An Actuarial Perspective on Tax Reform

Southeastern Actuaries Conference

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Agenda

- Tax reform - overview of key changes
- Impact of key changes
- Where does uncertainty exist?
- Strategic Opportunities
- Other topics

Disclaimer

Milliman does not provide tax advice. The topics discussed in this presentation reflect an actuarial analysis of the impact federal tax reform can have on long-tailed health insurance. It does not contain, and should not be interpreted as, tax or legal advice. Companies are encouraged to seek tax or legal counsel before pursuing any particular tax strategy.

Tax Reform – Overview of Key Changes

Tax Cuts and Jobs Act of 2017, signed into law on December 22, 2017, has far-reaching implications for health insurers with long-tailed business. The law becomes effective on the first tax year beginning after December 31, 2017.

	Old Law	New Law
Tax Rate	▪ 35%	▪ 21%
Proxy DAC Asset	▪ Capitalization rates: 7.70% (different rates apply to group contracts and annuities) ▪ 10-year amortization period	▪ Capitalization rates: 9.2% (different rates apply to group contracts and annuities) ▪ 15-year amortization period
Tax Reserves	▪ Prescribed tax methods ▪ Federally-prescribed interest rate	▪ Tax reserves capped at 92.81% of "tax reserve method otherwise applicable," following an 8-year grade-in period.

Impact of Key Changes – Baseline View (Old Law)

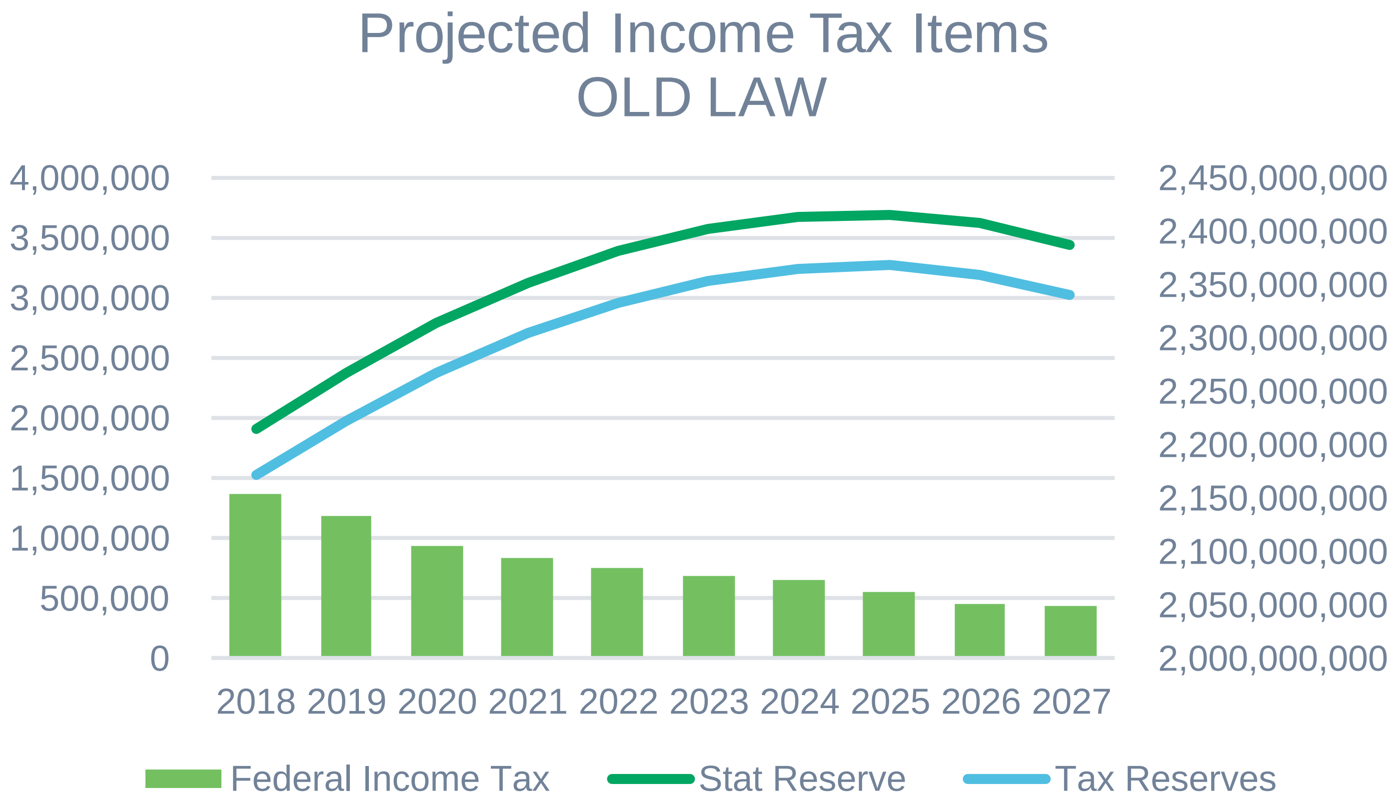
Following shows projected income tax items, under "old law," for next 10 years.

