CAPTIVES
SHAPING THE FUTURE

March 10-12 | Tucson, AZ
JW Marriott Tucson Starr Pass Resort & Spa
Changing Times: Accounting & Tax Update

Matt Gravelin – Johnson Lambert LLP
Dave Tatlock – Strategic Risk Solutions

March 12, 2019 from 1:15 - 2:15 pm
Agenda

• GAAP Financial Reporting Update
  • Financial Instruments
  • Leases
  • Revenue Recognition
  • Credit Losses

• Tax Reform Update
  • Loss discounting
  • Net operating losses
  • Alternative minimum taxes
  • Other relevant matters
Accounting for Financial Instruments

Context

- Historical Cost vs. Fair Value
  - Reliability vs. Relevance
- SEC Act through 1970s – Reliability
- 1980s – Present – Move toward Relevance
  - SFAS 12 (SFAS 60)
  - SFAS 115
  - SFAS 157
  - ASU 2016-01
- Services vs. Manufacturing – IFRS – The Internet
Financial Instruments

- New reporting model for investments in equity securities (ASU 2016-01)
  - Unrealized gains/losses included in net income
  - Excludes those accounted for under the equity method (>20% ownership)
  - Not fooling anybody (rating agencies)
Financial Instruments

- FV not readily determinable – use cost less impairment & info for similar investments ("changes in observable prices in orderly transactions")
- Rhymes with LCM (see SFAS 12)
- Transition for insurance companies – use current carrying value with prospective changes
- Prospective adoption results in cumulative-effect adjustment at BOY - Reclassify AOCI to retained earnings
# Financial Instruments

## Pre ASU 2016-01

<table>
<thead>
<tr>
<th></th>
<th>Common Stock</th>
<th>Accumulated Other Comprehensive Income, Net of Tax</th>
<th>Retained Earnings</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1, 2018</td>
<td>$10,000</td>
<td>$100,000</td>
<td>$2,000,000</td>
<td>$2,110,000</td>
</tr>
<tr>
<td>Other Comprehensive Income</td>
<td></td>
<td>35,100</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td></td>
<td>41,000</td>
<td>41,000</td>
</tr>
<tr>
<td>December 31, 2018</td>
<td>$10,000</td>
<td>$135,100</td>
<td>$2,041,000</td>
<td>$2,186,100</td>
</tr>
</tbody>
</table>

## Post ASU 2016-01

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<td>$100,000</td>
<td>$2,000,000</td>
<td>$2,110,000</td>
</tr>
<tr>
<td>Impact of adoption of ASU 2016-01</td>
<td></td>
<td>(100,000)</td>
<td>100,000</td>
<td>-</td>
</tr>
<tr>
<td>Net income</td>
<td></td>
<td></td>
<td>76,100</td>
<td>76,100</td>
</tr>
<tr>
<td>December 31, 2018</td>
<td>$10,000</td>
<td>$ -</td>
<td>$2,176,100</td>
<td>$2,186,100</td>
</tr>
</tbody>
</table>
Financial Instruments

Debt Securities

- Eliminates requirement to disclose FV hierarchy of bonds held at amortized cost
- Eliminates separate consideration of DTA valuation allowance for underwater bonds (consideration of intent and ability to hold the bonds to recovery or maturity)
- Still need to consider valuation allowance for net DTA

WHY? To reduce diversity in practice
Financial Instruments – Tax Considerations

- More tax adjustments
- Geography of reporting – equity vs. bonds
- Book vs. tax basis tracking
- No more OTTI for equities
- Impact on reciprocal companies
Financial Instruments

**Eliminated disclosures (ASU 2018-13)**
+ Amount and reasons for transfers between Level 1 and Level 2
+ Policy for timing of transfers between levels
+ Valuation processes for Level 3 FV measurements
+ Changes in unrealized gains and losses for the period included in earnings for recurring Level 3 investments held at BS date
+ Eliminate Level 3 rollforward table
+ Disclose purchases, sales and transfers in and out of Level 3

**Effective date – can be early adopted for 2018!**
Leases
Leases

Context

+ Recognition of Rights and Obligations
  + SFAS 13 Defined Capital Lease vs. Operating Lease
    + A compromise
  + Non-BS recognition of Operating Leases not justifiable under accounting concepts
Leases

Key Changes

- Recognize Right-of-Use Asset and Lease Liability for all leases with terms greater than 1 year
- 2 Models – Finance or Operating Lease
- Lease model impacts timing and classification of amortization and interest expense on income statement
- Similar to old rules except Operating Leases go on the balance sheet now, in a simplified way
## Leases – Two Models

