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WORLD

CAPTIVE FORUM

Tax Discussion/Update

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JANUARY 30 – FEBRUARY 1, 2019

Our Panel

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Agenda

- Update on Microsoft
- Update on Tax Reform Act- One Year Later
- Pooling Considerations

Update on Microsoft

- Background
 - Microsoft had formed a captive in Arizona
 - Captive wrote both Washington State and non-Washington State risk
 - Initial assertion by Washington State Director of Insurance (DOI) was to impose a 2% tax on entire premium written plus penalties, interest and fines
 - Case settled and only terms available indicate that tax would be imposed solely on Washington State risk premium; interest and penalties were imposed; and, in the future, Microsoft would pay tax through a surplus lines broker

Update on Microsoft

- Recent Developments
 - DOI comment that risk can be placed only with an admitted carrier or with an unauthorized carrier only through a surplus lines broker
 - Now DOI requesting all captives who have not paid premium tax to self report and, if done so, penalties and interest will be reduced

Update on Microsoft

- Recent Developments

- Generally, if self reported

- Between 1/1/2019 and 6/30/2019 100% tax on premium, 100% interest plus **25%** of tax penalty, plus **\$25,000** fine
 - Between 7/1/2019 and 12/31/2019 same regarding tax and interest **but 50%** of tax penalty, plus **\$100,000** fine
 - Between 1/1/2020 and 6/30/2020 same regarding tax and interest **but 70%** of tax penalty and **use of full fining authority**
 - 7/1/2020 or thereafter same as to tax and interest **but 100%** of tax penalty and **full fining authority**

Tax Reform Act – Types of Guidance

Tax Cuts and Jobs Act (“TCJA”)- December 22, 2017

- Guidance to follow
 - Administrative Guidance
 - Notices
 - Revenue Procedures
 - Treasury Regulations
 - TCJA Technical Corrections
 - TCJA Blue Book

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 thereby reducing benefit (asset value) of deferred tax asset adversely affecting surplus

Other 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

Revenue Recognition- Accrual Method Taxpayers (Sec. 451)

- An accrual-method taxpayer cannot treat the all-events test as being met for any item of gross income (or portion thereof) any later than when that item is taken into account as revenue in either an applicable financial statement or another financial statement that Treasury and the IRS identify as applying for this purpose.

Property and Casualty

- In the TCJA, provisions applicable to property and casualty (P&C) insurance companies will:
- Reserves
 - Require P&C insurance companies to use the corporate bond yield curve when discounting loss reserves
 - The present-law 10-year period for certain long tail lines of business is extended for a maximum of 14 more years
 - Repeal the election to use company-specific, rather than industrywide, historical loss payment patterns
 - Re-computation of 2018 opening vs 2017 closing balance amortized into income over 8 years

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

Tax Reform- Guidance Issued

- Business Interest Expense Limitation
 - Notice 2018-28 (April 2, 2018)
 - Proposed Regulation (Nov. 27, 2018)
- Market Discount
 - Notice 2018-80 (Sept. 27, 2018)
- Expenses for Business Meals
 - Notice 2018-76 (Oct. 3, 2018)
- Discounting of Unpaid Loss Reserves and S&S
 - Prop. Reg. 103163-18 (Nov. 5, 2018)
 - Rev. Proc. 2019-16 (Dec. 20, 2018)
- Adjustment for computing change in Life Insurance Reserve
 - Blue Book (December, 2018)

Tax Reform- Guidance Issued

- BEAT
 - Proposed Regulations (Nov/Dec, 2018)
 - Draft reporting Form 8991 (Sept. 2018)
 - Instructions for 8991 (Dec. 2018)
- GILTI
 - Proposed Regulation (Sept. 2018)

Proposed Regulations 11/5/18- Discounting

- TCJA – annual rate based on corporate bond yield curve (CBYC)
 - Single annual rate applicable to all lines
 - Intent to match rate to bond investment yield and returns and cash flows which fund the undiscounted losses to be incurred in the future
- Alternative approach – direct application of the BYC to the loss payment pattern for each line of business
- Smoothing Adjustments – 7-step process proposed methodology
- No longer separate salvage discount rates – netted with unpaid losses for discounting
- Applicable for tax years beginning after 12/31/17

Rev. Proc. 2019-06- Discounting

- Provides updated discount factors for 12/31/17 to comply with transition rule.
- Provides discount factors for the 12/31/2018 tax year.
- Annual rate for the calendar year 2018- Interest rate 3.12%.
- Leaves open opportunity for revised discount factors pending outcome of regulations.

