U.S. TAX UPDATE

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CAYMAN CAPTIVE FORUM 2018

KEY PRINCIPLES

- **Simplification of the tax code for Individuals**
  - Limitations on itemized deductions / increase to standard deductions
  - Changes to tax rates including reduction of top rate from 39.6% to 37%
  - Increase to estate, GS and gift tax exemptions
  - No changes for US citizens working abroad
- **Make US businesses more competitive in the global market**
  - Reduction in corporate tax rate
  - Move to territorial tax system compared to worldwide tax system

KEY PROVISIONS – BUSINESSES AND INSURANCE

Business provisions:

- Reduction of corporate tax rate from 35% to 21%
- Corporate alternative minimum tax (AMT) provisions repealed
- Changes to net operating loss (NOL) provisions (excluding P&C insco's)
- Full expensing of qualified assets in year of acquisition
- Introduction of limitations on deductibility of interest expense

Insurance-specific provisions:

- Modification of proration rules for P&C insurance companies
- Modification to the discounting rules for P&C insurance companies
- Simplification of the method for computing life insurance tax reserves
- Modification to the DAC capitalization rules for life companies

Impacts to captives:

- Changes to the 'value of a captive'
- Reduction in DTA figures due to lowered tax rate
- Breakeven analysis of US/953(d) captive or CFC shifts to US taxpaying entity

TAX CUTS AND JOBS ACT: TAKE-AWAY ITEMS

Captives were not specifically targeted by this legislation – changes apply to all insurance companies (no changes uniquely applicable to IRC 831(b) micro-captives or to cell captives

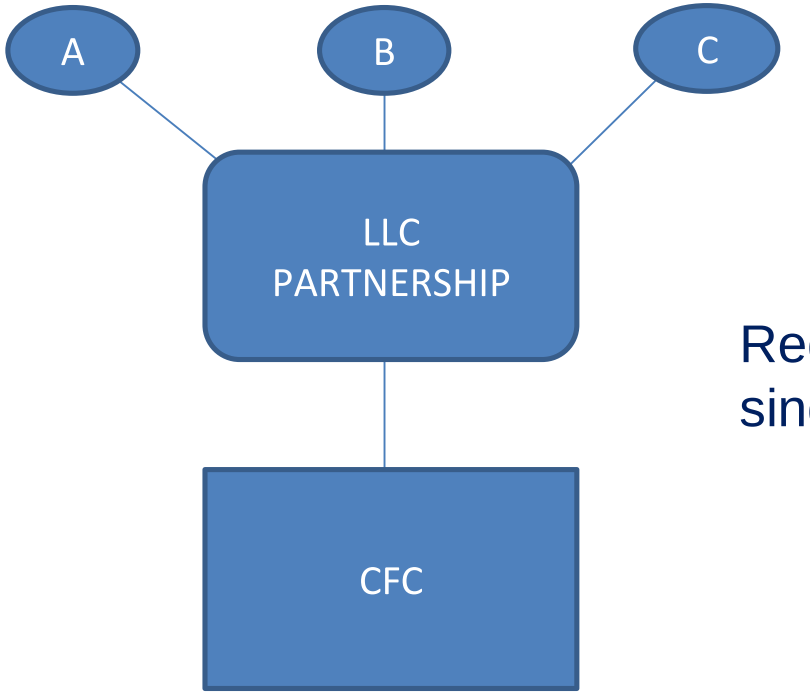
Impact very fact specific so hard to generalize especially without IRS guidance

None of the changes are favorable to captives, but overall relatively small effect on most captive's tax positions

Tax deductions less valuable with new 21% corporate rate versus old 35% rate

Possible migration from pass-through LLCs & S corps to C corp family business structures – better for brother-sister risk distribution

Foreign captives more adversely impacted than domestic – could lead to more Sec. 953(d) domestic tax elections and/or more offshore captive redomiciling onshore



Reduction of rate on single level taxation

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

CFC rules:

