HAWAII CAPTIVE INSURANCE COUNCIL

CAPTIVE INNOVATIONS

Thinking Differently

2023

Audit and Tax Update

Rebecca James – Audit Partner, Johnson Lambert LLP
Kriss Rizzolo, Partner, Eversheds-Sutherland
Allan Autry, Tax Partner, Johnson Lambert LLP

HAWAII CAPTIVE INSURANCE COUNCIL

HAWAIʻI CAPTIVE INSURANCE

SESSION DESCRIPTION

Session will provide an update on significant changes in both audit and tax. The audit updates include changes to standards and documentation requirements along with CECL considerations. The tax updates include the impact of corporate alternative minimum tax on captives and related groups, IR-2023-74's impact on 831(b) filers, and other hot topics.

Current Expected Credit Losses

("CECL")

Current Expected Credit Losses (CECL)
ASC Topic 326 – *Financial Instruments – Credit Losses*

- Effective for calendar years beginning after December 15, 2022 for nonpublic companies
- Impacts GAAP filers only
- Requires entities to record the current expected credit loss on certain financial assets after considering:
  - Historical information
  - Current losses, and
  - *NEW* Reasonable and supportable forecasts to project future losses

Current Expected Credit Losses (CECL) ASC Topic 326 – *Financial Instruments – Credit Losses*

- Common financial assets held by insurance companies subject to CECL include:
  - Held-to-maturity debt securities
  - Premiums and commissions receivable
  - Reinsurance receivables (paid and unpaid)
  - Receivables from adjustable features
  - Deductible receivables
  - Funds withheld
  - Escrow accounts
- Common financial assets that are excluded are:
  - Available-for-sale debt securities (they are already recorded at fair value)
  - Loans and receivables between entities under common control

Current Expected Credit Losses (CECL)
ASC Topic 326 – *Financial Instruments – Credit Losses*

- Now required to estimate and record a credit allowance against impacted financial assets
  - Offsetting charge or credit to net income
- Credit allowance is updated for subsequent increases and decreases <u>at each reporting period</u>
- Guidance does not prescribe a method to estimate CECL; it requires management to use a reasonable estimation method
  - Judgement will be involved
  - Maintain sufficient, appropriate documentation to support ultimate conclusions

Change in Auditing Standards

Changes in Auditing Standards
SAS 143-145: Estimates, Specialists and Risk Assessment

- Effective for periods ending on or after December 15, 2023
- SAS 143: Accounting Estimates
  - Clarifies auditor's responsibilities for evaluating accounting estimates, including fair value accounting estimates
  - What to Expect?
    - More detailed inquiries of management regarding the system of internal controls to identify and assess risks that could result in material misstatement related to estimates
      - Includes understanding the underlying data, methodology and assumptions used in the estimation process

Changes in Auditing Standards
SAS 143-145: Estimates, Specialists and Risk Assessment

- SAS 144: Use of Specialists and Pricing Information
  - Enhances guidance for (1) the auditor's evaluation of management's use of an external specialist and (2) the use of an auditor's specialist
    - Evaluate competencies, objectivity, obtain an understanding of their work and it's appropriateness
    - Also applies to pricing information from external source (to assist in pricing investment portfolios with holdings at level 2 or level 3)
    - Impact is primarily to auditor procedures rather than deliverables
  - What to Expect?
    - More detailed inquiries of management and its specialists
    - Management should ensure they have:
      - Procedures to evaluate competency of specialists and the quality of the source data provided to them
      - An understanding of their pricing sources and the involvement of pricing services and specialists

Changes in Auditing Standards
SAS 143-145: Estimates, Specialists and Risk Assessment

- SAS 145: Risk Assessment
  - Supersedes AU-C 315
  - Focus is on enhanced risk assessments to support audit quality and defines auditor responsibilities for understanding the system of internal controls
  - New terminology is introduced and familiar terms are re-defined
  - What to Expect?
    - An increased emphasis on the risk assessment phase of the audit
    - Performance of audit procedures that are responsive to the risks identified

Corporate Alternative Minimum Tax

("CAMT")

Overview

- On August 16, 2022, President Biden signed the Inflation Reduction Act of 2022 into law (the "IRA").
- The IRA establishes a 15% corporate minimum tax generally on corporations with book profits exceeding $1 billion.
- The CAMT is effective for taxable years <u>beginning</u> <u>after</u> December 31, 2022.
- The CAMT applies only if the 15% rate applied to a designated corporation's financial statement income exceeding $1 billion with adjustments is greater than the corporation's regular U.S. federal income tax liability, plus any BEAT.
- According to the Joint Committee on Taxation, approximately 150 of the world's largest companies may potentially be subject to the CAMT.

