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FEDERAL INCOME TAX

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1. Canadian Income Tax

   a. What theoretical, interpretational and practical problems and deficiencies have been found in the new Canadian income tax act and regulations, with particular reference to the new rules for Maximum Tax Actuarial Reserves?

   b. What effect will the new tax rules have on profits, pricing and plan design? Is the overall tax burden fair? Is it fairly distributed?

2. U. S. Income Tax

   a. What impact will proposals for tax reform, if adopted, have on the life insurance business in the U.S.? What alternatives have been proposed by the industry?

   b. Are legislative changes needed in the 1959 Company Tax Act? If so, in what areas; e.g., the Menge Formula? Qualified group pension reserves?

   c. What are the implications of recent Court decisions; e.g., Standard Life and Accident (U. S. Supreme Court); Lincoln National (Court of Claims); Union Mutual (Court of Appeals); Southwestern Life (Court of Appeals); Bankers Life (Court of Appeals)?

3. Other current issues in Canada and the U. S.

MR. DAVID R. CARPENTER: I would like to begin by introducing the members of the panel this afternoon. First, we will hear from James Jeffery, Associate Actuary of London Life who is going to cover Canadian Income Tax. He will be followed by Bill Harman, formerly an Executive Vice President of the American Council of Life Insurance who will discuss U. S. Income Tax. We will then hear from Bob Griffith, tax partner with Ernst & Ernst who will present the tax implications of recent court decisions in the United States.

MR. JAMES E. JEFFERY: It has been said that two things only are certain in this world - death and taxes. This well-known saying should have special significance for the life insurance industry. We depend for our existence on the certainty of mortality. Ironically, we have yet to come to terms with the inevitability of an effective corporate tax structure.

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Today, we are celebrating the tenth anniversary of the birth of modern corporate life insurance taxation in Canada. It was exactly ten years ago last night, October 22, 1968 at 8 p.m., that the Honourable Edgar Benson rose in the House of Commons and virtually rewrote the rules for life insurance companies. Those rules were not destined to survive even ten years, and today we face a new Minister of Finance and a new set of rules.

The new 1978 income tax law applicable to Canadian life insurance businesses is the main subject of my discussion today. But, the 1978 Act is largely a product of its predecessor. Accordingly, my plan for this afternoon is to first perform a brief post mortem examination of the now defunct 1969 Income Tax Act. This is followed by a general discussion of the new 1978 Act, and a more detailed review of the new 1978 tax reserve basis. An assessment of the future in light of past mistakes forms the final section of my prepared remarks.

In retrospect, Mr. Benson's 1968 Budget can be viewed as an imaginative attempt at a structure which would be fair in overall level of burden, even-handed amongst companies and reasonably easy to administer. The new 1969 life insurance corporation income tax was a two-part structure. The so-called Part I tax was a normal corporate "profits" tax with taxable income computed by methods similar to the computation of net income in an ordinary revenue account. The 15% investment income tax was designed to provide a reasonable measure of tax load on the inside build up in life insurance policies, while avoiding the pitfalls of an investment tax at the policyholder level. These two taxes were interrelated, that is, each one contained a deduction in respect of the other.

Part I reserve deductions were generous. For ordinary insurance, reserves were computed on the net level premium basis for all companies, even those with weaker statement bases. Generous annuity reserves were permitted by allowing an interest rate margin of up to 1 1/4% compared with the premium basis. Optional calculation methods were provided for ease of administration. Certain group contingency reserves were allowed, and in the case of group health there was almost no limit on the year to year increase which could be deducted from taxable income.

In recognition of the long-term nature of the life insurance business, special arrangements were made for tax losses to be carried forward indefinitely for later application in years of taxable income. This was accomplished by permitting deduction of less than the maximum permitted actuarial reserves, without prejudice to future such claims.

Special treatment was also given to the insurance industry with respect to geographic coverage of the tax. The normal technique of taxation of global operations combined with foreign tax credits was abandoned in favor of a domestic only tax, for both Canadian and foreign domiciled companies.

In order to prevent tax "management" by manipulation of policyholder dividends, and also to put the taxation of profits from non-participating business on the same footing for both mutual and stock companies, the deduction for policyholder dividends was limited to an amount not exceeding current income in the participating branch.

We now know that this corporate tax structure suffered from a variety of inherent structural problems. A complete listing would be long. Here are a few:

1. A mathematical fluke was found which permitted artificial manipulations to avoid a major portion of the investment income tax. This was the so-called "flip-flop".

2. Universal application of Net Level Premium tax reserves meant minimal or no Part I taxable income for many companies using modified statement reserves.

3. Unlimited deductibility of certain group health contingency reserves produced predictable results: large increases were suddenly "needed" in years of high taxable income.

4. The amount of tax payable was significantly affected by the classification of transactions as between investment versus insurance operations, participating versus non-participating, and in-Canada versus out-of-Canada. Major areas required subjective allocations, for example, expenses and investment earnings, inviting manipulation for tax purposes.

5. Participating branch income in excess of current policyholder dividends could not be carried forward for later use in justifying dividend payout under the dividend limitation provision.

6. Last but not least, the net result of this complex structure was an actuary's delight. It contained a variety of phases, situations and discontinuities; tax consequences often could not be determined without elaborate algebraic analysis or modeling; the overall structure was virtually incomprehensible to the non-specialist.