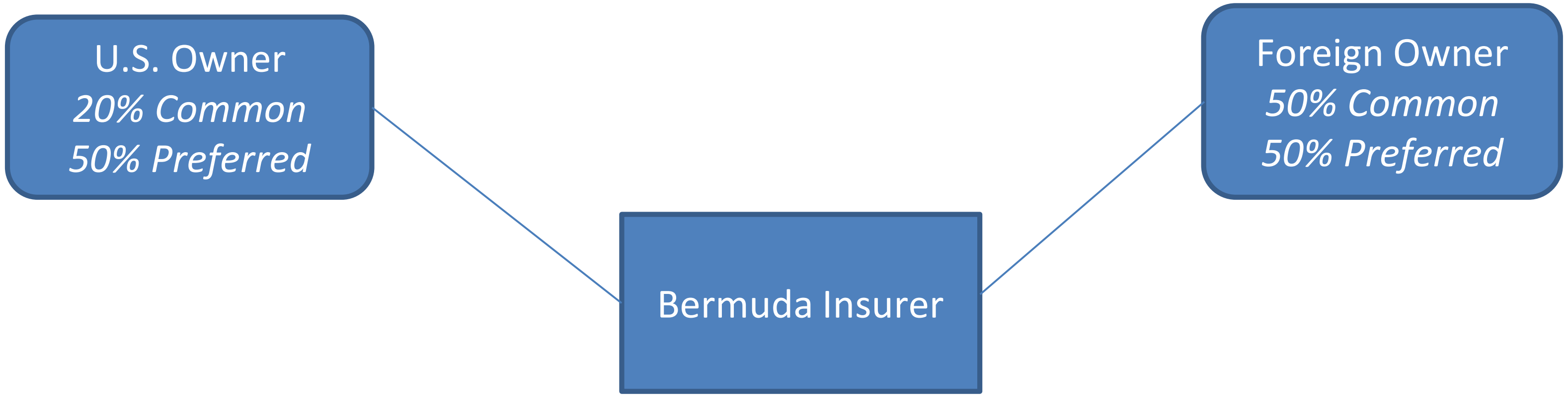
- Changes to definition of US shareholder for CFC purposes:
  - Post-US Tax Reform:
    any US person who owns 10% or more of the total vote or value of shares including all classes of stock.
  - Pre-US Tax Reform:
    vote only test
  - ‘Voter cutback’ and non-voting shares no longer mitigate CFC risk
- Removal of ‘30 day rule’
- Changes to attribution rules

Impact on CFC information reporting will result in more foreign corporations being subject to the Subpart F regime and Form 5471 filing requirements.