Provisions – "Cheat Sheet"

Section 55(b)	Section 59(k)	Section 56A
• Establishes the tax.	• Lays out the procedural rules, i.e., defining applicable corporation, implicating Section 52(a)/(b), establishing the foreign-parented MNG test, as well as the mechanics of the average annual AFSI test.	• Defines and clarifies AFS as well as AFSI adjustments

Who's In? Who's Out?: Applicable Taxpayers

- CAMT applies to "applicable corporations"
- Applicable corporation = corporation which meet "average annual adjusted financial statement income test"
- Met if "average annual adjusted financial statement income" for a three-taxable year period ending with the relevant taxable year exceeds $1 billion
- All "adjusted financial statement income" ("AFSI") of group is treated as AFSI for testing applicability
  - Group = all persons treated as a single employer under sections 52(a) and 52(b)

Foreign-Parented Multinational Groups

- A US corporation that is a member of a foreign-parented multinational group may be liable for the CAMT if two statutory tests are satisfied:
  - If, solely for purposes of determining whether a corporation meets the average annual adjusted financial statement income test, the AFSI of the group must exceed $1 billion with income of all foreign group members included in the determination; and
  - Provided the foreign-parented group's AFSI exceeds $1 billion, then the AFSI of the domestic member must by itself exceed $100 million.
- A foreign-parented multinational group is two or more entities (at least one domestic corporation and one foreign corporation) that are included in the same applicable financial statement (AFS) and either have a common foreign corporate parent or are treated (as determined by Treasury) as having a common parent that is a foreign corporation.

Rules for Applicability

Once a corporation is in CAMT, it stays in (subject to limited exceptions).

An applicable corporation's status may only be changed if:

(i) there is an ownership change, or

(ii) the corporation fails the CMT income test for a specified number of consecutive tax years (to be determined by Treasury and the IRS); **and,**

Treasury and the IRS determine that it would not be appropriate to continue to treat such corporation as an applicable corporation.

It is unclear how to apply the CAMT following an ownership change or change in the CAMT income test.

Although Notice 2023-7 does address the impact on applicable corporation status when a target or target group is acquired in certain circumstances (with the target's status terminating), the standard by which a corporation may fall out of applicable corporation status remains an open item.

Base Amount Subject to the CAMT

- Applicable Financial Statement Income: Defined as the taxpayer's net income or losses reported on its "applicable financial statement" or "AFS" as defined in section 451(b)(3), with adjustments for certain items.
- After confirming an applicable corporation's AFSI, there are a number of adjustments for tax deductions and credits:
  - an AFS that covers more than one taxable year;
  - an applicable corporation that is part of a consolidated group;
  - an applicable corporation that is a partner in a partnership;
  - an applicable corporation that is a U.S. shareholder of one or more CFCs;
  - an applicable corporation that has a disregarded entity;
  - there are depreciation and/or certain amortization deductions; and
  - there are NOLs.
- If the applicable corporation chooses to credit foreign taxes for regular U.S. federal income tax purposes, the CAMT foreign tax credit may reduce the CAMT.
- General business credits are limited.

Timing of the CAMT Calculation

The CAMT applies to any applicable corporation whose average annual AFSI exceeds $1 billion for any three consecutive tax years preceding the tax year.

The "three-tax-year period" means any three consecutive tax years preceding the tax year in which the tax applies (beginning with three-tax-year periods in which the third year of the period ends after December 31, 2021).

For example, the three-tax-year period for a calendar-year taxpayer possibly subject to the CAMT for 2023, includes calendar years ending December 31, 2020, December 31, 2021, and December 31, 2022.

If a corporation has been in existence for less than three tax years, the CAMT income test is applied on the basis of the period during which the corporation has been in existence.

For any tax year of less than 12 months, AFSI is required to be annualized by multiplying the AFSI for the short period by 12 and dividing the result by the number of months in the short period. The annualization provision and the application of the CAMT income test to applicable corporations in existence for less than three tax years may produce unexpected results.