Two significant environmental influences were superimposed on these structural flaws. Inflation became a major problem in Canada soon after 1969, and inflationary increases in new business combined with inflationary increases in administrative expenses put substantial strain on insurance companies' profit statements. Taxable income was just as adversely affected, especially since Net Level Reserves were the basis. A second serious environmental problem came along in 1974 when the government of the day decided to encourage investment in Canada by granting exemption from taxation for the first $1000 of investment income earned by individual Canadian taxpayers. The investment income tax on Canadian life insurance companies was not simultaneously removed and life insurance became a tax-disadvantaged instrument from a personal savings point of view.

This tax structure was probably fatally unstable in its own right. The industry was complaining bitterly about the triple whammy of a profits tax, an investment tax and a premium tax. The government was upset because revenue was considerably lower than original projections. Corporate tax officers and governmental assessors alike were overwhelmed by mathematical and other complexities.

But the end was hastened considerably when a number of companies began to discover technical defects in the rules relating to allocation of investment earnings between countries. These were the so-called "branch loopholes". If these defects had been allowed to persist for even a couple of years, multinational insurers could have completely avoided current Canadian taxation while building up huge unwarranted loss carryforwards for the future. Both the current competitive balance and the future tax base would have been completely destroyed.

The government officials who drafted the new 1978 Income Tax Act and regulations had four major areas of difficulty to resolve. The old rules contained major technical defects. The investment income tax was now largely unjustified. The Part I tax base had proven to be inadequate. Many taxpayers had accumulated huge loss carryforwards. The new 1978 rules can be adequately described by reviewing the solutions offered in these four areas.

The old rules contained a large number of technical defects in wording and calculation methods, several of which were sufficiently severe in their own right to wreck the tax system. Determination of the Canadian portion of investment earnings, the treatment of policy loans, segregated fund handling, to mention just a few. Details of the corrections of these errors are largely outside the scope of this discussion. Many of the rules appear to be extremely complicated and cumbersome. One area of interest to actuaries concerns the correction of the so-called policy loan loophole. The new rules stipulate that policy loans will be treated as a reduction in actuarial reserves rather than as assets, and that policy loan interest will be treated as premium income rather than as investment income.

The granting of a $1000 investment income exemption to individual policyholders largely undermined the rationale underlying the old investment income tax. Accordingly, the new 1978 rules completely abolished this tax. However, this concession was originally accompanied by a stiffening of the personal tax rules with respect to life insurance policies. The result was the so-called death tax - but this proposal had to be shelved in the face of a loud public outcry sparked largely by life insurance agency associations. Whether or not this was a hollow victory remains to be seen.

The lack of Part I tax revenue in the 1969 to 1977 period may have resulted from the environmental influences mentioned before, or from the technical defects contained in the old rules, or partly from the existence of the investment income tax, or from the generosity of the reserve basis provided, or from a combination of all of these. This is still being debated. In the view of Ottawa officials, the reserve basis was heavily at fault. Accordingly, the new 1978 rules contain reserve rules which have been cut to the bone. This is a subject of special interest which we will address in more detail shortly.

Because of the major technical defects, structural flaws and the general inadequacy of the Part I tax base for other reasons, a substantial number of companies had managed to build up huge loss carryforwards which would have negated the effect of any new tax structure, perhaps until the next century. Although a significant portion of these carryforwards was eliminated before 1978 with some "bandaid" adjustments to the old rules, a significant portion still remained. Some commentators suggested a total fresh start - that is, pretend the old structure had never existed; everyone start again with a clean slate. The new 1978 rules do not go quite that far. Instead, the rules limit carryforwards brought into the new system to the amount which an insurer can justify by recomputing 1969 to 1977 income using the 1978 reserve rules.

One other new feature of the 1978 rules relates to the taxation of dividends received on common and preferred stocks. Coincident with a change in the treatment accorded taxpayers generally, life insurance companies were granted complete exemption from taxation of these amounts.

Apart from the changes mentioned above, most of the other major features of the old Act were carried forward to the new. The tax is still based on domestic operations only. The deduction for policyholder dividends continues to be limited to an amount not exceeding current income in the participating branch. The defects in this latter rule have not been corrected.

Let's turn now to some details of the actuarial reserve bases prescribed by the new rules. Finance Minister Jean Chretien finally released the draft reserve regulations for industry review on July 7, 1978. Since then, they have been undergoing intensive study by individual companies and by a committee of the Canadian Life Insurance Association. Strong representations have been made for certain changes. We believe that chances of success are quite good in some cases and quite poor in others. I will try to describe the major elements of the draft rules. The description of each element is followed by a comment which represents a mixture of the official Association position and my own observations.

For basic insurance and annuity benefits, an ordinary prospective reserve is calculated using the full preliminary term method for annual premium plans. The permitted reserve equals the higher of this value and the guaranteed cash surrender value. In the case of participating insurance policies which contain cash values, the mortality and interest assumptions used in the calculation must be the same as the assumptions used in computing the cash values. For all other cases, mortality and interest assumptions must be the same as the basis assumed by the insurer in fixing the premiums.

