December 21, 2017

First Look – Tax Reform 2017

New law contains wide-ranging provisions affecting insurers

The Tax Cuts and Jobs Act will generate changes to laws impacting the insurance industry. The legislation, which passed both the House and Senate, now awaits President Trump's signature. We will continue to monitor the implementation of the new rules and how they are interpreted by regulators and insurers. The discussion below and the table that follows highlight provisions we perceive initially as having the greatest impact on insurers. The repeal of the individual mandate promulgated under the Affordable Care Act will be discussed in greater detail in the future. The new law generally is effective for taxable years beginning after December 31, 2017.

Corporate Tax Rate and Corporate Alternative Minimum Tax

At the core of the Conference Committee's agreement was the permanent reduction in the corporate tax rate from 35% to 21% that is set to take effect on January 1, 2018. Special rules will apply to fiscal year filers with a blended tax rate for their tax year. The legislation produced by the Conference Committee repeals the corporate alternative minimum tax (AMT).

Net Operating Loss Deductions

The new law preserves current law for net operating losses of P/C companies, which may be carried back two years and carried forward twenty years.

This differs from the new law's treatment of life insurance companies, which alters the operations loss carryback and carryover (currently carried back three years and forward fifteen years), making these periods conform to those of other corporations. For life insurers, the new law repeals all net operating loss carrybacks but allows net operating losses to be carried forward indefinitely. Taxpayers' ability to deduct a net operating loss carryover will be limited to 80% of the taxpayer's taxable income for the year for tax years beginning after December 31, 2017.

Life companies may be significantly impacted by the repeal of the loss carryback period, as this change has the potential to reduce the amount of gross deferred tax assets that can be admitted, thereby reducing capital and surplus. Higher after-tax earnings may offset the surplus declines, but this may take time to emerge. Insurers in a net deferred tax liability position may see benefits as future tax liabilities will be based on lower rates. A.M. Best will view companies on a case-by-case basis to determine future surplus expectations as the new law takes effect. The mismatch of the treatment of NOLs between P/C and life companies could come into play with respect to potential organizational consolidations.

Tax Reserving

In order to determine loss reserves for tax purposes, P/C companies will be required to use loss payout patterns prescribed by the Treasury and a discount rate that reflects an average of monthly yields on investment grade bonds for the prior 60 months. This is a departure from the current law that allows insurers to use their own experience in determining the loss payout patterns and the new discount rate would be higher than the one used previously. The Treasury's published loss payment patterns for each line of business typically assume payment over the accident year and the following three years, or the accident year and the following 10

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SR-2017-B-991

years. In the case of long-tail lines of business such as general liability, director's and officer's liability, and workers' compensation, however, the 10-year period is extended, but not by more than five years, such that the maximum duration for the assumed loss payment pattern is extended to the accident year and the following 15 years. Using the corporate bond yield curve would typically result in a higher rate than what is used to discount unpaid loss reserves under current law, therefore, this change would likely result in larger tax discounting, resulting in higher levels of taxable income, all else remaining equal.

Life insurance company tax reserves are now the greater of 92.81% of the statutory reserves and the cash surrender value. Tax reserves cannot exceed the statutory reserves held. As with the current code, deficiency reserves and additional reserves held for asset adequacy are not deductible for tax purposes. Previously, life tax reserves were determined using the greater of a prevailing state rate (highest interest rate used in at least 26 states) or a 60-month average of the applicable federal mid-term rate. With low interest rates over the last several years, the prevailing state rate was used, bringing tax reserves closer to statutory reserves. The new tax law brings the tax reserve down to levels closer to the cash surrender value. As with the changes to P/C reserves, changes to the life tax reserves are expected to be a significant source of tax revenue over the next 10 years.

