FINANCIAL SERVICES TRENDS

HOW WILL THE POTENTIAL DROP IN THE U.S. CORPORATE INCOME TAX RATE IMPACT INSURERS' FINANCIAL STATEMENTS?

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With Republicans now in control of the White House and both Houses of Congress, there is a very strong likelihood that the corporate income tax rate will have the most significant drop since the Tax Reform Act of 1986 when the rate dropped from 46% to 34%. This would not only impact a company's current income tax expense, but also its deferred income tax expense, potentially causing a dramatic impact to the company's income statement and equity (surplus). Company Tax departments and CFOs need to start planning ahead to see how an income tax rate reduction will affect their U.S. Statutory and GAAP (or IFRS) financials and look for any opportunities now that can minimize those impacts and maximize cash tax benefits today and in the future.

Current Tax (Cash Tax)
One may easily conclude that a drop in the corporate income tax rate will reduce a company's current income tax expense. However, it's not as simple as that. Tax law changes are required to be revenue neutral. As such, a decrease in the corporate tax rate must be paid for in other areas of the Internal Revenue Code (the "Code"). Lawmakers are currently looking at the 2016 House Ways and Means Committee Republication Blueprint and Representative Camp's 2014 Tax Reform Proposal ("Camp Proposal") as a template for 2017 tax reform; both of which advocate lowering the corporate income tax rate, with specific alterations to long standing Code sections and changes to existing tax adjustments that could result in increasing taxable income to insurers, while at the same time lowering the income tax rate.

With much conjecture that the corporate income tax rate could drop down as low as 15-20% (down from 34/35%), there has been serious discussion amongst lawmakers of eliminating the alternative minimum tax ("AMT") in conjunction with any tax rate reduction. Additionally, any discussion of eliminating the corporate AMT comes with a limitation on regular net operating loss carryforward ("NOLCF") utilization to 90% of regular taxable income. With the prospect of eliminating the corporate AMT, one then naturally would ask "what becomes of any AMT Credit Carryforwards?" The Camp Proposal would allow for a refund of the AMT credit balance over a three year period. With this in mind, companies with a NOLCF would need to rethink current cash tax forecasts.

As with any typical tax planning to minimize cash taxes, accelerating deductions/deferring income, with such a dramatic drop in the tax rate, these planning strategies will now result in a one-time permanent tax benefit if deductions are accelerated to a higher tax rate year or income deferred to a lower tax rate year. Insurers, who have ignored favorable tax method changes as benefits that would only result in a minimal interest play, as interest rates have been at historical lows recently, may now want to seriously reconsider these. A favorable tax method change effective before the tax rate changes would create permanent tax savings. Lastly, insurers must keep a focus on their loss reserves, as any reserve increases in the year prior to a drop in the corporate tax rate may very well be subject to increased scrutiny by the IRS, keeping in mind that the ending loss reserves must continue to be "fair and reasonable" in accordance with the Code and regulations.

Tax Adjustment Changes that May Impact Insurers
As discussed previously, lawmakers must find areas to make tax reform revenue neutral. Adjustments adversely impacting insurers were specifically addressed in the Camp Proposal and were as follows:

1) **Life Insurers**
   a. Life reserves - interest rate changes would reduce tax basis life reserves
   b. Section 848 Tax DAC (deferred acquisition costs): Increase in the capitalization percentage rate.
   c. Changes in proration adjustment (further reducing tax-exempt investment income)
   d. Repeal of the Section 807(f) 10 year spread
   e. Change in the Operating Loss Deduction ("OLD") adjustment carryback/carryforward periods (3 years/15 years) to match the regular corporate net operating loss ("NOL") carryback/carryforward periods (2 years/20 years)
   f. Repeal of the small life deduction (permanent deduction)

2) **Property and Casualty Insurers**
   a. Change in loss reserve discount rates
   b. Change in proration adjustment (further reducing tax-exempt investment income)
   c. Repeal of Blue Cross/Blue Shield special deductions

These potential changes in tax adjustments would not only increase current taxable income, but will increase temporary differences impacting deferred tax assets ("DTA") and admissibility of DTAs under U.S. Statutory accounting.

