Tax Reform Impacts on Dealer Owned Reinsurance Programs

F&I Reinsurance and Product Conference
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Tax Cuts and Jobs Act of 2017 F&I Impacts

- Changes to passive foreign investment company (PFIC) exemption
- Change in definition of U.S. shareholder for CFCs
- Changes in overall income tax rates and elimination of AMT

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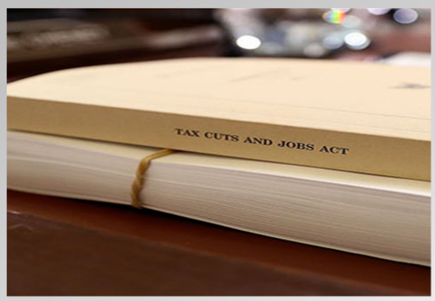
Tax Cuts and Jobs Act 2017



TCJA tax reduction offsets created several changes impacting Dealer Owned Reinsurance Programs:

- Life Insurance Companies
- Non-Life Insurance Companies
- NCFC Reinsurance Programs

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What to Know

- New 21% flat corporate income tax rate
- No more AMT
- New rules for off-shore entities
  - Definition of U.S. Shareholder
  - PFIC Exemption
- Elimination of Small Life Insurance Company deduction
- Reinsurance and Captive programs remain versatile with market change

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Tax Cuts & Reinsurance Programs

- Corporate Income Tax Rate Changes
  - Increase (taxes within the current 15% corporate tax bracket)
  - Decrease (on taxable income exceeding $50,000) taxes for reinsurance companies
  - No more Corporate AMT
- Individual Tax Changes
  - New pass-through rules do not make retro arrangements materially more competitive with reinsurance programs
  - Individual rates lessen difference between the after tax effect of ordinary income and after tax proceeds generated from reinsurance programs

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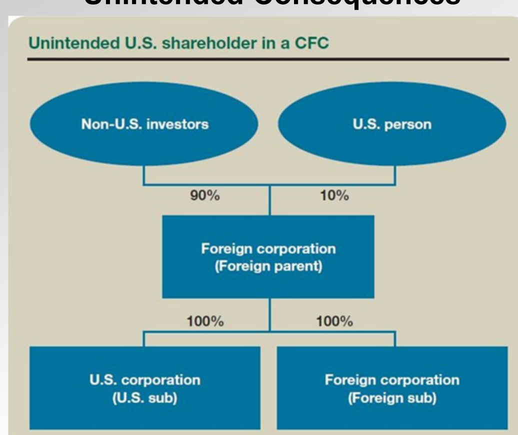
CFC Changes

Main Impacts

- U.S. shareholder definition changed from shareholder holding 10% voting power of foreign corporation to holding 10% voting power or 10% of total company value
- Also changed: number of days required to be classified as a CFC
- TCJA eliminated the 30-day rule, if foreign entity is a CFC for one day, the U.S. shareholders must include pro rata share of income on their personal return

Unintended Consequences



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BEAT (Anti-Base Erosion)

Ensure companies doing business in the U.S. pay minimum tax

- Minimum tax on multinationals with at least $500 million of annual U.S. gross receipts over a three-year lookback period and a base erosion percentage of at least 3% for the taxable year
- Similar to old AMT, corporations required to add base erosion payments back to taxable income and multiply the result by 5%
- BEAT will be compared to their regular tax to determine any additional taxes owed. The rate increases to 10% of the taxpayer's modified taxable income after 2018 to 12.5% after 2025.

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Life Insurance Companies

- Elimination of the small life insurance company deduction (60% haircut is gone)
- Life insurance company NOLs now handled the same as other corporations (no carrybacks and limited ability to utilize going forward)
- Any Policyholder Surplus Account tax balances would be subject to tax over the next eight years (beginning after 2017 tax year)

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Non-Life Insurance Companies

- Reduction of effective exclusion of tax exempt interest by increasing the proration for "Regular" P&C companies from 15% to 25% (to reflect new 21% flat tax rate)
- Loss Reserve Discounting (increased from 10-24 years)
  - Change to the calculation of P&C claim reserve discount rates from mid-term applicable federal rate to corporate bond yield rates
- Requirement to use industry-wide historical loss payment patterns, not company-specific patterns