- Federal income tax = 35% of taxable income.
- Proxy DAC capitalization rate = 7.70%, amortized over 10 years
- Tax reserves use formerly prescribed tax methods (e.g., FPT1) and interest rates. Tax-to-Stat reserve ratio is approximately 98%, and gradually grades to 100% over life of the business.

Present Value of Taxes Paid	$23.0
PV (Effective Tax Rate)	28.1%

** Amounts in $millions*

Present values calculated at 4.0% discount rate



Impact of Key Changes – Change 35% rate to 21%

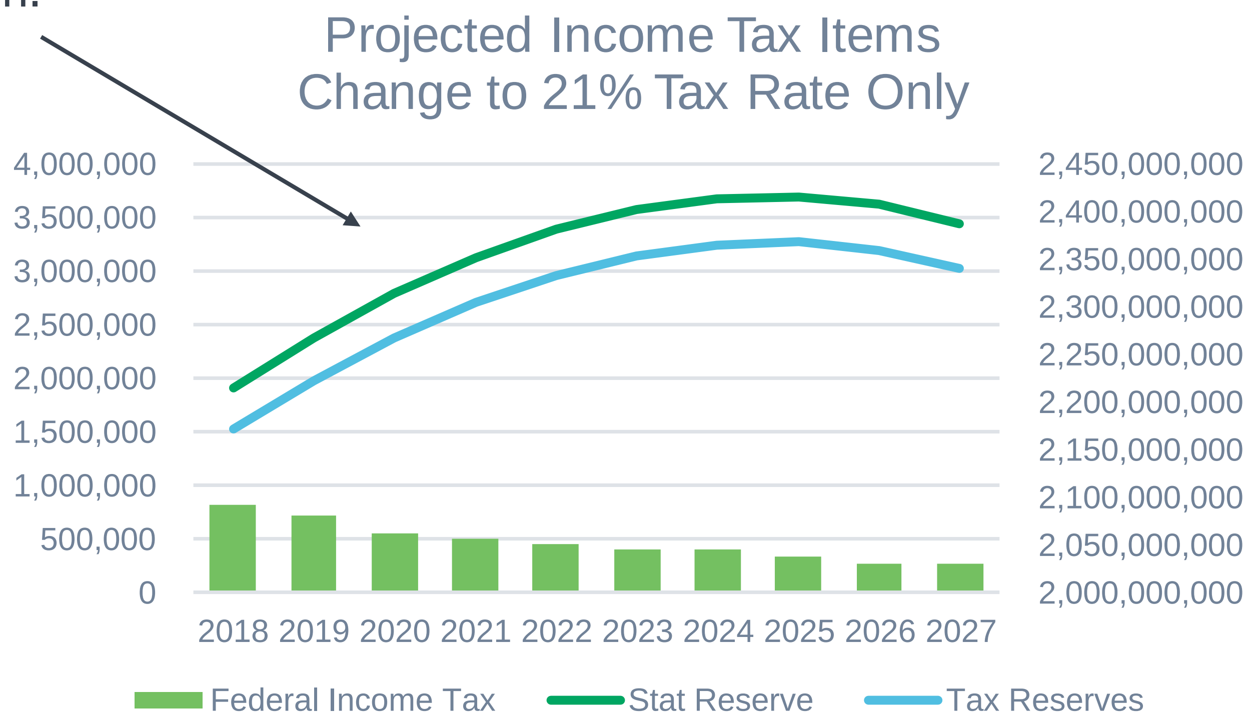
Following shows projected income tax items reflecting only the change from 35% tax rate to 21%.

No change in reserve runoff pattern.