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Passive Foreign Investment Companies
 - Background
 - In general, PFIC rules originally enacted to address attempts to invest in foreign corporations when U.S. investor would not have to include amounts in income under controlled foreign corporation (“CFC”) rules and the foreign corporation’s primary focus was investment activity, *i.e.*, the definition was a foreign corporation if more than 50% of its assets were held for the production of passive income, or if more than 75% of its income was passive
 - So not applicable to single parent captive
 - But note RPII not included

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Passive Foreign Investment Companies
 - Background
 - If the test met in any year a U.S. shareholder held its interest, then a PFIC forever as to that shareholder
 - Penalty was, *e.g.*, in case of sale of shares to allocate gain ratably over period shares held, tax each “annual segment” at highest applicable rate in each year to which a segment was allocated and then impose, in essence, an interest factor to the tax from the year it arose to present

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Passive Foreign Investment Companies
 - Background
 - Elections were possible to tax allocable share of income annually notwithstanding no distributions were made
 - There was an exception to PFIC status if the foreign entity was in the “active” conduct of an insurance business
 - What is an “insurance business”
 - What is “active conduct”

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Passive Foreign Investment Companies
 - New Legislation
 - Statute amended to require foreign insurer to not only be in the active conduct (which remains undefined in the statute) of an insurance business, but to be a qualified corporation. The latter provision generally relates to a requirement, in most instances, that reserves equal 25% of assets

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Passive Foreign Investment Companies
 - New Legislation
 - Alternatively if in run off, the 25% can drop to 10% if based on facts and circumstances the entity is predominantly engaged in the insurance business and its failure to qualify under the 25% test is due to solely run off related or rating related circumstances present. Joint Committee Report gives examples of other factors that tend to indicate an entity is not in the insurance business
 - “Small number of insured risks with low likelihood but large potential costs”
 - Workers focused to a greater degree on investment activities than underwriting activities
 - Low loss exposure

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - New Legislation
 - Other relevant factors set forth in the report
 - Claims payment patterns for the current and prior years
 - The firm's loss exposure as evaluated for a regulator such as the SEC or a rating agency, or if those not calculated, for internal pricing purposes
 - The percentage of gross receipts constituting premiums for the current and prior years
 - The number and size of insurance contracts issued or “taken on” through reinsurance
 - The fact that a firm has been holding itself out as an insurer for a long period is not determinative either way

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - New Legislation
 - Other relevant factors set forth in the report
 - Run off related or rating related circumstances include:
 - The fact that the company is in run off (*i.e.*, not writing any new business) and has little or no premium income
 - Is using its remaining assets to pay off claims on existing insurance risks
 - Specific requirements with respect to capital and surplus imposed by a rating agency as a condition to obtain a rating necessary to write the business for the current year
 - As noted above, an issue for “CFC’s” with respect to “US Shareholders” as there is a “kick-out” provision, so no application, *e.g.*, to single parent captives although most think there should be a similar provision for RPII CFC’s, there is no similar statutory provision
 - Also affected are dealer group entities writing warranty n.o.v. significant loss ratios

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Proposed Regulation Provision
 - Foreign Account Tax Compliance Act (FATCA)
 - When initially enacted, FATCA imposed withholding tax on various payments including insurance premiums and investment proceeds (*e.g.*, interest, dividends, etc.) paid by a U.S. person to certain foreign entities including captive insurance companies
 - Under these provisions, the withholding obligations would be obviated by, in the case of a property casualty insurer, relatively concise filings with the payor (or, if elected, with the Internal Revenue Service)

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Proposed Regulation Provision
 - Foreign Account Tax Compliance Act (FATCA)
 - Once it was determined that the filings were, in general, quite simple, management companies generally took them over
 - Proposed Regulations regarding FATCA conclude that premiums for “non” cash value insurance policies will no longer be considered “withholdable payments” because it is assumed that because of new PFIC provisions, *i.e.*, if they are PFICS, shareholders will have to report the income eliminating the need to withhold on premiums
 - But remember that FATCA still applies to payments of investment income so the filing requirements do not entirely go away for captives that are offshore and have not made IRC § 953(d) elections

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Base Erosion Antiabuse Tax (BEAT)
 - Background
 - BEAT is generally imposed if
 - The BEAT, when enacted, was designed to impose a tax on certain deductible payments made to affiliates provided the corporate group met certain fundamental requirements
 - The tax is to be applied at a 5% rate for 2018, a 10% rate for year 2019-2025 and a 12½% rate thereafter

