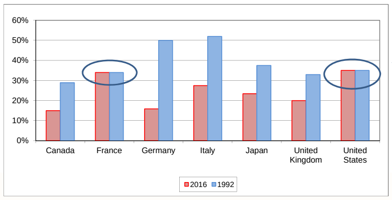
Corporate Tax Rates Have Been Declining Globally…

Average global tax rates



Source: OECD: 34 countries excluding U.S.

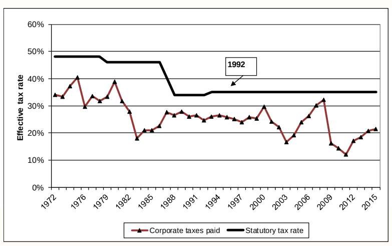
…But Not in the US



Only the US and France have not lowered their tax rates since 1992; and the US now has the highest statutory rate among major countries

Source: OECD

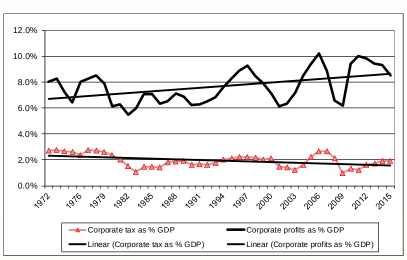
The US Statutory Tax Rate Has Been Constant Since 1992



But the effective tax rate has declined

Source: Congressional Budget Office (CBO)

Corporate Profits Have Increased as a % of GDP



But corporate taxes have not

Source: Congressional Budget Office (CBO)

The U.S. Taxes World-Wide Income

- "Worldwide System" – A domestic taxpayer's worldwide income, regardless of source, is subject to taxation by the country of residence. In order to mitigate double taxation the country of residence grants domestic taxpayers a credit for foreign income taxes paid.
- "Territorial System"- A country taxes the income that is earned in that particular location.

Proposed Tax Reform in 2017

Key Proposals – Business

	President Trump's outline (April 2017)	House Republican "Blueprint" (June 2016)	House Ways & Means Chairman Camp's proposal (February 2014)
Corporate rate	15%	20%	Reduce to 25% (over several years)
Individual owners of passthroughs and proprietorships	15% rate, possibly limited to "small" and "medium" passthrough businesses (with unspecified anti-abuse rules)	"Active business income" of owners of passthrough entities capped at 25% ordinary income rate. Backstopped by "reasonable compensation" requirement for owner-operators	Qualified domestic manufacturing generally taxed at no higher than 25%. Owners who materially participate treat 70% of combined compensation and distributive share as subject to employment taxes. Other changes to Sub K.
Carried interest	Not mentioned	Not clear	Special rules
Cost recovery	Not mentioned	Full and immediate expensing for investments in tangible property and intangible assets, but not land	Replace MACRS with system that lengthens recovery lives and indexes depreciable basis for inflation. Extend amortization period for acquired Code section 197 intangibles. Caps on expensing. Other.
Interest expense	Not mentioned	Net interest expense not deductible but carried forward indefinitely—with unspecified special rules for financial services companies	No broad rule, but limits amount of deductible interest expense that could apply to a U.S. corporation shareholder with one or more foreign corporations in some cases

Key Proposals – Business (cont'd)

	President Trump's outline (April 2017)	House Republican "Blueprint" (June 2016)	House Ways & Means Chairman Camp's proposal (February 2014)
NOLs	Not mentioned	Carry forward indefinitely and indexed for inflation, but no carry back. Carryforwards limited to 90% of the net taxable amount for the year	Limit deduction to 90% of taxable income. Repeal some special NOL carryback provisions as well as limitation on the carryback of excess interest losses attributable to CERTs
Corporate AMT	Not clear	Repeal	Repeal (with unused AMT credits refundable over several years)
Research credit	Not mentioned	Keep, with unspecified modifications	Keep, with modifications
Last in, first out (LIFO)	Not mentioned	Superseded by expensing of non-imported inventory	Repeal
Selected revenue raisers	Eliminate unspecified tax breaks for "special interests"	Eliminate various unspecified "special interest" deductions and credits, including section 199 (but not R&D credit)	Numerous raisers specified

Key Proposals - International

	President Trump's outline (April 2017)	House Republican "Blueprint" (June 2016)	House Ways & Means Chairman Camp's proposal (February 2014)
Destination based cash flow system, with border adjustments	Not mentioned in one-page summary document	Move towards a destination-based tax system, with border adjustments	Not included
Territorial system	Move to territorial system. No details.	Territorial tax system, with 100% exemption for dividends received from foreign subsidiaries. Repeal most of current subpart F regime, but retain foreign personal holding company rules for passive foreign income.	U.S. corporate shareholder gets 95% deduction for foreign sourced portion of dividends received from certain foreign subsidiaries. Complex provisions to prevent offshore shifting of profits. Minimum tax of 15% on CFC's foreign earnings. Modify active financing exception
Repatriation of existing earnings and profits (E&P)	Foreign earnings accumulated under old system taxed; rate determined in consultation with Congress	Foreign earnings accumulated under old system repatriated by paying tax of 8.75% to the extent held in cash or cash equivalents or 3.5% otherwise (payable in installments over 8 years)	Foreign earnings accumulated under old system repatriated by paying tax of 8.75% to the extent held in cash or cash equivalents or 3.5% otherwise (payable in installments over 8 years)