> Comment: We are not happy with the full preliminary term basis, but we have already exhausted all of our arguments against it. We were surprised at the absence of any softening of the modification for high premium plans. Apparently officials tried to apply the Commissioners Reserve Method, but found the resulting wording to be unacceptably complex. Curiously, the industry has been unable to agree on the desirability of the Commissioners Method, and the Association has made no recommendation in this regard. The application of the full preliminary term method to annual premium annuities will be difficult, but the cash value floor is likely to be governing in most cases.
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> The phrase "basis assumed by the insurer in fixing premiums" will be difficult to interpret and even harder to apply. In the case of non-par insurance products this would seem to be a needless complication. We have been unable to discover the government's real reasons for this requirement, hence we are unsure of the likelihood of change. No provision has been made for potentially needed reserve strengthening, and we have been told that we will not win that argument for the present.

Single premium immediate life annuities are to be granted the same reserve as above, but with an additional 1/2% margin in the interest rate assumption.

Comment: We are asking for an extension of the 1/2% margin so that it covers virtually all of the common annuity products issued in Canada. We are reasonably confident that some expansion will be granted, perhaps not all that we have asked.

Two provisions are included in an attempt to prevent abuse in the choice of mortality and interest assumptions. One section permits ministerial adjustment of the mortality or morbidity assumption. The second provision contains a highly unusual test of the interest assumption. Basically, it requires the calculation of a notional gross premium on the basis of the mortality and interest assumptions you plan to use. If this notional gross premium exceeds the actual gross premium, a higher rate of interest must be found such that the two are equal.

Comment: This test would be very difficult to apply, and in some cases would yield ridiculous or impossible results. We are hoping for a change to something more reasonable.

A specific list of additional benefits is supplied under which reserves will be allowed in the statement amount, provided this is reasonable.

Comment: The list includes most additional benefit reserves you might think of, but there are some things that may have been forgotten. In any event a specific list is cumbersome. We are hoping for addition of some kind of "catch-all" provision. On the whole, I am afraid our chances may be poor here.

Unearned premium reserves are permitted for group life and health at 80% of the gross premium, or greater if justified in specific cases. Justification is to be based on a measurement of the actual acquisition costs of the policies. A ten year grading-in feature is provided.

Comment: The method stipulated for justifying values higher than 80% has been erroneously formulated. I think we have a simple misunderstanding here and I would rate our chances of winning a change as quite good.

The total amount of health branch general contingency reserves deducted under the old law up to the end of 1977 is to be released back into income over a 10-year period commencing in 1978.

Comment: It had been expected from the Minister's remarks that the clawback would be based on 1976 and not 1977. This is a contentious issue in the industry because the effect goes in different directions for different companies, and the rules as written provide unexpected relief for some. However, I would assess the likelihood of change as quite high.

Among additional items worthy of note, the rules give explicit permission for certain approximate methods in some reserve calculations. The requirement that an actuary's certificate accompany the tax return is being reviewed by the Candian Institute of Actuaries. As mentioned before, allowable actuarial reserves are reduced by policy loans outstanding. The regulations specify that 1978 opening reserves must be recalculated on the new basis. In other words, the 1978 reserve basis applies to all business in force, not just new business.

This completes my abridged description of the new 1978 rules.

Let's stand back now and ask these questions. What major mistakes were made in the drafting and application of the 1969 tax act? Has the 1978 version found successful solutions to these problems?

When I first gave these questions some thought a few days ago, several important features of a good tax structure occurred to me. The structure should yeild a reasonable but not excessive amount of tax. The burden of payment should be fairly distributed amongst taxpayers. The tax should not be unduly cumbersome to calculate or administer. These are certainly not all of the important features which could be mentioned, but these were the first three which came to mind.

It seems to me that the structure in effect from 1969 to 1977 violated all three of these principles. How could Edgar Benson's good intentions have gone so far astray? Consider these suggestions for entries in the list of pitfalls into which the old rules fell:

- Too many options were permitted. Insurers were able to wander through the rules, calculating a host of alternatives, and choosing the one combination which resulted in minimum tax.

- The overall structure and some of its particular provisions were excessively complicated.

- Subjective allocations were required in too many places. For some of these, the rules were totally silent, leaving companies and assessors alike wondering what to do. In other places, highly detailed arbitrary rules were established which left no room for discussion, and most importantly no room for general tests of reasonableness.

Of course, these pitfalls might not have been so deadly if the industry had taken a sensible view of its obligation to support a realistic and reasonable tax system.

What about the new 1978 rules? Well, most of the options and some of the subjective allocations have been removed, and the general structure has been simplified. Unfortunately, particular provisions have been considerably complicated in the process, with a corresponding increase in the likelihood that serious technical defects remain. Also, it seems highly unlikely that the administrative burden will be lightened overall. The number of highly detailed arbitrary rules has increased; a situation which seems unlikely to lead to satisfactory equity in the distribution of the burden amongst taxpayers. Moreover, there has been little sign yet of a wholesale return to an attitude of responsibility in the industry.

A couple of potentially serious problems can already be perceived. In the first place, the total removal from the tax base of dividends received on common and preferred stocks may be desirable overall, but for taxpayers whose taxable income contains a significant element of investment income, there is the possibility of a major erosion of the amount of tax revenue produced. Insurers may choose to move towards these tax-free investments in a major way. If they do, Canadian taxation authorities would have to watch helplessly as the tax revenue from Canadian insurers dwindled to an unreasonably low level once again.