- *Penalty for non-filing: $10,000 per year per missed Form 5471 filing*

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

CFC - EXAMPLE 1



Pre-Tax Reform: Non-CFC
Post-Tax Reform: CFC

Common Voting
Preferred
Non-Voting

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

CFC - EXAMPLE 2

20%	20%	6%	6%	6%	6%	6%	6%	6%	6%	6%	6%
A	B	C	D	E	F	G	H	I	J	K	L

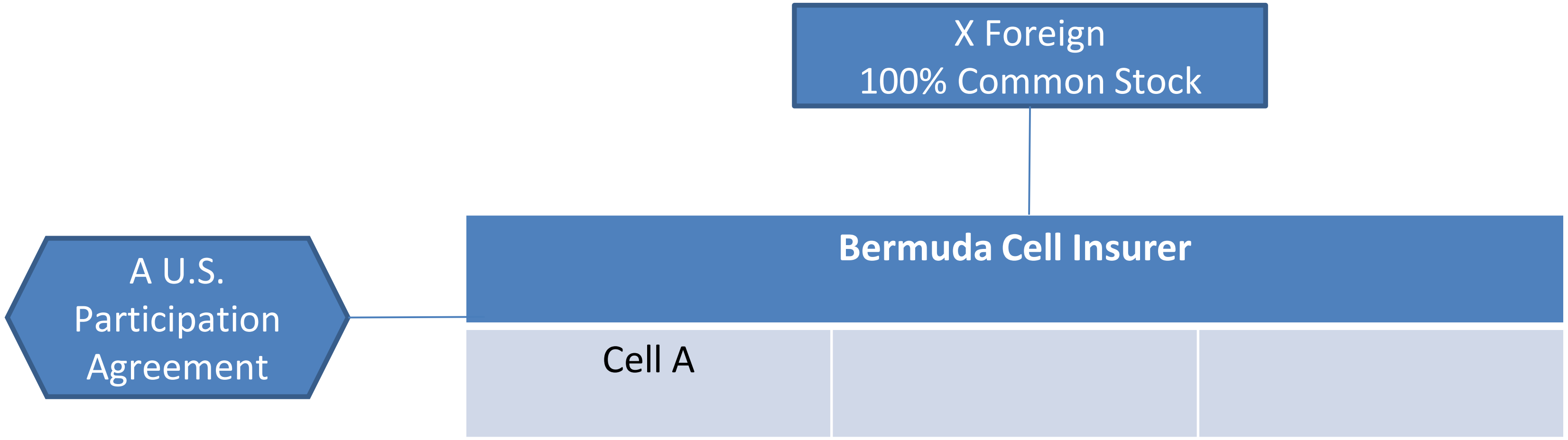
Bermuda Insurer

Pre-Tax Reform: Non-CFC
Post-Tax Reform: CFC

All U.S. Shareholders
1 Class Common Stock
Voting cut back to 95%

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

CFC - EXAMPLE 3



Pre-Tax Reform:

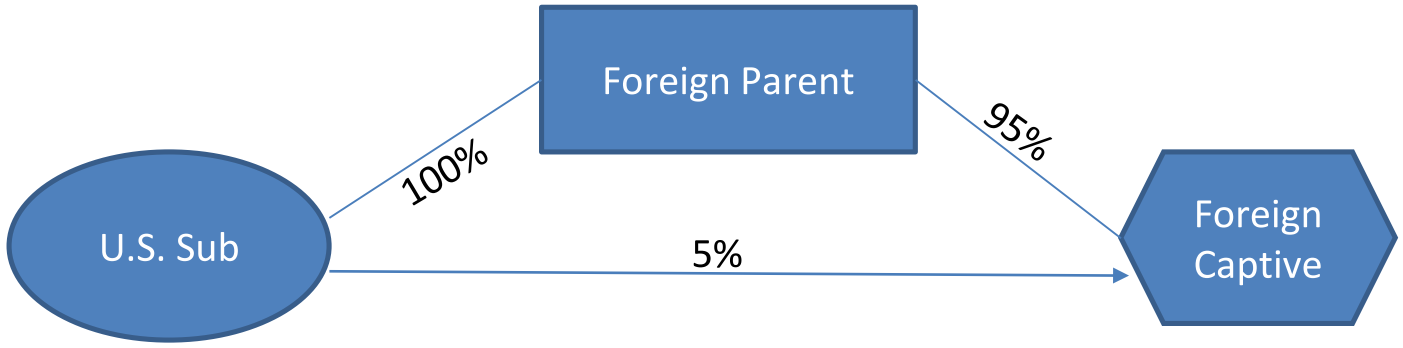
- Proposed regs took position Cell A could be a CFC if an insurance company n.o.v. no voting rights

Post-Tax Reform

- No need for analysis re: vote, as Participation Agreement seemingly provides 100% of value of cell

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

CFC EXAMPLE - ATTRIBUTION RULES



Note: n.o.v. foreign captive would be a CFC under new rule. Only 5% of the income would have to be reported by U.S. insured.

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

PFIC Rules

•Changes to PFIC rules “active insurance company” exception to include an objective test based on insurance liabilities:

1. Insurance liabilities > 25% of total assets, and if not met
2. Secondary two-part test:
    - (a) Insurance liabilities >=10% of total assets and
    - (b) Entity predominately engaged in insurance business and the failure of (1) above can be justified by facts and circumstances (e.g., run-off or rating agency related circumstances).

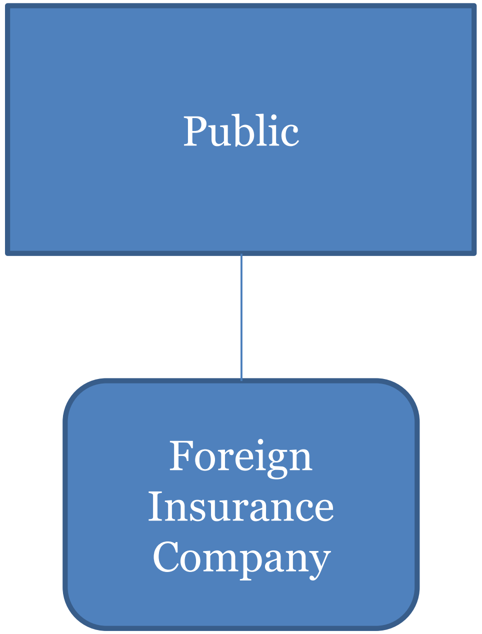
•Insurance Liabilities:

- Loss/Loss Adjustment Expenses and Loss Reserves
- UPR does not qualify

•An active non-CFC foreign insurance company with longer tail risks (e.g., WC, professional liability, etc. risks) should pass unless overcapitalized.