Discussion of High Level Potential Impacts

Conditions in Washington make it possible that 2017 could bring significant changes to how U.S. domiciled insurance companies will be taxed

Summary of Business Tax Proposals under Trump's outline as of April 2017:

- 15% corporate rate (currently 35%)
- Move from a worldwide to a territorial tax system
- Impose a one-time tax on existing overseas profits
- Eliminate tax breaks for "special interests"

Discussion of High Level Potential Impacts

Summary of Business Tax Proposals under Blueprint:

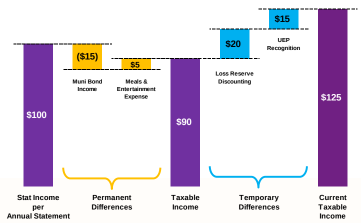
- Cash Flow Tax
  - Replace depreciation and amortization with expensing
  - Eliminate the deduction for net interest expense
    - Provides for an indefinite carryforward for disallowed deductions
    - Purpose is to provide equal treatment for interest and dividends to reduce the tax incentive to favor debt funding
    - Results in a permanent disallowance that impacts GAAP financial statements and effective tax rates
- Eliminate tax breaks for special interests
  - Section 199 repealed
  - R&D credit remains available

Property Casualty Taxation: Overview and Potential Implications of Reform

P&C Taxation Overview

- P&C taxation begins with the annual statements filed with the state regulators so **Statutory Income** is the starting point
- Statutory income is modified to arrive at **Taxable Income**
- **Permanent Differences** arise from income that is not taxable or expenses that are not deductible:
  - Interest on Muni Bonds
  - Dividends on Stocks
  - A portion of Meals & Entertainment Expense
- **Temporary Differences** arise from items of income or expense that are recognized earlier or later for income tax purposes:
  - 20% of unearned premium "UEP" is recognized currently
  - Reserves are discounted

Statutory vs. Effective Rates



- Expected Tax = $100 x 35% = $35
- Total Tax = $90 x 35% = $31.5
- Effective Tax Rate = $31.5 / $100 = 31.5%
- Current Tax Payable = $125 x 35% = $43.75
- Deferred Tax Benefit = $31.5 - $43.75 = $12.25

P&C Potential Implications

- The property/casualty industry is generally in a favorable tax position; chiefly because of the ability to invest in securities such as municipal bonds and equities where income is taxed at lower than statutory rates
- Over the last 5 years the industry's average tax rate has been about 19% driven chiefly by a 16% (estimated) rate on investment income.*
- By comparison the average S&P 500 overall was 24% in 2015 (other industries have their own unique advantages).*
- What happens when the rate is reduced?

*Source: S&P, Factset and Assured Research

Leveraging U/W Income

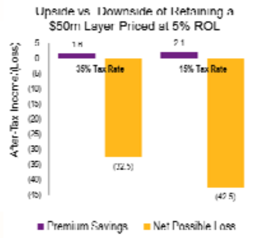
	35% Tax Rate	15% Tax Rate	35% Tax Rate
NEP	100,000	100,000	130,769
Less: Losses (65%)	(65,000)	(65,000)	(85,000)
Pre-Tax UW Income	35,000	35,000	45,769
Less: Taxes	(12,250)	(5,250)	(16,019)
Net UW Income	22,750	29,750	29,750
Percentage Increase		30.8%	30.8%

A drop in the tax rate from 35% to 15% has the same effect on Surplus as a 31% increase in premium volume.

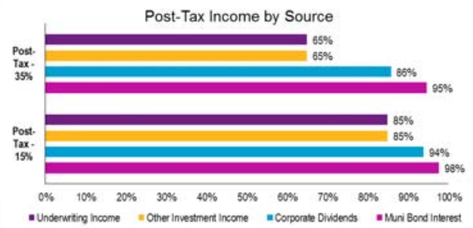
- Underwriting Income is taxed at an effective rate of 35%
- This means that the Government has a 35% "quota share" of every company's results, good or bad
- Cutting the corporate tax rate reduces this "quota share" and leverages the impact of underwriting results on surplus

Effect on Cat Layers

- The leveraging effects of a cut in corporate tax rates may particularly affect buying decisions on cat layers
- For example, if a particular $50m layer is priced at 5% ROL ($2.5m pre-tax cost), going from a 35% tax rate to a 15% tax rate increases the downside risk of retaining the layer by $10m after tax