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Base Erosion Antiabuse Tax (BEAT)
 - Background
 - BEAT Tax is generally imposed if
 - The BEAT is applicable to deductible payments made by, in general, a U.S. entity, to a foreign affiliate if
 - The corporate group has average gross earnings over the prior three-year period of at least \$500,000, and
 - Deductible BEAT payments exceed 3% of all deductible payments
 - The BEAT provisions also include an “anti abuse” provision intended to address, among other issues, payments made through third parties
 - Applies to premium payments on direct insurance, reinsurance premiums, loss payments from US insurer/reinsurer to affiliate

Tax Reform Act – Proposed Regulations

- Update on Proposed Regulations Issues with Respect to Provisions of the Tax Reform Act
 - Base Erosion Antiabuse Tax (BEAT)
 - Background
 - Some alternatives to address the tax that have been discussed and implemented:
 - Redomestication of foreign captives
 - Elections under IRC § 953(d) for foreign captives
 - Restructuring reinsurance arrangements to have payments go directly to retrocessionaires
 - Questions remained regarding fronting arrangements
 - Proposed Regulations which have recently published do not provide very much enlightenment, *e.g.*, on anti-abuse arrangements and may raise some concerns
 - For example – if losses are characterized as reductions to income, loss payments would not be included in the base erosion percentage denominator and could cause more companies to reach the hurdles for BEAT taxation

Pooling Considerations

- *Avrahami* and *Reserve Mechanical* cases in Tax Court seemed to call into question the efficacy of pooling arrangements
- These cases, however, seem to start from a premise (especially *Reserve Mechanical*) that there was some basic deficiency in the insurance program, *e.g.*, there was really no risk being insured

Pooling Considerations

- Accordingly, there seem to be a number of factors discussed by the Court (**some of which overlap**) that one should give some thought to:
 - Individually underwritten premium
 - Each insured participating in the pool has its circumstances taken into account in establishing its premium
 - Likely having a common actuary is advisable
 - Business reason
 - Risk distribution/reduction of variability
 - Cat vs. frequency

Pooling Considerations

- Accordingly, there seem to be a number of factors discussed by the Court (**some of which overlap**) that one should give some thought to:
 - Economic effect
 - GL vs. satellite
 - Whether the pool assumes catastrophic risk or less severe frequent risk, there should be an economic effect. In addition, there should be an ability of each pool member to demonstrate the ability to respond to pool obligations

Pooling Considerations

- Accordingly, there seem to be a number of factors discussed by the Court (**some of which overlap**) that one should give some thought to
 - Risk of loss and insurance risk
 - Realistic expectation of ROL
 - Acceptable reinsurance
 - Sufficient capital/financial resources
 - Can pool participant bear the ROL
 - There is a fundamental element, *i.e.*, is whether the pool participants are ceding risk with a realistic expectation, there is a risk of loss, if not, perhaps there is no insurance “going in” and thus none “going out” to the participating pool members