Secondly, the recently released draft regulations pertaining to the division of investment income between countries are already showing signs of strain. In order to prevent all possible abuses, the rules have been drafted so stringently that multinational insurers may find themselves at a competitive disadvantage. This is a very difficult problem to resolve because a weakening of the rules might once again disadvantage domestic insurers. It may be that the concept of a domestic only tax is doomed to ultimate failure. It will be interesting to watch U.S. experiments in this regard.

The new reserve rules limit deductions to a level lower than many companies would prefer to hold in their statements. This is unfortunate because competitive considerations will ultimately force most companies to weaken statement reserves until they are more or less consistent with tax reserves. However, it now appears that we will succeed in negotiating reserve levels which are at least manageable, and I predict that companies generally will successfully adjust. Many companies are proceeding, and some are waiting to see whether the 1978 income tax system survives before submitting to this adjustment.

In summary, the 1969 Income Tax Act for life insurers was a valiant attempt, but certain basic flaws were inherent in its structure. The new 1978 rules are highly complicated, and only some of the defects of the old rules have been corrected. Sources of strain can already be perceived and lengthy survival of the 1978 structure is open to doubt.

MR. WILLIAM B. HARMAN, JR: I would first like to discuss the impact that proposals for tax reform, if adopted, will have on life insurance business in the U.S.; and the alternatives that have been proposed by the industry.

Let me just try and cover some of the highlights that are in the bill recently passed by the Congress, the so-called Revenue Act of 1978. This bill is not law yet, but my prediction is that when the bill does reach the President's desk, he will sign it and it will become law. This should probably occur in early November.

One of the major provisions affecting life insurance companies is an amendment added to this bill by the Senate Finance Committee. This amendment would amend Section 805(d) of the Code, which relates to pension plan reserves of life insurance companies. You may recall that the basic pension plan deduction grants a life insurance company a deduction for, in essence, its qualified pension business, and such deduction is based on the pension plan reserve times the company's current earnings rate. This section of the law has been amended to include an additional category of reserves that will qualify for this current earnings rate deduction. Under Section 155 of the Act, life companies will be able to include under Section 805(d) the reserves on contracts issued under state and local government pension plans (whether or not qualified), or issued to such a government for use under an unfunded plan of deferred compensation pursuant to the pension plan reserve rules. It should also be noted that both types of these contracts will now qualify for separate account treatment in a manner like other separate account contracts. This amendment applies to taxable years beginning after December 31, 1978. The key point here is that now when life insurance companies sell such agreements through this general account (as opposed to a separate account), the life company will now receive a current earnings rate deduction for the reserves under such plans. Likewise, if you are marketing this type of plan through some form of separate account or variable annuity type of contract, there are comparable amendments to Section 801(g), the separate account provision of the Code. Thus, this amendment will permit a life insurance company to compete with banks, mutual funds, savings and loans, which had succeeded in cornering most of the marketing of these deferred compensation plans because of more favorable tax treatment than life insurance companies had.

In addition, there was some corporate rate reductions in this revenue bill that provide that the basic corporate rate for income of over $100,000 is being reduced starting next year from 48% to 46%. The investment tax credit provisions have been codified on a permanent basis at a 10% rate. The amount that can be credited has been increased on a graduating basis from basically 50% of your tax liability over $25,000 up to 90% of tax liability on a phased-in basis.

There was an interesting provision included by the Senate Finance Committee, but it was deleted on the floor of the Senate, that would have modified the treatment of municipal bond interest. I mention this because having received the approval of the Senate Finance Committee, it is likely that it will be considered again by the Congress within the next few years. Basically, it would have given a taxpayer, including a corporation such as a life insurance company, the option to treat municipal bond interest on a taxable basis with a tax credit. The concept can be best explained by the following illustration: if a life company had $100 of municipal bond income, it could elect to include it in gross investment income in the amount of $167, a 40% gross-up of the $100 amount; then the company would be granted a tax credit of $67. So, you can see in this simple example, you would have included $167 in income, and you would have had a tax credit of $67. Next, you would have to follow through the intricate calculations of the '59 Act to see whether or not it would be advantageous, depending on your effective tax rate, to make such an election. It would have fascinated the actuarial and tax people because of all the numbers involved and as to whether or not it was a plus or minus to so include such municipal interest. When this provision was added by the Finance Committee, we had some industry people look at it quickly. One day they said it was a great bonanza, and the next day they said it didn't have any effect! The third day they concluded it probably had some effect, but they weren't sure what it was. However, you should be aware of this provision. The reason it was defeated was the municipal people basically are scared to death of any change in the current treatment of municipal bond interest for fear it might ultimately result in municipal bond interest losing its tax-exempt status.

Another provision not related to the '59 Company Tax Acts as such, but I think one of considerable importance to the life insurance business, is a provision that clarifies a matter that has affected many life insurance companies, as well as other employers. This issue involves the proper treatment of FICA, FUTA and wage withholding for a number of your workers. The question is whether or not the worker is a true employee subject to these taxes or is an independent contractor and, therefore, not subject to these taxes at the employer level. This provision basically forgives tax liability through 1979 if the employer had a reasonable basis for so classifying these workers as independent contractors. Look at those provisions because it probably resolves one of the more important audit issues that has come up in the last several years.