Notices

Notice 2023-7

- AFSI and applicable corporation status resulting from certain transactions; Tax consolidated groups
- Depreciation adjustments
- Safe harbor method for determining applicable corporation status
- AFSI adjustment with respect to certain credits
- Application of section 56A(c)(2)(D)(i) (related to partnership income) for purposes of determining application corporation status

Notice 2023-20

- AFSI adjustments for covered variable contracts
- AFSI adjustments for covered reinsurance agreements
- AFSI determination respects Congressional “fresh start”

Notice 2023-42

- Estimated tax relief

Notice 2023-64

- Determining a taxpayer’s AFS
- General rules for determining AFSI
- Determining FSI, AFSI, and tax imposed for tax consolidated groups
- Determining AFSI with respect to certain foreign corporations
- AFSI adjustment for certain taxes
- AFSI adjustment for section 168 property
- AFSI adjustment for qualified wireless spectrum
- AFSI adjustment to prevent certain duplications and omissions
- Financial statement net operating losses
- Determining applicable corporation status
- CAMT FTC

Pillar Two

Global Minimum Tax

Overview

- Part of the OECD's Inclusive Framework "Two Pillar" solution to addressing the tax challenges arising from the digitalization of the economy
  - Applies to the largest taxpayers: Multinational groups with consolidated revenue over €750m
    - Impact is not limited to businesses in the digital economy
- Designed to subject all income to a minimum ETR of 15% (the "GloBE rules"), through:
  - Income inclusion rule (IIR), that applies a minimum tax similar to the GILTI rules
  - Undertaxed profits rule (UTPR), that allocates taxing rights ensure income is taxed at minimum 15% rate in jurisdictions where received

Overview

Qualified Domestic Minimum top-up tax (QDMTT)

- Allows the local jurisdiction to collect any top-up tax that would otherwise be paid to another jurisdiction under Pillar Two
- Tax paid under a QDMTT eliminates or reduces top-up tax payable under IIR/UTPR
- Local country measure

Income Inclusion Rule (IIR)

- Triggers top-up at the level of the Parent where the income of a constituent entity (aggregated at the jurisdictional level) is taxed at a rate less than 15%
- “Parent” country measure

Undertaxed Profits Rule (UTPR)

- UTPR is a backstop; it only applies where Group income is not already subject to IIR
- It operates by denying deductions (or an “equivalent adjustment”)
- Applies to ultimate parent jurisdiction, including the U.S., with equal force
- Backstop measure

Pillar Two in Operation

OECD Rules are Model Rules as part of OECD's efforts at international standards setting, and therefore require local adoption

- Several countries pushing ahead, although some countries have stated the need to push back the effective dates to 2024 and 2025

The GloBE rules are structured, particularly with the IIR and the UTPR, such that universal adoption is not required

- Although universal adoption is not required, inconsistent adoption in the countries that do apply some form could result in double taxation

Applicability

OECD model would subject only in scope companies to the Pillar 2 rules

- Must be a constituent entity of an MNE Group
- Consolidated revenue for the MNE group must be at least 750 million Euro for at least two of the preceding 4 years

Burden reaches beyond in scope companies

- Resources are required to determine if thresholds are met
- Companies close to thresholds will require regular monitoring to ensure ability to comply

Exceptions and Safe Harbors

- Recognizing complexity of the rules, particularly in implementation phase, the OECD has proposed a transitional safe harbor and a framework for a permanent safe harbor that reduce the compliance burden as to low risk jurisdictions
- Transitional CbCR Safe Harbour
  - Short term model that excludes an MNE's operations in certain lower-risk jurisdictions from the scope of GLoBE in the initial years.
  - Requires demonstrating that, based on qualifying CbCR and financial accounting data, it has
    - (i) de minimis revenue and income, and an ETR that exceeds an agreed rate ("De Minimis Test"); or
    - (ii) no excess profits after excluding routine profits ("Routine Profits Test")
  - De Minimis Test requires revenue of less than 10 million Euro and profit before tax of less than 1 million Euro, and the transition ETRs are 15% for 2023-2024, 16% for 2025 and 17% for 2026
  - To satisfy the Routine Profits Test, it is still necessary to perform a full "Substance-based Income Exclusion" calculation.