Deferred Income Taxes – US GAAP
Under U.S. GAAP accounting, Accounting Standards Codification ("ASC") Topic 740, *Income Taxes* ("ASC 740") temporary differences ordinarily become taxable or deductible when the related asset is recovered or the related liability is settled. A deferred tax liability ("DTL") or DTA represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and tax loss/credit carryforwards at the end of the current year. ASC 740 establishes procedures to (a) measure DTLs and DTAs using a tax rate convention and (b) assess whether a valuation allowance should be established for deferred tax assets. Under ASC 740, enacted tax laws and rates are considered in determining the applicable statutory tax rate and

in assessing the need for a valuation allowance. As such, a drop in the corporate income tax rate to 15-20% will have some potentially significant impacts on a company's financial statement.

Companies with significant DTAs, such as NOL carryforwards, discounted loss reserves, unearned premium reserves, Section 848 Tax DAC, and unrealized portfolio losses, and in a net DTA position, will see income statement hits. Insurers who have net DTL positions, for example those with unrealized portfolio gains, bond discount, GAAP deferred policy acquisition costs, exceeding their DTAs, will see an income statement benefit.

The effect of a tax rate change shall be included in income from continuing operations. This would include items such as discontinued operations, a prior business combination, or items of accumulated other comprehensive income (e.g., unrealized portfolio gains and losses). This could have an unexpected impact on a company's deferred tax provision, especially if a company has significant DTAs established for unrealized portfolio gains/losses, and post-retirement benefit obligations, which would be highlighted in a company's effective tax rate footnote disclosure. Tax rate changes are to be reflected in the period that includes the enactment date. Thus, if a company issues interim financial statements, the impact of a tax rate change must be reflected in the interim period the tax rate change is enacted. This means if tax rate law change is signed into law by the President on September 30, 2017, the impact of the tax rate change must be reflected in a company's third quarter 2017 financial statements (e.g., SEC Form 10-Q). Keep in mind that if there is a phase-in of a corporate tax rate change, determination of the impact of the applicable future tax rate requires knowledge about when DTLs and DTAs will be settled and realized. As such, scheduling may very well be required. Additionally, companies with valuation allowances will need to reevaluate their ability to recognize their DTAs and adjust for the new tax rates.

U.S. Statutory Deferred Tax Assets and Admissibility- SSAP No.101 Impacts

U.S. Statutory accounting for income taxes under SSAP No. 101, *Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10* ("SSAP 101"), will present additional issues and challenges due to the potential tax rate decreases and tax law changes. As with U.S. GAAP, the impact of corporate tax rate changes is to be recorded in the period the rate change is enacted. Keep in mind that the recording of the rate change is in "change in deferred taxes", which is a direct surplus adjustment and not to the income statement. Companies with significant admitted DTAs, such as NOL carryforwards, discounted loss reserves, unearned premium reserves and Section 848 Tax DAC, will see surplus hits, while those that are in a net DTL position, due to unrealized portfolio gains, for example, will see surplus benefits.

Admitted Deferred Tax Asset Issues

Tax rate decreases and potential tax law changes will create some interesting impacts on the DTA admissibility calculation. In the first prong of the admissibility test (paragraph 11.a of SSAP 101), the hypothetical carryback of up to three years of reversing DTAs will, for the next two to three years (capital items in nature), have carrybacks going back into tax years where profitable insurers paid taxes based on the previous higher tax rates. Also, life insurers may have an additional twist in the 11.a test if the OLD carryback period of three (3) years is replaced by the regular two (2) year NOL carryback rules. Additionally, if NOL use is limited to 90% of taxable income, this will impact the 11.a test, thus insurers' admissibility models will need revamping.

In the second prong of the admissibility test (paragraph 11.b of SSAP 101), the potential 90% NOL utilization limitation will need to be considered and modeled. On a positive note, if AMT credits are to be recouped over a phase in period under new tax law, the recoupment of these credits can now be a scheduled reversal in the 11.b test and result in potentially increasing admitted DTAs.

In Summary

With the likelihood of a drop in the corporate tax rate looming, prudent tax department leaders and CFOs will need to stay on top of pending legislation. Planning and modeling how the potential impact that rate changes and tax adjustment changes will have on their financial statements, both U.S. GAAP and U.S. Statutory, will be vital to avoiding unexpected surprises. They must be in a position to communicate and advise management of what the tax law changes will mean to the insurer, and be prepared to explain this to their Board of Directors, shareholders and insurance industry regulators.

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