Another provision of the House version of the Revenue Act would have changed the treatment of the health insurance premiums on the individual tax side. As you know, under existing law, you can deduct one-half of your health insurance premiums up to $150; this is outside of the medical expense limitation. The House provision would have changed existing law by not permitting a deduction outside of the medical expense limitation. Fortunately, the Senate did not go along with this change, and the final version of the 1978 Revenue Act makes no change in existing law.

Another provision of the House version of the 1978 Revenue Act would have provided for the indexing of the tax basis of certain capital assets, such as common stocks. Such a provision caused some concern within the life insurance business because of its possible competitive effect upon life insurance contracts which were not subject to the indexing provision. The basic issue was whether or not such a provision would change the competitive balance between equity and insurance products because of more favorable tax treatment equity products would receive due to indexing. Fortunately, no indexing provision was contained in the final version of the 1978 Act. However, the indexing concept is one that the Congress will undoubtedly consider in the next few years, and it is one the life insurance business must study seriously to determine its possible merits and demerits and its impact upon insurance products.

There were four tax reform proposals made by the Carter Administration in 1978 that were considered by the House Ways and Means Committee and rejected by the Committee. I mention these provisions only to alert you that the business must continue to study these proposals and be alert that such proposals, or variations thereof, will likely be considered by Congress in future years when tax reform measures receive serious consideration.

The four provisions are as follows: One, the proposal to change the existing law treatment of individual non-tax qualified deferred annuities; presently, there is no current tax to the policyholder on the interest credited each year under the annuity contract by the life insurance company. The Administration proposed, basically, that such interest should be taxed currently. The industry opposed this suggested change.

A second proposal would have revised the existing rules for integrating qualified retirement plans with social security benefits. As you recall, there were similar proposals made in the late sixties by the Johnson Administration. The insurance business, and business in general, opposed this proposal, basically on the grounds it was premature in view of three major studies presently underway in Washington relating to both the private retirement system and the entire social security system. Moreover, the integration proposal had a number of technical flaws that needed some study before they could be resolved.

A third proposal was to eliminate the $5,000 employee death benefit exclusion under Section 101 of the Code. The basic industry position was that it should be continued for tax qualified, non-discriminatory plans; however, the business did not defend existing law where the exclusion had been used in what many persons thought was a discriminatory fashion.

The last proposal was one that would have required group life and group health plans to meet new statutory non-discrimination rules in order for such plans to continue to receive existing tax law treatment. Again, this was opposed by the business. The general argument was that such new rules were unnecessary since most such plans were non-discriminatory, and the addition of statutory rules would be burdensome and costly on these very desirable plans. An argument was further made that if any abuses did exist then specific rules relating only to such abuse areas should be developed.

While the Congress rejected this last described Administration proposal, the Senate Finance Committee adopted a proposal sponsored by Senator Packwood of Oregon which ultimately became Section 366 of the 1978 Act. This provision amends Section 105 of the Code to require uninsured medical reimbursement plans of employers to meet various non-discrimination requirements with respect to both coverage and benefits. If the plan does not meet such requirements, part or all of the medical benefits under the plan that are paid to highly compensated employees will be included in their income. This provision is applicable to claims filed and paid in taxable years beginning after December 31, 1979. This provision will have to be carefully studied to determine its effect on these uninsured plans. Moreover, this provision will create a possible precedent for applying similar rules to insured plans.

Now, in the remaining time, let me turn to the other area of my assignment - are legislative changes needed in the 1959 Company Tax Act?

First, let's look at the revenue yield of the '59 Act. The Life Insurance Fact Book contains figures relating to the Federal income taxes incurred by U. S. life companies which are obtained from the annual statements, and the American Council compiles similar statistics from the returns submitted by a number of member companies for a number of specific items under the '59 Act provisions. While the latter statistics do not include all life insurance companies, these returns account for about 85% of the total revenue paid under the 1959 Act and would appear to be statistically valid for purposes of reviewing how various provisions of the '59 Act are working in actual practice. It is these numbers that I will be referring to in the next few minutes of my talk.

In 1958, life companies incurred $455 million in Federal income taxes, and this amount had increased to $2.209 billion in 1976. Thus, we can conclude that the '59 Act has produced considerable tax revenues to the Federal government, and such revenue has increased over the years as the life business has grown. Of course, as the business has grown over the past twenty years, the income of the business has grown too. It is reasonable, therefore, for the income tax liability of the business to increase since the '59 Act is based on net taxable income. It is nearly impossible, however, to conclude whether the particular tax base underlying the '59 Act — the so-called Menge formula — has produced a truly realistic measure of the taxable income of life companies. Some persons suspect it may have produced a somewhat higher tax base than is proper, and I am sure there are certain persons who may believe it did not produce as large a tax base as another type of formula would have produced. My basic view is that it has resulted in a very workable tax formula, and one that has produced increased revenue in a manner consistent with a typical net income tax approach. At the most, I believe the '59 Act may need some fine-tuning from time-to-time, but I do not believe it is in need of any major over-hauling.

Some statistics that the Council has compiled from tax returns would indicate that the tax revenue obtained from stocks and mutuals over the years appears to be consistent with basic formulation of the '59 Act. For example, it would appear that stock companies were paying around 30% of the total industry tax in the early years of the '59 Act, and stock companies were continuing to pay around 30% of the industry total in recent years. This percentage of around 30% has remained quite consistent over the years, and it will appear reasonable to many persons in view of the make-up of the industry.