Exceptions and Safe Harbors

- Proposed permanent safe harbor
  - Intended to reduce the number of required computations
  - Allow MNE to rely on simplified income, revenue and tax calculations in determining application of de minimis, routine profits and ETR tests under the GLoBE rules
  - The OECD is considering a safe harbor for businesses which prepare a QDMTT calculation under local rules, and guidance is expected during Summer 2023
- OECD also has recommended transitional penalty relief

Local Adoption

Asia-Pacific

- South Korea is the first country to enact Pillar 2 legislation, effective January 2024
- Japan has passed tax reform legislation to implement an IIR consistent with the OECD model rules in 2024
- Both Singapore and Hong Kong have confirmed plans to move forward with the adoption of the GloBE rules and a QDMTT starting in 2025
- Australia announced the implementation of 15% global and domestic minimum taxes, but is considering public comments before moving forward with legislation

European Union

- The EU Council passed a directive requiring all EU countries to enact the GloBE rules
  - Generally, EU jurisdictions are required to have IIR by the end of 2023, and UTPR by the end of 2024
- Germany has published a draft law in February 2023, which was updated in August 2023
- The Netherlands submitted legislative proposal to the Dutch Parliament in May 2023.

Non-EU Countries

- In July 2023, the UK enacted legislation which implemented an income inclusion rule and a domestic minimum top-up tax which will apply for tax periods after December 31, 2023.
- Switzerland has proposed draft legislation to implement GloBE rules

Local Adoption

United States

- The Build Back Better Act (BBBA), which was introduced but not passed in 2022, included provisions intended to better align U.S. rules with GloBE requirements
  - The corporate alternative minimum tax was passed in the IRA which includes some elements necessary for a QDMTT
  - Significant open items:
    - Treatment of U.S. tax credits, including foreign tax credits and energy credits, for purposes of determining effective rate
    - Application of GILTI on a country-by-country basis

Canada and Mexico

- Canada has announced intentions to adopt Pillar 2 in the 2023 budget, with implementation effective in 2024 with the adoption of an IIR and QDMTT
- Mexico has unofficially announced plans to implement Pillar 2 but has not yet taken any official steps to do so