Decreased Advantage for Tax-Free Investments



Advantage for Companies that Rely on UW Income

35% Rate	UW Loss		UW Flat		UW Gain	
	Pre-Tax	Post-Tax	Pre-Tax	Post-Tax	Pre-Tax	Post-Tax
Underwriting Income	(769,231)	(500,000)	0	0	769,231	500,000
Taxable Bond Income	1,153,846	750,000	769,231	500,000	384,615	250,000
Muni Bond Income	791,557	750,000	527,704	500,000	263,852	250,000
Net Income	1,176,172	1,000,000	1,296,935	1,000,000	1,417,698	1,000,000

15% Rate	UW Loss		UW Flat		UW Gain	
	Pre-Tax	Post-Tax	Pre-Tax	Post-Tax	Pre-Tax	Post-Tax
Underwriting Income	(769,231)	(653,846)	0	0	769,231	653,846
Taxable Bond Income	1,153,846	980,769	769,231	653,846	384,615	326,923
Muni Bond Income	791,557	773,747	527,704	527,704	263,852	263,852
Net Income	1,176,172	1,100,670	1,296,935	1,181,551	1,417,698	1,244,621

Balance Sheet Potential Impacts

- Temporary Differences (reflecting future additions or subtractions from current taxable income) are tax-effected and carried on the balance sheet as Deferred Tax Assets or Liabilities
- With a lower potential rate, adjustments to DTAs will result in a charge to income while DTLs will result in a gain
- Insurance companies tend to carry net DTAs:
  - Discount on Loss Reserves
  - Acceleration of UEP
  - Net Operating Loss Carryforwards
- Following a cut in the corporate tax rate these DTAs would be recalculated reflecting their lower value

Potential Impact on Muni-Bond Pricing

- Muni Bonds will re-price resulting in a drop in the carrying value of portfolios classified as "Available for Sale"
- Effects also felt in companies are forced to sell Muni Bonds classified as "Hold to Maturity"

	35% Corporate Rate		15% Corporate Rate	
	Corporate Bond	Muni Bond	Corporate Bond	Muni Bond
Pre-Tax Yield	3.00%	2.06%	3.00%	2.61%
Effective Tax Rate	35.00%	5.25%	15.00%	2.25%
After-Tax Yield	1.95%	1.95%	2.55%	2.55%

If the corporate rate is dropped from 35% to 15% yields on Muni Bonds may need to increase significantly to provide after tax parity with other bonds, which may lead to pushing down market values.

International Tax Overview

Destination Based Cash Flow Tax

- In its simplest form, a tax on cash entering the business less cash leaving the business
- Objectives – Simplicity, improved incentives for growth and investment, eliminate bias towards debt financing
- For insurers – how to determine net cash flows?
  - Premiums less claims?
  - Is interest deductible in a cash flow tax and if not, what might be the potential impact on bond supply?
  - Is there a deduction for reserves? If no, can insurers exclude investments made to support reserves?
  - How would DAC be treated?
  - What about reinsurance premiums, ceding commissions, agent commissions, policy loans?
  - Impact of no carryback of NOLs

Border Adjustment

- Territorial Tax System vs. Worldwide Taxation System
- The Boarder Adjustment Tax (BAT) is a material revenue raiser, that can help fund large decreases in corporate rate
- Determine tax situs based upon place of consumption instead of production
  - Revenue from exports is excluded from taxable income
  - Imports are fully subject to tax
    - Either directly or indirectly by denying deduction for cost of imports
- Proposed territorial tax system would eliminate US tax on foreign earnings
- BAT could favor risk coming to the U.S. and favor keeping U.S. risk onshore

Border Adjustment Potential Impact on Insurance Industry

- Impact of cross-border and reinsurance transactions given uncertainty about policy objectives
- When a US insurer purchases cover from an offshore reinsurer, is this an import of insurance services or an export of insurance risk?
- If cash flowing offshore is treated as an import, what is the treatment of loss reserves?
  - Significant taxable income to the importing insurer, disincentive to use offshore reinsurance
  - Is concentration of risk in US market desirable for efficient functioning of insurance and reinsurance markets – effect of foreign reinsurers' capital capacity
- Ceding to a U.S. insurance company could result in significant tax benefit in year of transaction if the premium income of the U.S. company is not taxable
- U.S. insurance company ceding to a foreign insurance company could result in high tax rate due to loss of deduction on premium ceded

Tax Planning

Tax Planning

- As taxes have a direct impact on reported earnings and cash flow now is the time to consider tax planning efforts as strategic moves ahead of any change can provide for considerable rewards
- At a minimum, consideration should be given to investment portfolio reallocations considering that the relationship between taxable and tax exempt securities could change
- Companies with unrepatriated foreign earnings, should consider whether there may be some type of discount given for bringing funds back in future years
- Companies should also consider deferring revenue into future years where the rate will be lower and expenses into years where they will generate the most favorable tax treatment, assuming such changes
- Possible impact to regulatory capital as a result of revaluing deferred taxes and elimination of NOL carryback

Questions?

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