In an analysis of the taxable income of the life industry—between investment income and underwriting income—it appears most of the taxable income of the industry comes from the investment income tax part of the '59 Act. This is what was anticipated in 1959, and I believe it has turned out in this fashion. The numbers indicate that the mutual part of the industry has paid tax on a gain from operations tax base less $250,000; in other words, it has been taxed on free or excess investment income. This result is absolutely consistent with the theory of the '59 Act.

Similarly, the stock part of the industry has incurred taxes on investment income plus $30-$60 million a year in underwriting income (with the other half of the underwriting income, $30-$60 million, going into a deferred tax account). This, too, is consistent with '59 Act theory. Thus, I conclude between the two segments within the life industry, the tax formula is producing reasonable results, and, more importantly, results consistent with the intent of the '59 Act.

The current earnings rate of the industry has increased from 3.73% in 1958 to slightly in excess of 6% in 1976. On the other hand, the averaged assumed interest rate of the business has changed only slightly over the years—in 1958 it was 2.77% and had increased to only 2.81% by 1976. The average assumed interest rate for mutuals was 2.72% in 1958 and 2.74% in 1976; for stocks, the rate was 2.97% in 1958 and 2.98% in 1976. Obviously, with the industry assumed interest rate remaining constant and the current earnings rate rising around 60%, the free investment income of the industry rose substantially, particularly when coupled with a growth in assets of around three-fold for the period 1958-1976. The adjusted reserves rate for the industry increased from 3.56% in 1958 to 5.80% for 1976.

It is interesting to note the rapid growth of the pension plan business of the life companies. In 1958, life companies had interest on pension plan reserves of $157 million; this increased to $1.7 billion in 1976. Similarly, the interest paid deduction of the companies increased from $278 million in 1958 to $2.3 billion in 1976. While the interest paid deduction will include items that do not relate to the pension business, I believe the substantial rise in this deduction is attributable primarily to pension business.

With respect to policyholders dividends, the non-par deduction and the group life (and A&H) deduction, the limitations in the law substantially reduced the amount of these deductions. For example, in 1976, policy dividends totaled $5.4 billion but only $3.4 billion was deducted on tax returns because of the limitation. This limitation affected both stock and mutual companies; mutuals paid $4.6 billion in policyholders dividends but were allowed deductions totalling $2.67 billion; similarly, stock companies paid $830 million in policyholders dividends, but were allowed deductions totalling $717 million.

The stock companies had a tentative deduction for the non-par deduction of $248 million in 1976, but were allowed an actual deduction of only $101 million. Again, this was due to the limitation. With respect to the group life (and A&H) deduction for 1976, the tentative deduction was $209 million for stocks with the actual deduction being only $115 million.

In summary, I believe the '59 Act is still functioning on a sound and realistic basis, and it is producing tax revenue in the magnitude one might suspect when one considers the growth in the business, the large increase in assets, and the much higher interest rates recently than in the late fifties. Of course, no tax laws are perfect. Therefore, there may be need to fine-tune several parts of the '59 Act from time-to-time, and to amend it on occasion as new products are developed, such as separate accounts and variable life, where the law does not produce reasonable and fair tax results. Otherwise, I think the basic framework and structure of the '59 Act has been sound and will remain with us for at least the near future and probably even longer.

MR. ROBERT D. GRIFFITH: We have had in the past year or year and a half a number of court decisions affecting the interpretation of the Life Insurance Company Tax Act of 1959. After almost 20 years of taxation under that law we are finally getting some areas cleared up, for example loading. However, there still remain a number of areas such as escrow funds or advance interest that are as unsettled as ever, and there are many new areas of controversy developing in the field examinations. Some of these new areas promise to be as difficult to resolve as those issues that are now being disposed of.

However, because we have probably had more significant life insurance tax cases decided in the past year than any comparable period, it seems worthwhile to review some of those decisions and try to identify their significance in terms of specific issues resolved but perhaps more importantly in terms of trends, definitions, and other aspects that may affect our future planning. I have felt for some time that the issues with respect to reserves have been particularly slow in being resolved. Because this is the Society of Actuaries I think that you too are probably interested in the developments in court cases with respect to reserves. Therefore, I will concentrate on the reserve issues of the court cases and only briefly summarize other significant issues.

I think that the Lincoln National Life Insurance is particularly interesting with respect to reserve issues. This is true not only because the decision in Lincoln National is generally favorable to insurance companies but also because the reasoning and findings of the court are particularly noteworthy as they might apply to issues other than those specifically being litigated.

The Lincoln National Case of course, is a Court of Claims case. This means that it is not subject to appeal except in special circumstances to the Supreme Court. It also means that it may not have precedent value except in other Court of Claims cases. Nevertheless, I think it does give us some authority in resolving future reserve issues, it gives us some sound reasoning, and if nothing else may indicate an appropriate body in which to try future issues of this type.

RESERVE FOR SETTLEMENT OPTIONS

One of the interesting reserve issues litigated in the Lincoln National case was with respect to future settlement options. Many policies contain a feature which guarantees the payment of an amount over the life of a beneficiary or in other instances for a fixed period of time. At the time that the contracts in question were issued and the reserve basis was established, it was estimated that the policy proceeds would be sufficient to fund the settlement to the beneficiary under any possible settlement option. However, the reserves established with respect to these contracts were based upon old mortality studies. Current studies of the experience of the insurance industry indicated that individual annuitants were generally living longer than the time predicted in the mortality tables being used. Because of this longer life the insurance company would be obligated to make payments greater than those estimated at the time that the contract was set up.