Modification of Proration Rules

In order to calculate the deductible amount of its reserves for losses incurred under the current tax code, a P/C company has to reduce its losses incurred by 15% of (a) the company's tax-exempt interest income, (b) the deductible portion of dividends received (with special rules applying to dividends from affiliates), and (c) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns. The new tax law replaces the 15% reduction with a reduction equal to 5.25% divided by the top corporate tax rate. Under the new proposal, starting in 2018, with the top corporate tax rate going down to 21% from 35%, the percentage reduction is 25%. The proration percentage will be automatically adjusted in the future if the top corporate tax rate is changed.

Many insurers may look at the new proration provision as preferable to the current provision because tying the calculation of the deductible amount of reserves to the product of the proration percentage and the top corporate tax rate could bring about more predictability relative to the after-tax rates of return on tax-exempt bonds.

Affiliated Foreign Reinsurance

Fundamental changes will apply to the taxation of multinational entities under the new tax legislation. In general, the Conference Committee agreement shifted from a system of worldwide taxation with deferral, to a participation exemption regime with current taxation of certain foreign income. This shift involves the adoption of a few key features:

- A 100% deduction for dividends received from a "specified 10%-owned foreign corporation", defined as any foreign corporation with respect to which any domestic corporation owns at least 10%.
- A minimum tax on a new, broad class of income identified as "global intangible low-taxed income".
- In accordance with the new law's transition rule to effect a participation exemption regime, a 15.5% tax rate would apply to earnings attributable to a company or shareholder's earnings to the extent it is attributable to its aggregate foreign cash position, and at an 8% rate otherwise.

Exhibit 1
Tax Bill's Effects on the Insurance Industry

Issue	Property/Casualty	Life/Annuity
Corporate Tax Cut	A reduction in the corporate tax rate from 35% to 21% will benefit insurance companies' income statements, but short-term impacts are uncertain.	A reduction in the corporate tax rate from 35% to 21% will benefit insurance companies' income statements, but short-term impacts are uncertain.
Net Operating Loss (NOL) Deductions	Present law preserved. Currently, NOL carryback of 2 taxable years and carryover of 20 taxable years is allowed up to 100% of taxable income. Different NOL treatments for non-life and life companies could cause issues for consolidated companies.	NOL carrybacks repealed (current law allows carryback of 3 years and carryover of 15 years) and NOL carryover limited to 80% of taxable income. Companies will no longer be able to use the first admissibility test under SSAP 101 for ordinary deferred tax assets, which could reduce total adjusted capital and RBC.
Reserving	The interest rate used for tax reserve discounting would change from the mid-term AFR to the corporate bond yield curve. This higher rate would decrease tax reserves, thus increasing taxable income. Also, companies will no longer be able to use their own loss payment patterns, and must use industry loss payment patterns. (P/C Only)	Life insurance reserves for any contract will be the greater of the net surrender value or 92.81% of the NAIC required reserve. Tax reserves still cannot be less than the contract's cash surrender value or greater than the statutory reserve.
Foreign Taxes	Changes include a 100% deduction for dividends received from an owned foreign corporation, a minimum tax on "global intangible low-taxed income", a 15.5% tax rate for earnings attributable to a foreign cash position, and a Base Erosion Anti-Abuse Tax (BEAT), which is a minimum tax on deductible payments to foreign affiliates.	Changes include a 100% deduction for dividends received from an owned foreign corporation, a minimum tax on "global intangible low-taxed income", a 15.5% tax rate for earnings attributable to a foreign cash position, and a Base Erosion Anti-Abuse Tax (BEAT), which is a minimum tax on deductible payments to foreign affiliates.
Proration of Reserve Deduction	The reduction in allowable deductions for losses incurred will increase from 15% to 25% of the sum of tax-exempt interest received, dividends, and the increase in policy cash values and will increase taxable income. This could lead to insurers re-evaluating their investment allocations to municipal bonds. (P/C Only)	N/A
Deferred Acquisition Costs (DAC) Tax	N/A	Increase capitalization rates for certain life contracts. Also, the amortization period would be increased from 120 months to 180 months (excluding the rule for the first $5 million).
Risk-based Capital (RBC)	RBC uses pre-tax factors	RBC uses after-tax factors, meaning life insurance companies' RBCs will be negatively impacted by a change in the corporate tax rate.
Best's Capital Adequacy Ratio (BCAR)	Stressed P/C BCAR includes probable maximum losses (PMLs) that may be provided on either a pre-tax or after-tax basis. (P/C Only)	Life/Health BCAR Is calculated on a pre-tax basis.