- Federal income tax = **21% of taxable income**.
- Proxy DAC capitalization rate = 7.70%, amortized over 10 years
- Tax reserves use formerly prescribed tax methods (e.g., FPT1) and interest rates. Tax-to-Stat reserve ratio is approximately 98%, and gradually grades to 100% over life of the business.

Present Value of Taxes Paid	$13.8
PV (Effective Tax Rate)	16.9%

** Amounts in $millions*
Present values calculated at 4.0% discount rate



Taxes paid and effective tax rate are both down sharply.

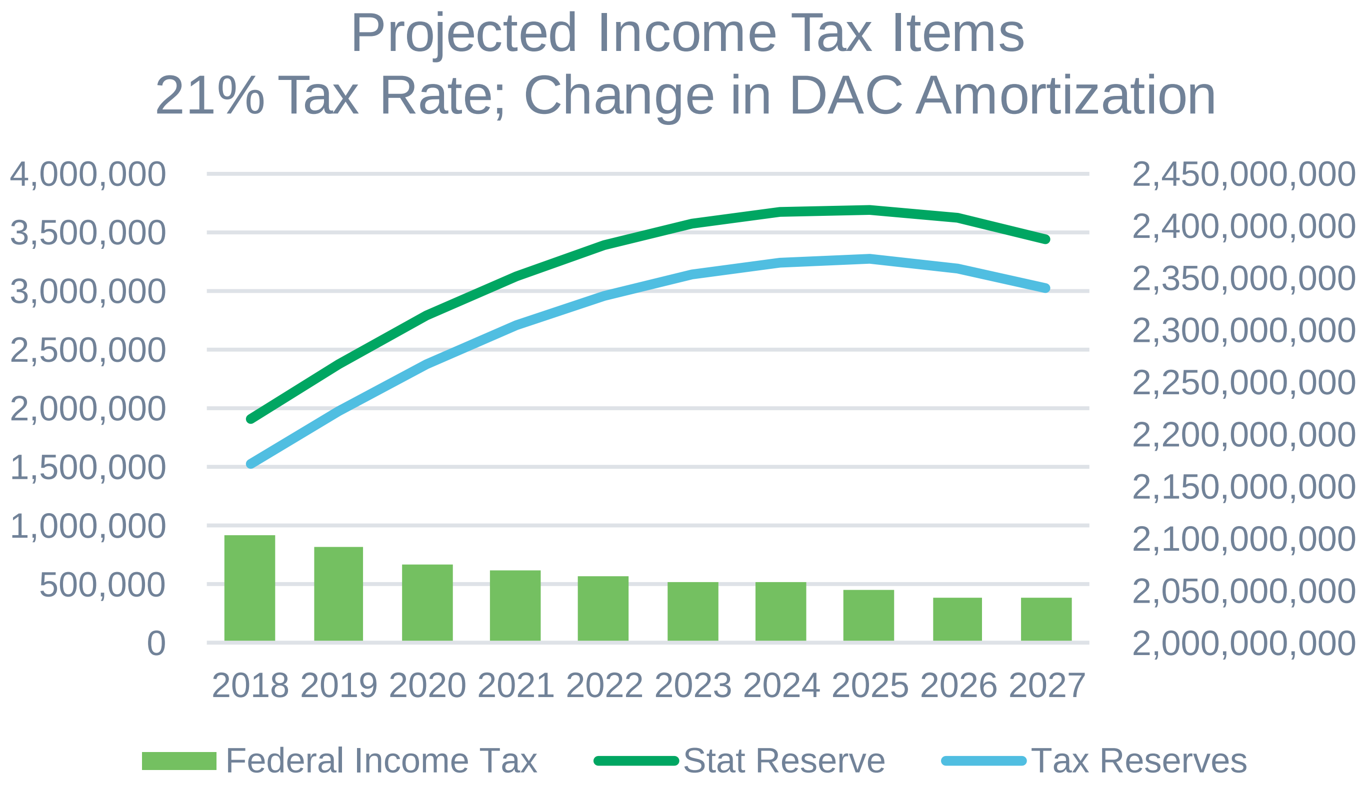
Impact of Key Changes – 21% Tax Rate; New DAC Schedule

Following shows projected income tax items reflecting impact of 21% tax rate and new DAC amortization schedule.