In 1959 Lincoln took action, because of those studies, to strengthen its reserves. It determined an additional amount to be included in its life insurance reserves, obtained the consent of the Indiana Commissioner of Insurance, and it was established that once approved by the Commissioner, Lincoln could not weaken its reserve. In other words Lincoln took all of the action that was necessary to strengthen its reserve and to determine the approval of the State Insurance Commissioner.

The fact that the longer life of the annuitant beneficiary would be more costly to Lincoln also indicates that the cost of normal life insurance should be less expensive to Lincoln since they could be expected to collect a premium over a longer period of time before the policy matured by death. Although Lincoln acknowledged this fact they took no action to weaken the reserves on the basic life insurance policy or to offset the excess against the additional reserve Lincoln required for the settlement option. It was indicated that this decision was based upon business judgment based upon sound actuarial principals coupled with obvious tax benefits.

The IRS challenged the reserve primarily on the grounds that it was a deficiency reserve and, of course, the Internal Revenue Code specifically disallows deficiency reserves as life insurance reserves. The tendency of the government to attack the reserve as a deficiency reserve is the first item I would like to call your attention to. We have seen a number of reserves, particularly those involved in new concepts such as deferred annuity reserves, split interest reserves, and similar items attacked on the grounds that they constitute deficiency reserves. Therefore, it is interesting to see how the court disposed of the issue of deficiency reserves.

There is some precedent for the interpretation of deficiency reserves contained in the Mutual Benefit case of a few years ago. The court in Lincoln National relied upon and repeated the conclusions contained in Mutual Benefit without adding much new dicta. However, it is significant to repeat the reasoning used in that case, particularly because it is repeated and followed by a new court. That reasoning essentially was based upon the following points:

1. The statutory definition of deficiency reserves is the excess of the present value of future premiums required over the present value of future actual premiums.

2. A deficiency reserve is a technical term to be interpreted within the meaning of the industry.

3. The deficiency reserve based upon the above definition is a mathematical amount determinable at the time the contract is issued and has no relationship to subsequent additional reserves set up with respect to a contract.

Thus, in the situation to which the court was addressing itself, the need for additional reserves developed after the issuance of the contract when it was determined that people were living longer than had been expected at the time the contract was issued. In view of the above arguments the court came to the conclusion that where there could be no future premium collected there could by definition be no deficiency reserve.

This part of the case has several items you should be alert to in controversies and in planning.

1. In any controversy where a deficiency reserve is being asserted by the IRS, you should adhere strictly to the definition of a deficiency reserve.

2. On any single premium policy such as single premium deferred annuities there can be no deficiency reserve.

3. As an industry group you should be very careful not to use the term loosely or to broaden the definition of a deficiency reserve.

An alternative argument was used partially to get around the deficiency reserve argument and perhaps to introduce a new dimension to the problem. The government contended that the settlement proceeds of the life policy became the premium for the settlement of the annuity contract. Thus a deficiency reserve was considered to result from the difference between the present value of the settlement proceeds and the present value of the required reserve on the settlement option contract. This argument was rejected on the grounds that all legal rights under a settlement contract flow from the basic life insurance contract itself.

The fact that the settlement option is not a contract separate and severable from the basic insurance contract also becomes very important in tax planning and in tax controversies. In other areas of insurance taxation, we have frequently seen the government try to fragment a policy. As is pointed out by the court the settlement option derives its rights and duties directly from the original contract. This principal may have application in such areas as experienced rating refunds in which an amount is left on deposit. In some cases, an IRS agent will try to treat it as a series of transactions involving a payment of a dividend, the return of that dividend as a premium by the insured, and a recognition of an increase in reserves for the deduction. This decision would seem to present some argument at least that the change is only an increase in reserves exclusive of any dividend treatment.

The final argument by the government in the Lincoln Case was that the amount should not be allowed as a life insurance reserve because it was a contingency reserve or a voluntary reserve. It was considered such, because additional factors were introduced other than mortality and morbidity factors. The additional factor was, that based upon the experience of the company, only 20% of the policyholders would elect the indicated options. Again relying on the Mutual Benefit Case, the court determined that there was nothing in the code or regulations that indicated a life insurance reserve was limited to only mortality and interest factors. Thus, Lincoln could properly include relevant additional factors based upon its experience in the computation of a life insurance reserve.

This has considerable significance in many specialized reserve areas where the company decides to modify a reserve. However, as we will see in a minute, it is important that any such factor be based upon proper experience to prove their validity.

RESERVE FOR TERM CONVERSIONS

Next lets take a look at a somewhat similar but different type of reserve item litigated in the Lincoln Case, i.e., the reserve for term insurance conversions. Lincoln had many term insurance policies and riders that contained a provision allowing the policyholder to convert the contract to permanent insurance without requiring evidence of insurability. The conversion privilege is an additional policy benefit for which an additional charge is made. The additional charge is based primarily on excess mortality among those exercising the privilege, less the expense saving factor determined by Lincoln. At the time the basic term policy or rider was issued the basic life insurance reserve was believed to be sufficient for all of Lincoln's obligations under the contract. However, in 1963 a study by the Society of Actuaries in which Lincoln participated determined a higher mortality rate among those policyholders exercising the conversion privilege. Therefore, in 1964 Lincoln strengthened its reserves to provide additional reserves for the increased mortality on these contracts.