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

PFIC – EXAMPLE 1



Facts

Foreign insurance company:

A) is in the active conduct of an insurance business,
B) is predominantly engaged in an insurance business, and
C) would be subject to tax as a domestic insurance company

Prior to TCJA

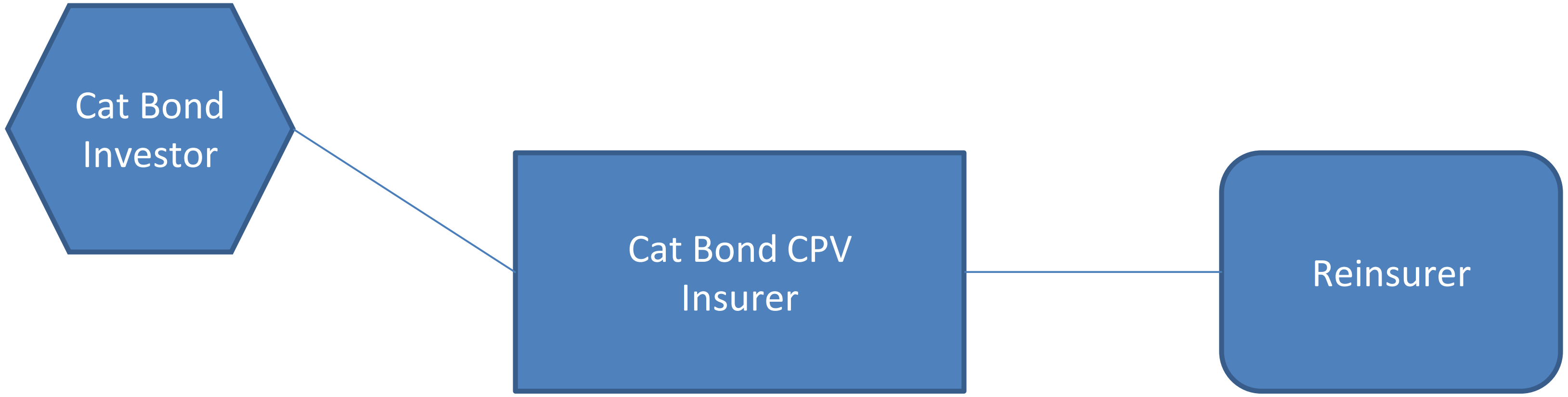
Foreign insurance company. Foreign insurance company was not a PFIC. Company meets the passive income exception for an insurance

Post TCJA

Foreign insurance company qualifies as a PFIC if its insurance obligations are less than 25 percent of foreign insurance company's assets.