- Federal income tax = **21% of taxable income**.
- Proxy DAC capitalization rate = **9.20%**, amortized over **15 years**
- Tax reserves use formerly prescribed tax methods (e.g., FPT1) and interest rates. Tax-to-Stat reserve ratio is approximately 98%, and gradually grades to 100% over life of the business.

Present Value of Taxes Paid	$14.3
PV (Effective Tax Rate)	17.4%

** Amounts in $millions*
Present values calculated at 4.0% discount rate



Taxes increase slightly. Effective tax rate increases slightly (less than 1%).

Impact of Key Changes – All Changes

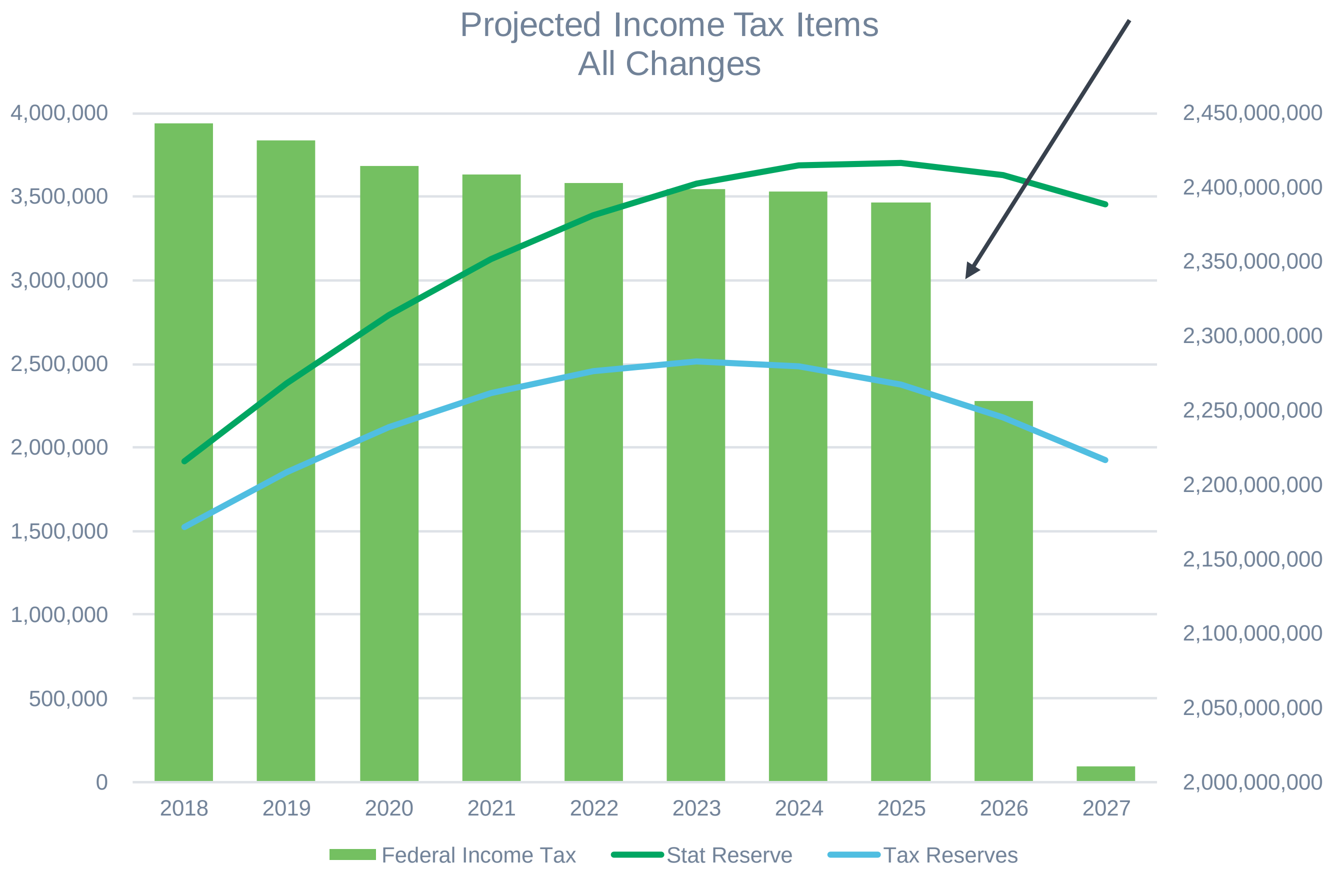
Following shows projected income tax items reflecting ALL relevant provisions of the new law.