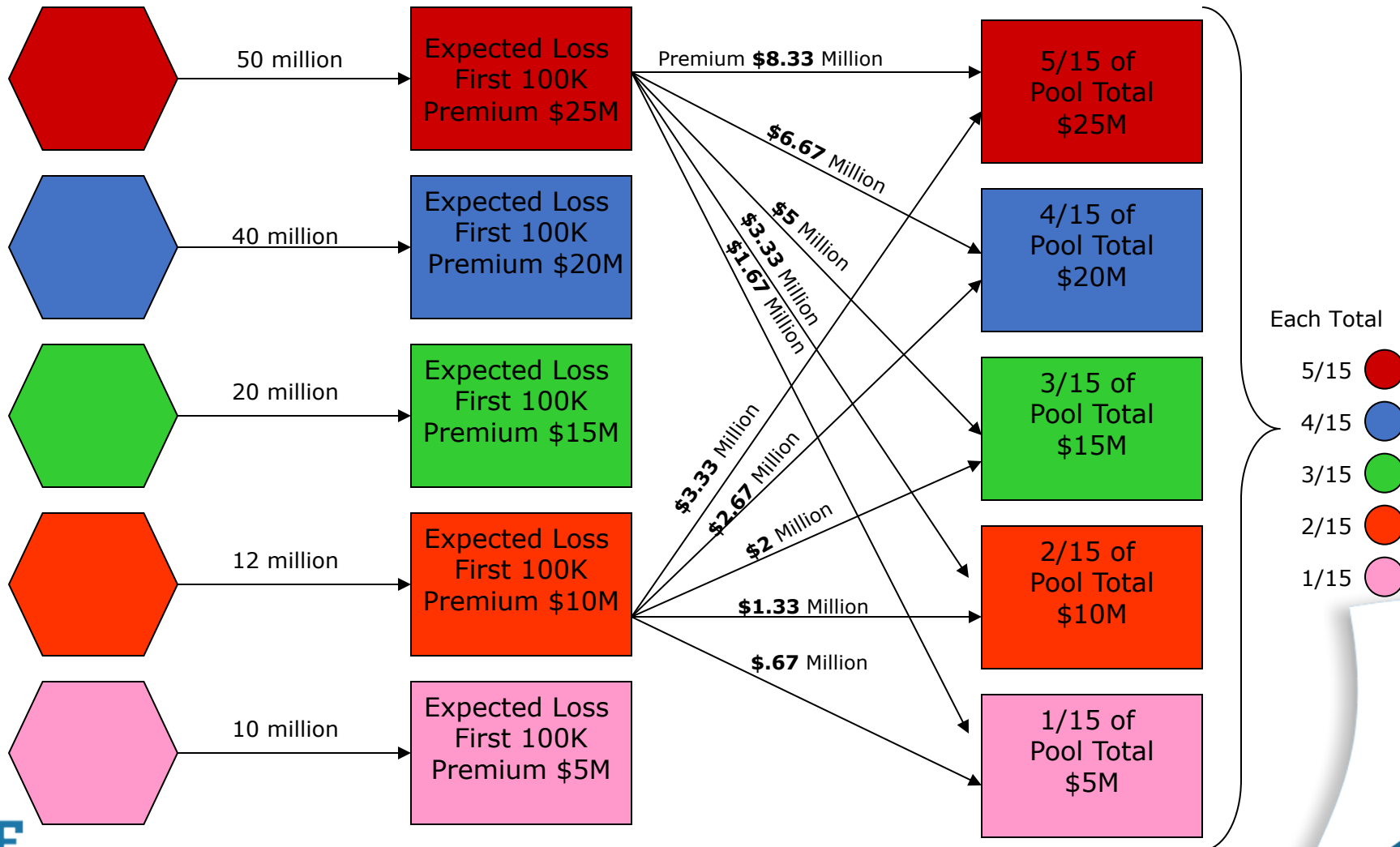
Pooling Considerations

- Accordingly, there seem to be a number of factors discussed by the Court (**some of which overlap**) that one should give some thought to
 - Knowledge of risk
 - This relates to whether the owner of the pool participant understands the economic ramifications of participation in the pool, including who the other participants are or what their risk profile might be
 - Possible delegation to knowledgeable advisor
 - Voting on new members?
 - Reinsuring a reinsurer?

Pooling Considerations

- Accordingly, there seem to be a number of factors discussed by the Court (**some of which overlap**) that one should give some thought to
 - Arm's length
 - Actuarially determined premium
 - Coverage descriptions
 - Coverage provided by the pool should have an economic effect and be relevant to the pool participant, *e.g.*, reduction of volatility, reduction of economic impact, etc.