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

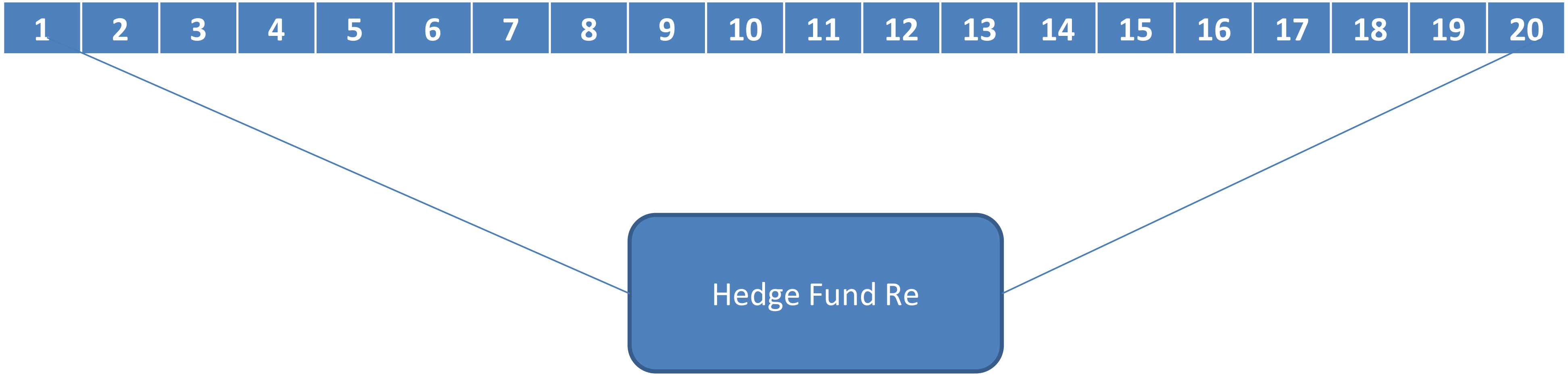
PFIC – EXAMPLE 2



Tax Reform: No direct effect on this structure

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

PFIC – EXAMPLE 3



Effect will be to require more insurance/reinsurance which will result in balance sheet liabilities

Note: Can also be affected by change in CFC rules depending on ownership

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

Base Erosion and Anti-Avoidance Tax (the BEAT):

•Provisions would apply to U.S. corporations (and U.S. branches) that are part of a group with $500M of annual domestic gross receipts (based on 3-year average) and with a base erosion percentage of 3% or higher

•Minimum tax on the excess of 10% of modified taxable income* (5% for 2018) over an amount equal to regular tax liability.

•"Base erosion payments" that are subject to the BEAT include deductible payments to foreign related parties and payments to acquire depreciable or amortizable property

- Final legislative text modified to clarify that cross-border reinsurance payments are treated as base erosion payments

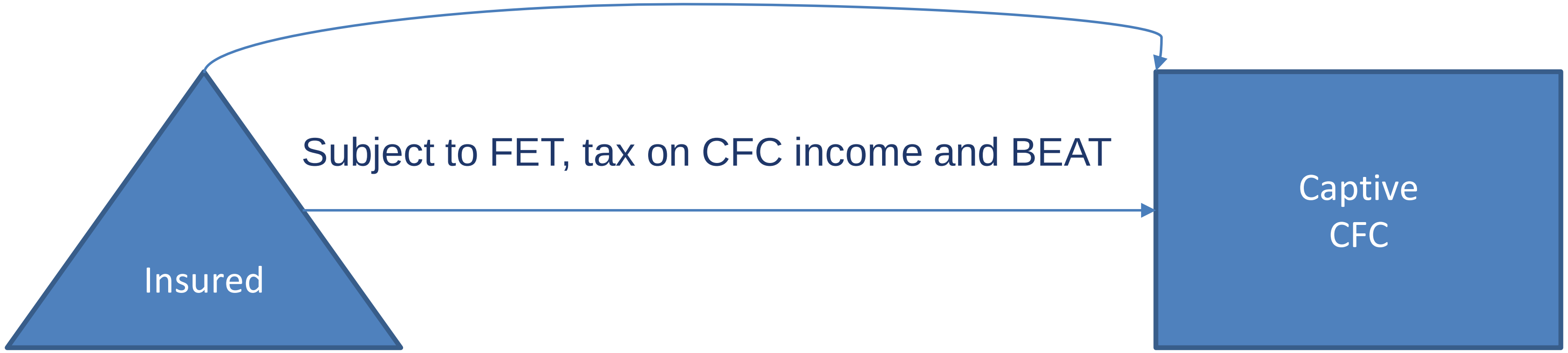
•Premiums paid to 953(d) captives not impacted