- Federal income tax = **21% of taxable income**.
- Proxy DAC capitalization rate = **9.20%**, amortized over **15 years**
- Tax reserves grade to 92.81% of statutory reserves over 8-year period.

Present Value of Taxes Paid	$25.1
PV (Effective Tax Rate)	30.7%

** Amounts in $millions*
Present values calculated at 4.0% discount rate

Tax – Stat divergence



Material increase in taxes and effective tax rate, driven by taxable gain of the reserve write-down. Effective tax rate has increased ABOVE that observed in the old law.

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Where does uncertainty exist?

With recent passage of the law, a lot of uncertainty remains…

- Treatment of Disabled Life Reserves
- Tax effect on NAIC RBC factors
- How to apply the 8-year phase-in.
- What is the basis to which the 92.81% limit applies?

Uncertainty: Application of the 92.81% Limit

- **Language from the Conference Agreement:**
  - *Limit applies to the tax reserve method otherwise applicable to the contract.*

- **Revised IRC Section 807:**
  - Appears to redefine “tax reserve method” to be based strictly on the NAIC-required reserve.

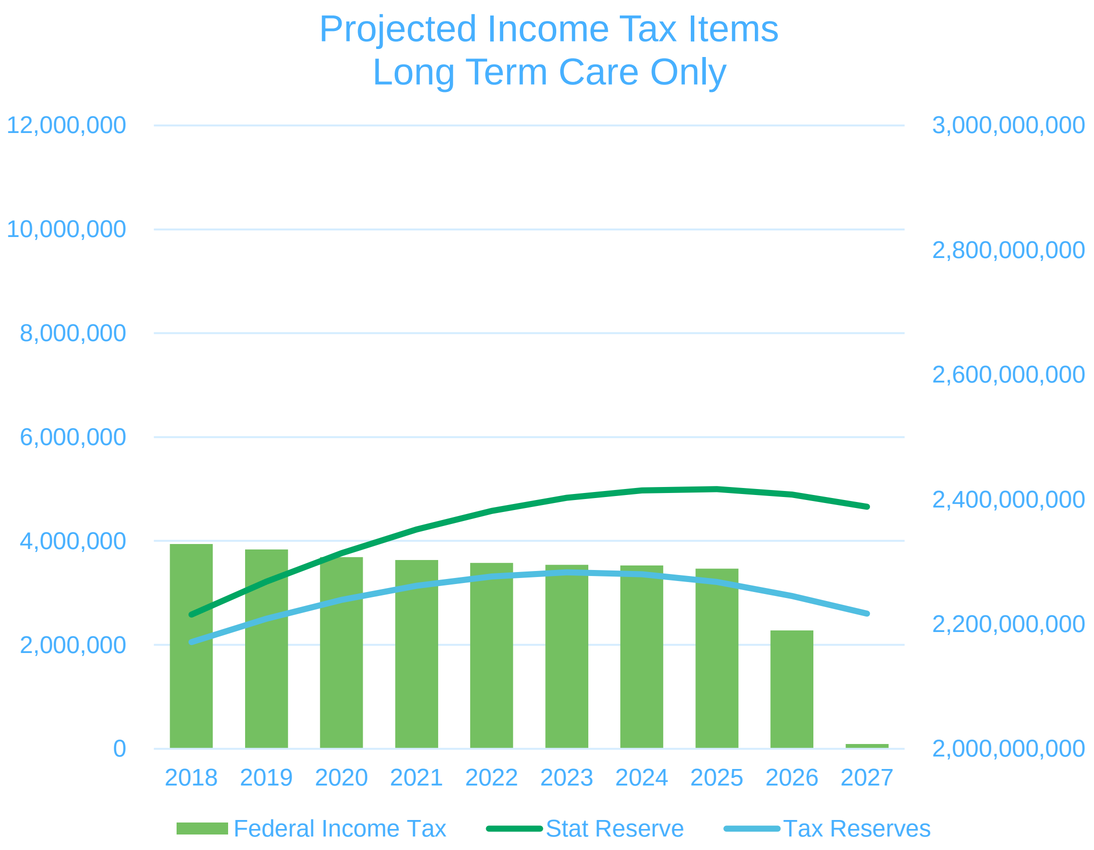
- **Client perspective:**
  - Calculate tax reserve using defined tax methods and assumptions (some of which may be based directly on statutory regulations).
  - The tax reserve basis uses defined <u>minimum</u> statutory standards, which may or may not be the same as the statutory reserves – e.g., if a statutory reserve voluntarily uses a lower interest rate than is required.
  - The tax reserve equals the statutory reserve, excluding any deficiency or asset adequacy reserves.