Source: A.M. Best data and research

The Conference Committee adopted a Base Erosion Anti-Abuse Tax (BEAT). The BEAT serves to impose a minimum tax on certain deductible payments made to a foreign affiliate, including payments such as management fees, and royalties, but excluding costs of goods sold. Per the legislation, the BEAT as stipulated will apply to payments paid or accrued in tax years beginning after December 31, 2017.

Deferred Acquisition Costs (DAC) Tax

Life insurance companies are required to capitalize certain amounts of net premiums on specified contracts and amortize these expenses into income over a period of 10 years. The current rates applied are as follows:

Contract Type	Current Rate	New Rate
Annuity Contracts	1.75%	2.09%
Group Life Contracts	2.05%	2.45%
All Other Specified Contracts	7.70%	9.20%

The new rates are roughly 20% higher than the current rates. The new law extends the amortization period from 10 years to 15 years. Unamortized DAC amounts existing before the tax law change will not be impacted and will continue to be amortized over the previous ten-year period. This change is expected to raise tax revenues over the next ten years, but not to the extent of the changes to Life tax reserves.

Risk-Based Capital (RBC) Impacts

Life company RBC is determined on a post-tax basis using the current effective tax rate of 35% (adjusted for some asset categories based on admitted portions of deferred tax assets). Using industry aggregate RBC data from the NAIC for 2016, A.M. Best estimates that industry aggregate RBC levels would drop substantially from 526% (company action level) to 440% as a result of higher post-tax required capital. P/C and Health company RBC ratios do not incorporate tax effects, so there would be no impact to these sectors. It remains to be seen what action will be taken by the NAIC in response to the new tax law.

Best's Capital Adequacy Ratio (BCAR) Impact

Unlike the RBC ratios, A.M. Best's BCAR models are pre-tax. When stress testing the P/C BCAR for catastrophic events, the pre- or post-tax impact may be considered depending on the current tax position of the company. Companies having recent losses may be unable to carry forward such losses, making it difficult to apply a tax adjustment.

Other Tax Changes

The new tax law includes other changes impacting life companies. Life companies with less than $500 million of assets could deduct 60% of their first $3 million of Life-related income (phased out when income exceeds $15 million). This provision was repealed in the new law. Life companies that change reserves due to tax accounting changes were allowed to spread such change over a ten-year period. The new law changes the period to four years, in line with non-life insurers. Finally, life companies are required to reduce dividends received and reserve deductions to account for the portion used to fund reserves for policyholder obligations. The portion was based on formulas using net investment income to determine the company share and policyholder share. The new law sets the company share at 70% and the policyholder share at 30%.

Near Term Uncertainty

The insurance industry will see overall benefits from the reduced tax rate. Partially offsetting the benefits are certain revenue enhancements that will impact both Life and P/C companies. The NOL changes will have the most impact on Life balance sheets as admitted deferred tax assets may decline. Reserve changes will impact both Life and P/C companies; however, changes applicable to business in effect as of December 31, 2017 will be spread over the next eight years. While Life RBC ratios could be significantly impacted, the required capital in A.M. Best's BCAR models may not change significantly.

Jurisdictions that had tax advantages may be impacted and more reinsurance transactions may move back on shore. Many P/C insurers and reinsurers use after-tax PML as a data point in the calibration of their catastrophe risk tolerances. These insurers will have to revisit the calibrations and consider increased after-tax PMLs, and balance that with increased after-tax earnings. It remains to be seen how companies' capital management, product pricing, and risk management will be impacted as management of these companies and investors re-evaluate risk and return measures such as effective cost of debt, cost of capital, returns on equity, etc.

Published by A.M. Best

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