(*) *generally taxable income adding back any base-eroding tax benefit*

CAYMAN CAPTIVE FORUM 2018

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

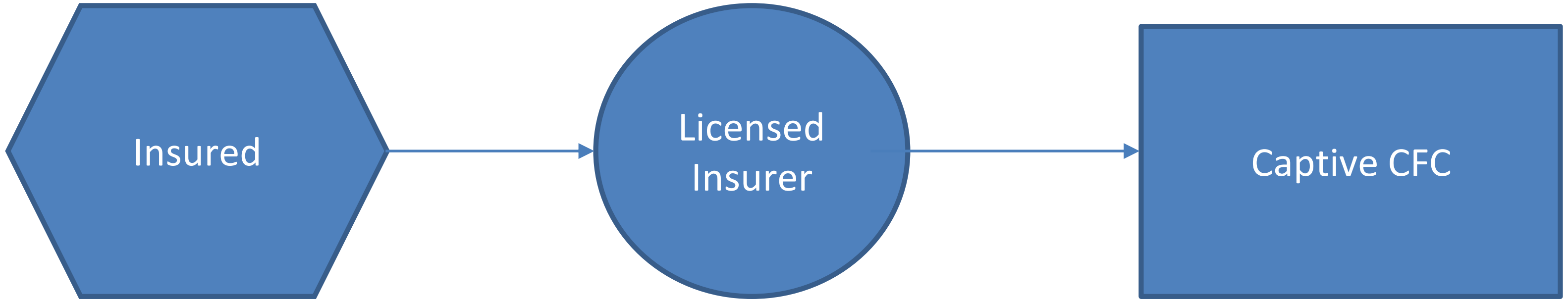
BEAT – EXAMPLE 1



Because BEAT is calculated as a minimum tax on excess of modified taxable income, the effect is greater on payments made to a captive with a high loss ratio (since ordinary tax is lower) than with respect to payments with a low loss ratio (because regular tax is higher)”

INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

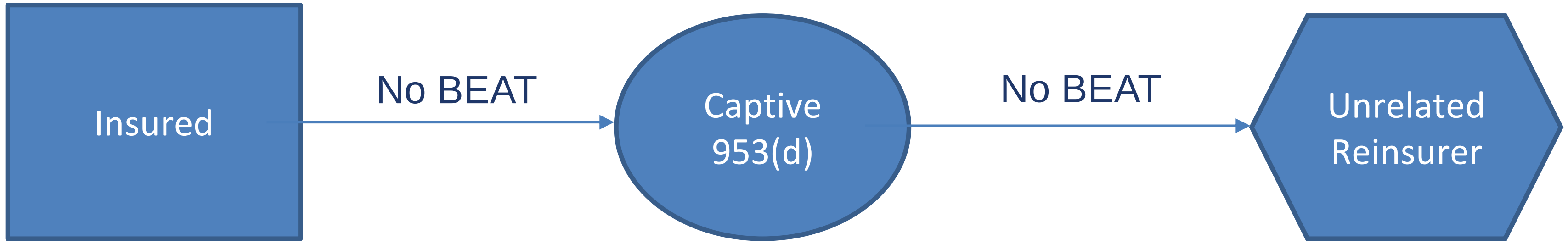
BEAT – EXAMPLE 2



Question whether BEAT will be imposed based on anti-abuse language

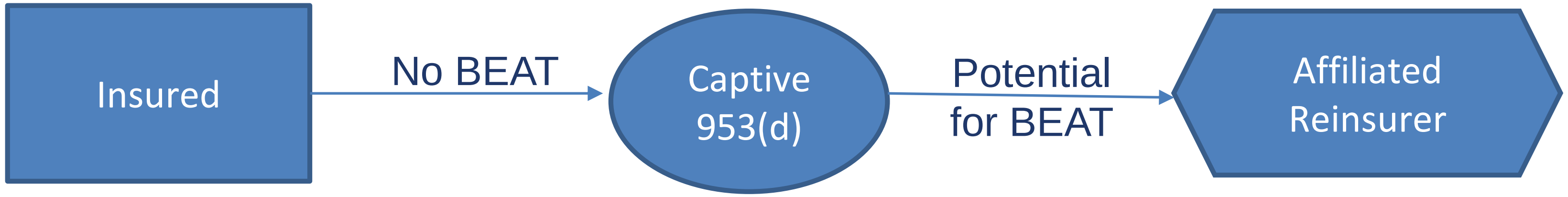
INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

BEAT – EXAMPLE 3



INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

BEAT – EXAMPLE 4



INTERNATIONAL PROVISIONS IMPACTING CAPTIVES

Other key international provisions

- **GILTI tax**
  - U.S. shareholders required to include in income global intangible low-taxed income (“GILTI”)
- **New participation exemption system**
  - 100% exemption for dividends received from 10% owned foreign corporations
- **Repatriation of existing earnings and profits (E&P)**
  - Foreign earnings accumulated under old system deemed repatriated; rate of 15.5% for cash/cash equivalents and 8% for illiquid assets; election available for the tax to be payable over a period up to 8 years