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Finance Lease</strong>&lt;br&gt;Type A&lt;br&gt;(Similar to Capital Leases)&lt;br&gt;Right-of-use asset / Lease liability</td>
<td><strong>Amortization expense / Interest expense</strong></td>
<td><strong>Cash paid for by principal &amp; interest payments</strong></td>
</tr>
<tr>
<td><strong>Operating Lease</strong>&lt;br&gt;Type B&lt;br&gt;(Similar to Operating Leases)&lt;br&gt;Right-of-use asset / Lease liability</td>
<td><strong>Single lease expense on a straight-line basis</strong></td>
<td><strong>Cash paid for lease payments</strong></td>
</tr>
</tbody>
</table>
Revenue Recognition – Exceptions

+ Good news
+ Applies to all contracts with customers except for:
  • **Insurance contracts**
  • Lease contracts
  • Financial instruments and other contractual rights or obligations
  • Guarantees (other than product or service warranties)
  • Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers
Revenue Recognition

Applicable to insurance companies and related entities as follows:

- Underwriting services
- Claim services
- Agencies (commission/profit sharing...)
- Management and accounting services
- Other revenue streams not considered an insurance contract under Topic 944 (insurance accounting)
- Warranty contracts not falling under ASC 944
Revenue Recognition – 5 Step Model

1. **Step 1**
   Identify the contract with the customer

2. **Step 2**
   Identify the performance obligations

3. **Step 3**
   Determine the transaction price

4. **Step 4**
   Allocate the transaction price to the performance obligations

5. **Step 5**
   Recognize revenue when (or as) the entity satisfies a performance obligation

CAPTIVES: SHAPING THE FUTURE
Credit Losses

Context

• SFAS 5 requirement of a loss being Probable and Reasonably Estimated delayed recognition of valuation problems during Financial Crisis of 2008

• Look for more on this as we get closer to implementation in 2022
New Code Section 451(b)

General Rule for Year of Taxable Inclusion
• Recognize income for tax at the earlier of:
  o When fixed and determinable, or
  o When taken into account in applicable financial statements

• Amount can be determined with reasonable accuracy
• Amount is fixed at the earlier of:
  o Required performance or event has taken place,
  o Due based on contract terms, or
  o When received

• Interaction with new revenue recognition standards
Book and Tax May Now Collide

- Rev. Proc. 2004-34 – limited 1-year deferral permitted
  - Notice 2018-35 – new §451(c) is consistent approach
- Notice 2018-80 – market discounts
- Not applicable to income items with a “special method of accounting” provided elsewhere in the code

- Possible impact areas:
  - Agency revenue
  - Accrued dividends
  - Retrospective credits
  - Others?
Loss Reserve Discounting

- Tax reform established a new basis for discount factors
  - Based on corporate bond yield vs applicable federal mid-term rate
  - Extended discount period for certain lines from 10 to 24 years
  - Repealed the company-specific payout pattern election

- Results in deeper discounts (higher taxable income)

- New rules to be treated similar to a method change
  - Recalculate 2017 discounting under the new law
  - Increase in taxable income between old vs. new method for 2017 spread ratably over 8-years
  - Cannot currently elect to recognize all in year one
Loss Reserve Discounting

• IRS released new factors on December 20, 2018
  o Request for comment & public hearing led to release of Rev. Proc. 2019-06
  o Interest rate increased from 1.46% to 3.12%
  o No longer separate factors for S&S – calculated on net basis

• SEC Staff Accounting Bulletin ("SAB") 118
  o Provided relief for estimating the impact for 2017 year-end
  o Companies can no longer rely on SAB 118 for 2018
  o Disclosures required for changes to finalize the accounting of tax reform
Assume the following as of December 31, 2017

- Undiscounted book reserves - $6,000,000
- Original discounted tax reserves at average 92% - $5,520,000
- Average discount rate under new law - 85%
- $6,000,000 x 85% = $5,100,000

Discounting Example

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original tax discount ($6M – 5.52M)</td>
<td>$480,000</td>
</tr>
<tr>
<td>New tax discount ($6M – 5.1M)</td>
<td>900,000</td>
</tr>
<tr>
<td>Difference ($6M – 5.1M)</td>
<td>$420,000</td>
</tr>
</tbody>
</table>

- DTA and DTL were both understated by $88,200 ($420k x 21%) in 2017
## Discounting Example