Pooling Considerations



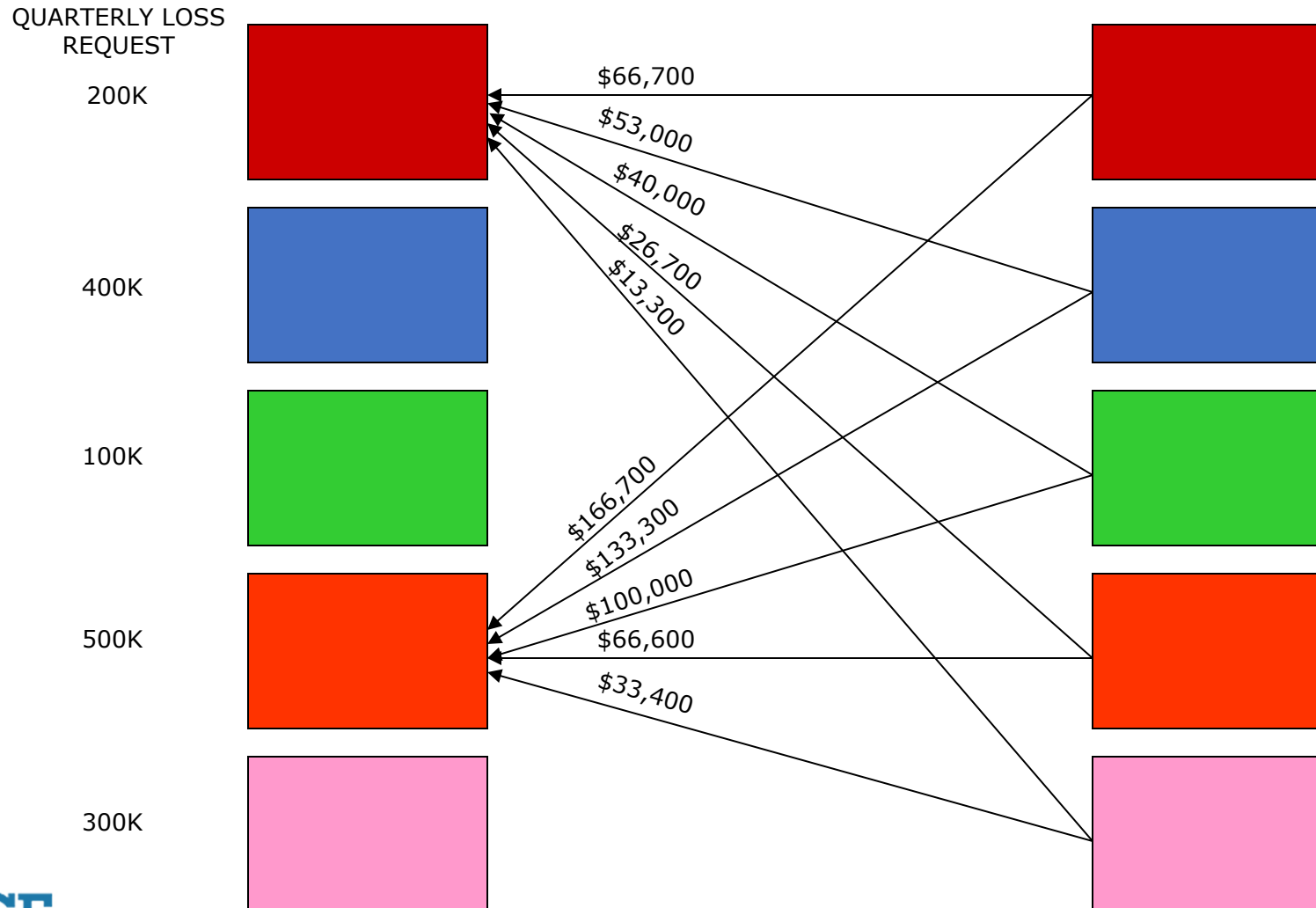
Percentage Unrelated Premium to Related Premium Breakdown

Original payment	\$ 50 million
Ceded to others participating	\$ 25 million
Premium received	\$ 25 million
Portion of premium received related to	\$ 8.33 million
Unrelated premium received	\$ 16.67 million
	<u>\$16.67 million</u>
	\$50 million
% Net unrelated premium	= 33.34%

Percentage Unrelated Premium to Related Premium Breakdown

Original payment	\$	12	million
Ceded to others	\$	10	million
Premium received	\$	10	million
Portion of premium received related to	\$	1.33	million
Unrelated premium	\$	<u>8.67</u>	million
% Net unrelated premium	=	72.25%	

Loss Payment Exhibit



Total Loss Payment Exhibit (Assumed 6 Year Runoff)

TOTAL LOSSES FOR WHICH PAYMENT HAS BEEN RECEIVED (A)	ORIGINAL PREMIUM PAID PREMIUMS (B)	ORIGINAL RECEIVED PREMIUMS (C)	TOTAL LOSS PAYMENTS (D)	NET BENEFIT OR LOSS (A) - (D)
24 million	25	25	25.33 (5/15 x 76)	-1,330,000
24 million	20	20	20.27 (4/15 x 76)	+3,730,000
16 million	15	15	15.2 (3/15 x 76)	+800,000
8 million	10	10	10.13 (2/15 x 76)	-2,130,000
4 million	5	5	5.07 (1/15 x 76)	-1,070,000
76			76	

Pooling Considerations

- Accordingly, there seem to be a number of factors discussed by the Court (**some of which overlap**) that one should give some thought to:
 - Actuarially determined premium (calculated separately for each insured)
 - Compliance with regulatory requirements
 - Minimum capital
 - License to do business
 - Credit risk of pool participants
 - No provisions that significantly affect economics, etc.
 - *E.g.*, limitation of loss to an amount equal to amount recouped for ceded loss or similar provision