Strategic Opportunities (…& Risks)

- Product Development/Product Mix
- Merger & Acquisition/Reinsurance to change reserve profile
  - However, beware of the “BEAT” tax.
- Reserve Unlocking/Strengthening

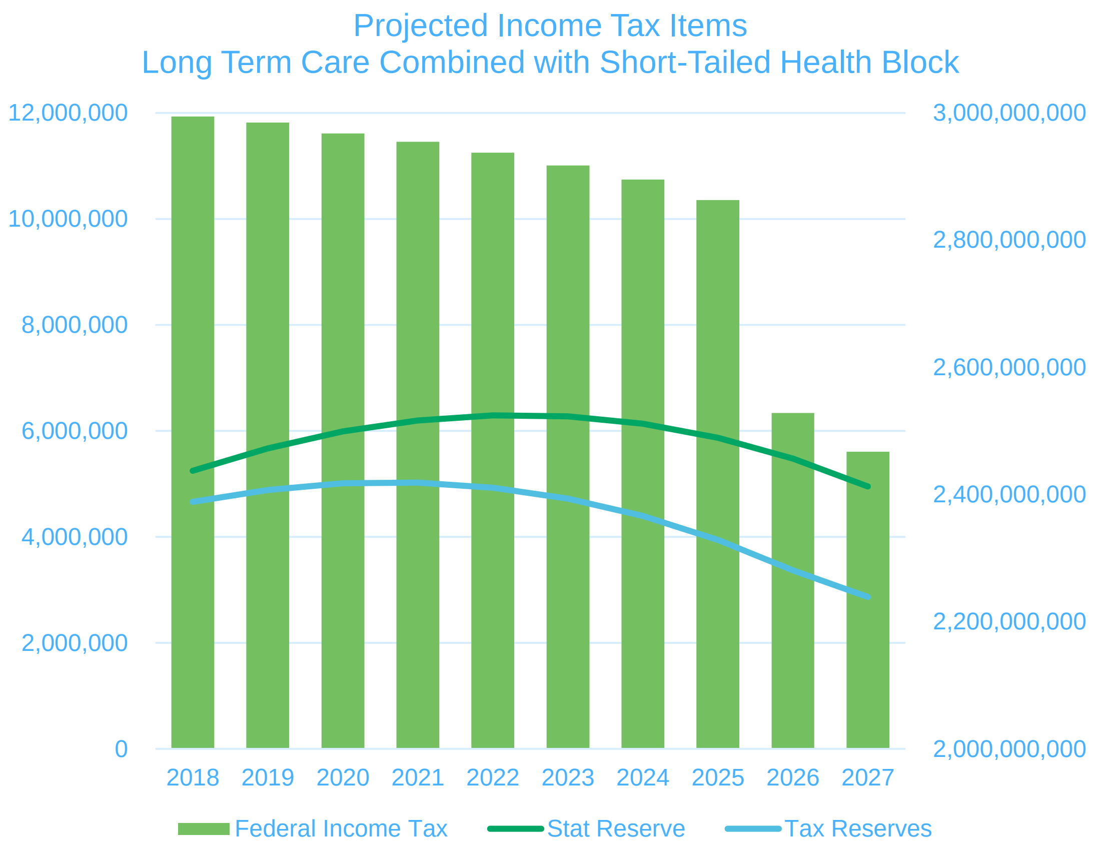
Opportunities to Merge Blocks

Combining “Reserve Intensive” blocks with “Non-Reserve Intensive” blocks reduces effective tax rate:



Present Value of Taxes Paid	$25.1
PV (Effective Tax Rate)	30.7%

** Amounts in $millions*
Present values calculated at 4.0% discount rate



Present Value of Taxes Paid	$80.1
PV (Effective Tax Rate)	23.4%

** Amounts in $millions*
Present values calculated at 4.0% discount rate

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I, Andrew Dalton, am a member of the American Academy of Actuaries. I am qualified under the Academy's Qualification Standards to render the opinions with regard to the actuarial information set forth herein.

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Thank you

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