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>M-3</th>
<th>DTL</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017</td>
<td></td>
<td>$88,200</td>
</tr>
<tr>
<td>2018</td>
<td>$11,025</td>
<td>77,175</td>
</tr>
<tr>
<td>2019</td>
<td>11,025</td>
<td>66,150</td>
</tr>
<tr>
<td>2020</td>
<td>11,025</td>
<td>55,125</td>
</tr>
<tr>
<td>2021</td>
<td>11,025</td>
<td>44,100</td>
</tr>
<tr>
<td>2022</td>
<td>11,025</td>
<td>33,075</td>
</tr>
<tr>
<td>2023</td>
<td>11,025</td>
<td>22,050</td>
</tr>
<tr>
<td>2024</td>
<td>11,025</td>
<td>11,025</td>
</tr>
<tr>
<td>2025</td>
<td>11,025</td>
<td>0</td>
</tr>
</tbody>
</table>

### Journal entry to true-up 2017

<table>
<thead>
<tr>
<th></th>
<th>DTA</th>
<th>DTL</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DTA</strong></td>
<td>$88,200</td>
<td>$88,200</td>
</tr>
</tbody>
</table>

### Journal entry for 2018

<table>
<thead>
<tr>
<th></th>
<th>DTL</th>
<th>DT Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>DTL</strong></td>
<td>$11,025</td>
<td>$11,025*</td>
</tr>
</tbody>
</table>

\[ \$420,000 \times 21\% = \$88,200 \]

* For STAT the change in DTL will flow through equity (change in DTA) net of tax.
Discounting Example

Assume the following for December 31, 2018

- Undiscounted book reserves - $7,200,000
- Average discount rate under new law - 85%*
- $7,200,000 x 85% = $6,120,000

<table>
<thead>
<tr>
<th></th>
<th>Book</th>
<th>Tax</th>
<th>M3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current year reserves (+)</td>
<td>7,200,000</td>
<td>6,120,000</td>
<td>1,080,000</td>
</tr>
<tr>
<td>Prior year reserves (-)</td>
<td>(6,000,000)</td>
<td>(5,100,000)</td>
<td>(900,000)</td>
</tr>
<tr>
<td>Reserve adjustment</td>
<td>1,200,000</td>
<td>1,020,000</td>
<td>180,000</td>
</tr>
</tbody>
</table>

Current expense

- M3 - LRD movement: 180,000
- M3 - LRD adjustment (tax reform): 52,500

Subtotal: 232,500

Tax rate: 21%

Tax expense: 48,825

* Happens to be the same rate for 2017 and 2018 which should not be the case going forward

** Calculated as follows: Adjustment of $420,000, divided by 8 = $52,500

New law – not from PY return
Repeal of the Alternative Minimum Tax ("AMT")

- Existing AMT credits can be used or refunded
  - 50% of unused credits not used in any year (2018-2020) will be refunded
  - 100% refund of unused credits remaining in 2021

- Current receivable or deferred tax asset ("DTA")

- IRS statement issued 1/14 – refunds are **not** subject to mandatory 6.2% limitation ("sequestration") under the Balanced Budget and Emergency Deficit Control Act of 1985
Net Operating Losses (“NOL’s”)

• Property & Casualty (“P&C”) companies – unchanged
  o Carryback claims for the next two years could result in receivable at 35% rate

• C corporations & life insurance companies
  o No carryback, but indefinite carryforward
  o Use of carryforward limited to 80% of taxable income
  o Old rules still apply to NOL’s generated in 2017 and prior
  o New consideration required for valuation allowance
New NOL Complexity

Consolidated group structures

- Rules applied at the consolidated level
- Tax sharing agreements - accounting for stand-alone P&C financial statements
- Clarifying guidance hopefully on the horizon
Other Tax Provisions

- Dividends received deduction
- Interest expense limitation
- Meals and entertainment
- Depreciation
Other Tax Provisions

Base Erosion and Anti-Abuse Tax ("BEAT")

- Payments by multinational entities to related foreign parties
- An additional tax, not a replacement tax
- If applicable, current provision should include estimate
- Deferred should be valued at regular corporate rate, not expected BEAT rate
State Taxes

- Washington state and Microsoft
  - Surplus lines tax
  - Not independent procurement or income tax
  - ASC 450 (i.e. FAS 5) - Contingencies

- State income/franchise taxes on risk retention groups
  - Some states have a filing requirement – is your captive filing?
  - FL, IL, LA, ME, MI, MS, NE, NH, OR and WI
  - ASC 740-10 (i.e. FIN 48) – Uncertainty in Income Taxes