TAX-EXEMPT ORGANIZATIONS UNDER FIRE

The legislative process leading to the Tax Cuts and Jobs Act reflects Congress' continued negative focus on the tax-exempt healthcare sector

- new excise tax on certain highly-compensated employees of tax-exempt organizations
- elimination of the tax-exemption for advance refunding bonds
- the IRS revoked the tax-exempt status of two hospitals in 2017, an unprecedented action given its prior enforcement history
- if a captive's insureds include a tax-exempt organization, the parent will be grappling with this difficult political environment, potentially leading to changes in its structure and that of its affiliated entities

TAX REFORM IMPACT ON FOREIGN CAPTIVES WITH A TAX-EXEMPT PARENT

Each line of business activity that may generate unrelated business income tax (UBIT) <u>for a tax-exempt captive owner</u> will now be treated separately in figuring this tax: i.e., if the captive's insurance operations are deemed to generate unrelated business taxable income, the tax-exempt captive owner will <u>not</u> be allowed to offset a captive's UBIT with losses from different unrelated businesses in calculating its overall unrelated business income tax (i.e., losses are now silo-ed) . But no definition of what constitutes a separate business activity is provided.

TAX REFORM IMPACT ON FOREIGN CAPTIVES WITH A TAX-EXEMPT PARENT

On April 24, 2018 the National Council of Nonprofits submitted a letter to Treasury/IRS pleading for more time to comply (until guidance is issued).

Letter concluded the TCJA applies to tax-exempt organizations in "strange and inexplicable ways."

The American Hospital Association recently submitted a similar plea.

Symptomatic of numerous taxpayer complaints of ambiguities and inconsistencies in the wording of the TCJA.

Doubtful "blue book" and overworked IRS can respond in a timely and comprehensive fashion.

OTHER DEVELOPMENTS IMPACTING THE CAPTIVE INDUSTRY

- Cases involving 831(b) companies
- Microsoft case

ISSUES – WHAT SHOULD WE THINK?

- Must the captive be admitted in each jurisdiction with insured risks?
- Does licensure mean the captive is an insurance company for tax?
- Does meeting the domicile’s minimum capitalization, automatically mean the captive has sufficient capital for Federal income tax purposes?
- Is non-tax business purpose required to have a valid insurance program?
- Is judgmental rate setting (no actuary) ever acceptable? Terrorism?
- How much due diligence must a pool participant do? Mutual insured?

ISSUES – WHAT SHOULD WE THINK?

- Must a captive have employees? Can the captive manager do all?
- Does the captive owner(s) have to understand insurance? The program?
- What is circular flow of funds? Does lack of claims prove lack of risk?
- If one has a sufficient number of statistically independent risk exposures, does the number of insureds matter?
- Can a single insured ever be the only insured of a captive?
- Do illiquid or long maturity investments undermine insurance?

ISSUES – WHAT SHOULD WE THINK?

- Must the captive program replace commercial coverage, or can one have $5 million of commercial policies and ADD $1 million of captive policies?
- Is the IRS' distinction between insurance risks v. business risks valid?
- When is a guarantee fatal to risk shifting?
- If a risk has been sold in the commercial market for years, is it automatically an insurance risk for Federal income tax purposes?
- Must a captive program mirror the commercial market?
- How much can a captive loan to an insured or affiliate and be safe?

ISSUES – WHAT SHOULD WE THINK?

- If a fronting company is not a valid insurance company for Federal income tax purposes, does that preclude the reinsurer from being a valid insurance company for Federal income tax purposes?
- Can a start-up captive charge more than the commercial market, in order to more quickly build up additional capital and minimize the chance of insolvency if catastrophic losses occur in the early years?
- Can the insured have a target amount or budget for premiums?
- If an insurance arrangement is invalid, can the IRS both disallow the deduction and impose income on the captive?

ISSUES – WHAT SHOULD WE THINK?

- Does failure to comply with regulatory requirements disqualify a captive from being an insurance company for Federal income tax purposes?
  - E.g., failure to timely make filings? Failure to make filings? Failure to get permission for loans or other items?
- Does sloppiness of policies disqualify an insurance arrangement?
- Must an insured file every claim with its captive?
- Does the payment of late filed claims, claims with lack of complete documentation, or other claims payments outside the policy terms disqualify an insurance arrangement for tax purposes?

KEY PRINCIPLES

QUESTIONS?