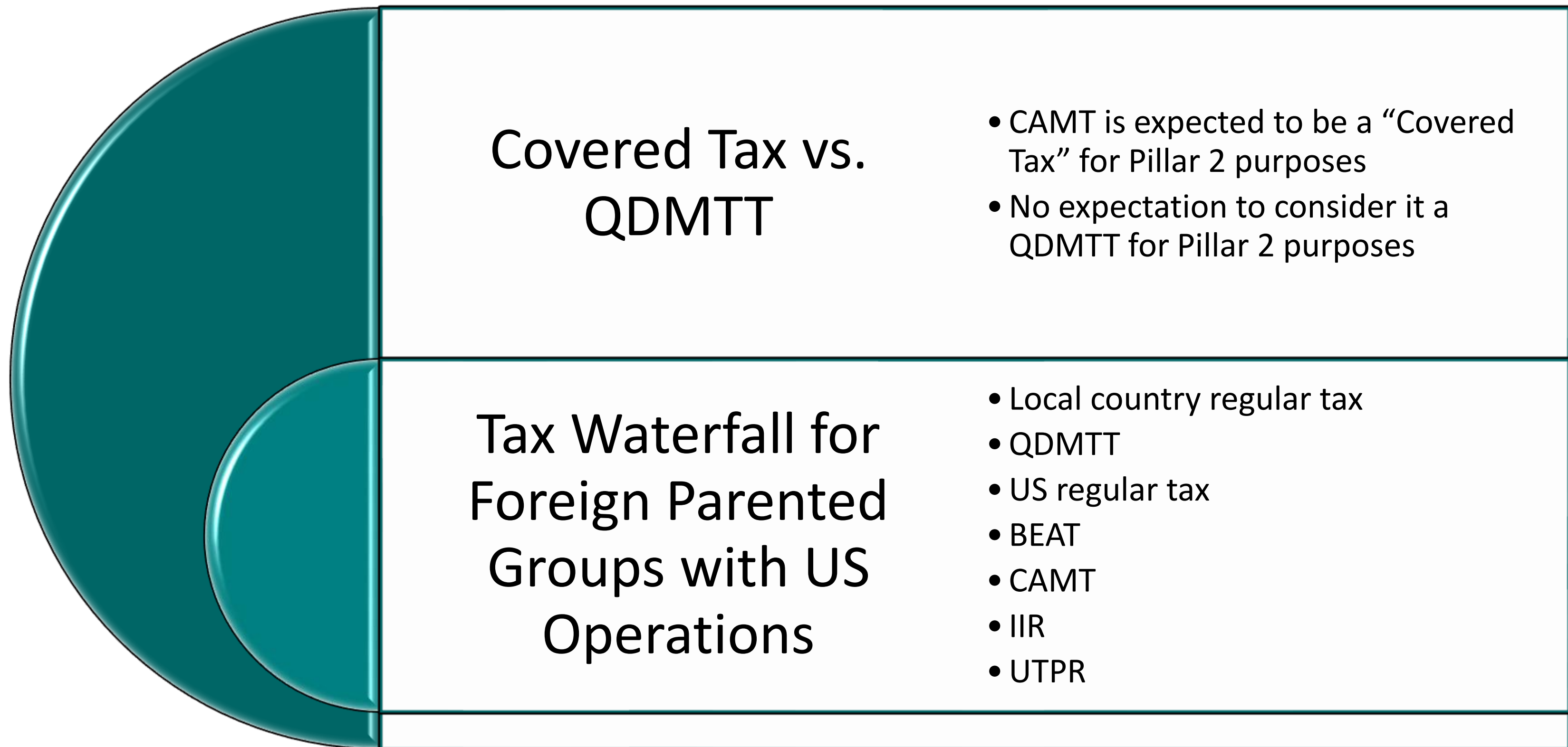
Bermuda

- The Government of Bermuda has announced that it is considering the implementation of a new corporate income tax regime to be effective on or after January 1, 2025, in response to the OECD's BEPS Pillar II global minimum tax rules.

South America

- While Colombia has not proposed adoption of GloBE , it has proposed other tax law changes in response
  - The government declined many OECD model rules, but instead implemented a unilateral domestic alternative minimum tax

Interaction between CAMT and Pillar 2



Micro-Captive Cases

Lessons Learned for Regular Captives and Others

Key Cases

- Avrahami v. Commissioner
- Syzygy v. Commissioner
- Caylor v. Commissioner
- Reserve Mechanical v. Commissioner

Problematic Facts Identified by Court

Avrahami

- Three or four direct insureds not sufficient
- Captive covered an insufficient number of risk units
- Pool lacked substance
- Claims dealt with on ad hoc basis
- Investments not within norms for insurance company
- Premiums were not market premiums
- Policy terms not clear

Syzygy

- Fronting arrangement lacked substance
- Pooling arrangement did not provide third-party risk
- Insured not submit claims
- Investments not liquid; not within norms for insurance company
- Policies not timely issued
- Premiums not arm's length

Caylor v. Commissioner

- Did not meet safe harbor
- Number of exposure units too small
- Risks were not independent
- Premiums and claims paid before underwriting complete and policies issued
- Premiums paid before amount for each insured was known

Reserve Mechanical v. Commissioner

- Number of insureds and number of independent exposure units were Insufficient to distribute risk
- Pool not insurance, did not provide unrelated business for Reserve
- CEO knew nothing
- Office in Anguilla – nothing done there
- Feasibility study after formation and did not cover insureds
- Assumed business from Pool Re unknown – no due diligence/underwriting
- Premium not reasonable for coverage
- Single claim handled in an atypical manner
- Not valid and binding policies

Lessons Learned

- Captives still work if designed well
- Premiums should be actuarially determined
- Insureds should file legitimate claims
- Captive should have regular claims processes that include investigating and documenting claims
- Officer or director of captive should oversee third-party captive manager
- Policies should clearly define coverages
- Policies should be issued timely
- Unless number of insured/risk units very large, consult an actuary regarding risk distribution
- Pools should be carefully designed

Lesson Learned

What to look for in a pool

- Proven track record
- Facility large enough to provide sufficient level of risk diversification and unrelated premium
- Structure that supports stable loss results
- Structure that mitigates credit risk without collateral requirements
- Common actuarial approach to premium determination
- Transparency in pooling structure
- Participant driven decision making based on contractual guidelines

Mahalo.
This concludes our presentation.

This presentation contains general information only. The Hawaii Captive Insurance Council and its guest speakers are not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Neither the Hawaii Captive Insurance Council nor its guest speakers shall be responsible for any loss sustained by any person who relies on this presentation.