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Non-Life Cont…

- Net operating loss carryovers can still be used at the rate of 100% (not 80%) going forward
- Flat 21% federal income tax rate applies
- Reduction of the dividend received deductions (DRD) rates to reflect new lower 21% income tax rate going forward

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PFIC & NCFCs

- Changes to prevent perceived off-shore income tax avoidance
  - Previously, off-shore captives received active trade or business exemption from PFIC if insurance company
- Exemption only if PFIC would be taxed as an insurance company in U.S. **AND** the combined amounts for losses, loss adjustment expenses and certain reserves (***excluding*** unearned premium reserves) are more than 25% of the foreign corporations total assets
  - The 25% test could be an issue for F&I NCFC programs utilizing GAAP or SAP accounting
  - IRS has issued proposed Regs that could be problematic
- If NCFC reinsurance program is deemed to be a PFIC, certain tax benefits to shareholders would be lost

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NCFC Shareholder Impacts

- U.S. shareholders should review NCFC programs with tax advisors to see if the program continues to meet new PFIC rules to insure continued preferential tax treatment
- Most NCFC programs have made accounting changes to meet new PFIC exemption criteria (move to IFRS from U.S. GAAP or SAP)
- NCFC reinsurance programs require more monitoring throughout the year

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NCFC Impacts Cont.

- For NCF programs considered PFICs, shareholders would report the income earned each year (change in the book value of the NCFC program) on personal tax returns via Form 8621
- Shareholders should consider making protective QEF (Qualifying Electing Fund) elections in 2018

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Global Intangible Low-Taxed Income

- GILTI intended to approximate the income from intangible assets held abroad
- **Congress worried that** completely exempting U.S. multinationals' foreign earnings might exacerbate incentive to shift profits to low-tax jurisdictions abroad
- Congress created 10.5% minimum GILTI tax to discourage profit shifting
- IRS Notice 2019-46 – S Corp Relief
- Final regulations narrowed the application of the GILTI tax, providing that non-U.S. shareholder partners in domestic partnerships that owned CFC were not required to include GILTI income

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2017 Tax Cuts and Jobs Act

What does this potentially mean for Reinsurance programs?

Individual and Corporate Tax Rate Changes

- New corporate tax rate changes may increase (on taxes within the current 15% corporate tax bracket) or decrease (on taxable income exceeding $50,000) taxes for reinsurance companies in 2018 and forward
- Tax rate changes for individuals (new pass-through rules) do not make retro arrangements materially more competitive with reinsurance programs
- Proposed changes to individual tax rates would also lessen the difference between the after tax effect of ordinary income and after tax proceeds generated from reinsurance programs with preferential taxation at both the reinsurance company (via IRC Section 831(b) election) and shareholder (capital gains taxes) levels

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Impact on Reinsurance Programs

Other Business Changes

- The continuation of the full benefit (100% deduction) for Non-Life Insurance Company NOLs keeps the DOWC programs viable going forward
- Repeal of Small Life Insurance Company deduction could eliminate the use of life insurance companies for F&I reinsurance programs
- Changes that would reduce the benefits of tax exempt interest and dividends could change the investment strategies used by reinsurers deductions

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Impacts on Reinsurance Programs

Increase of Estate Tax Exemption

- May reduce the use of reinsurance program as part of an overall estate plan
- New higher exemption amount is only in place for the next seven years
- May lessen the immediate use of trusts and family members in reinsurance company ownership

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What does this mean for reinsurance programs?

- Definition of U.S. shareholder and PFIC exemptions may impact the continued viability of NCFC programs
  - Participants may consider making a protective QEF election if dealer is in an NCFC program
  - Proposed IRS Regulations may make it difficult for continued exemption from PFIC effects
- Corporate tax rate still lower than all but the lowest individual rates
  - Compounding/deferral of taxes at 21% Corporate tax rate on net investment income (w/ IRC Section 831(b) election in place) still advantageous

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Which of the following was impacted by the TCJA?

Corporate tax rate

U.S. shareholder percentage for CFCs

Small life insurance company deduction eliminated

All of the above

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Questions/Takeaways

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