The reserves Lincoln computed for this purpose were based upon recognized mortality tables and interest rates and took into account policy year, ages, conversion costs and expense savings. The reserve was authorized by the Board of Directors of Lincoln, approved by the State Insurance Commissioner, and pursuant to the rules and regulations of the Insurance Department of the State of Indiana, Lincoln was prohibited from reducing that reserve without the approval of the Indiana Insurance Commission.

The government again challenged this reserve on the basis that it was a deficiency reserve but with slightly different arguments. The government contended that this reserve was not required because of a change in mortality assumptions, but merely because from the experience of the company it was determined that additional amounts were necessary. It then argued that what resulted was a deficiency in the future premiums which would be applied to substandard risks over the future standard premiums provided in the contract.

The court determined that the government's argument was incorrect since in this situation there were truly two contracts involved, that is, the basic insurance contract and the additional contract which the purchaser elects to acquire. The guaranteed insurability option was merely an additional benefit under the basic policy which would provide funds to pay for any additional premium required as a result of the substandard risk when the second contract was issued. As such Lincoln could properly establish a life reserve to provide for that insurance benefit independent of the reserve for the death benefit itself.

The government also argued that the reserve should not have been allowed as a life insurance reserve because Lincoln introduced a factor for the percentage of contracts in which conversion could reasonably be expected. The court determined that expert testimony had indicated Lincoln's introduction of additional factors were reasonable. Consistent with its decision on settlement options the court held that Lincoln was not in error to introduce such nonmortality factors in the computation of the reserve. The reserve for guaranteed insurability options was allowed as a life insurance reserve.

UNION MUTUAL GUARANTEED INSURABILITY OPTIONS

In contrast to the Lincoln National findings with respect to term conversions, the First Circuit Court of Appeals considered whether the guaranteed insurability options of Union Mutual Life Insurance Company should be considered life insurance reserves.

The provisions of the contracts in Union Mutual were essentially the same as in Lincoln National. The reserves Union Mutual used were computed using an assumed rate of interest, a recognized mortality table, and the assumption that 100% of the options would be exercised. The government again attacked the reserve on the basis that a non-mortality factor had been introduced. The assumption that 100% would exercise the privilege was considered an additional factor rather than a failure to specify an accurate percentage. The district court upheld the taxpayer citing the Mutual Benefit Case to the effect that non-mortality factors could be introduced.

The appeals court however, took note of the fact that in Mutual Benefit the non-mortality factors were based upon the experience of the company whereas Union Mutual had made no attempt to determine what its own experience would be or to reflect such actual experience in the determination. The court held that they did not understand how reserves could be computed or estimated on the basis of recognized mortality or morbidity tables unless the dollar obligations that are being undertaken by the company are a part of such computation or estimation.

A second part of the argument by the government was that the reserves were not required by law. The District Court cited the regulations which required that the reserve be required by express statutory provisions or rules and regulations of a state, be reported in the annual statement of the company, and be accepted by the regulatory authorities as held for the fulfillment of the claims of the policyholders. Evidence was presented in the District Court that proved that the amount was reported in the annual statement of the company and expert testimony indicated that the amounts would be required by the examiners of the Insurance Department of the State of Maine.

However, the Appeals Court noted the difference in the interest of the Commissioner of Internal Revenue and the State Insurance Department and said in effect that the term "required in express statutory provisions or by specific rules and regulations of the Insurance Department" must be followed literally. It did not believe that Congress intended to permit State Commissioners to affect taxable income by determining reserve requirements by action subsequent to the time that they were established. Therefore, because the State of Maine did not have specific rules or regulations requiring the reserve in question, the court determined that the reserves were not required by law.

The Lincoln and the Union Mutual cases came to different conclusions with respect to the guaranteed insurability options. However, the differences may be more due to the distinguishable facts between the two companies than to the difference in the courts in which they were tried. In any event, there are some lessons to be learned between the favorable decision in the Lincoln case and the unfavorable decision in the Union Mutual case.

To summarize these points:

1. I would like to re-emphasize the fact that it seems to be clearly established that factors other than straight mortality factors can be used in making your reserve computations. However, in order to be valid, the company should be able to establish by its own experience and perhaps the experience of other companies the need and accuracy of the additional data entered.

2. Secondly, with respect to the reserves required by law the company should do everything that is necessary to establish a "reserve required by law" including the authorization of its board to set up the reserve, the approval of the State Insurance Commissioner at the time that it is set up, and an indication by the State Insurance Commissioner that it can not be reduced without further permission.

Furthermore, the fact that the reserve must be required by specific rule or regulation of the state seems to be increasingly significant. In the property liability field, we have had much controversy with respect to salvage and subrogation. Because of a court decision holding that such amounts may be excluded when not permitted by specific rule or regulation of a state the government has been requiring that a state have specific written rules or regulations before the indicated treatment is allowed. They have been very consistent in not recognizing policy decisions or informal documentation that is short of a specific rule or regulation.

We may see an expansion of this concept to the life insurance reserves area in meeting the "required by law" test.

ESTIMATED RESERVES

Another court case decided in the year 1978 which has some interesting implications with respect to life insurance reserves is the case of Central National Life Insurance Company of Omaha vs. the U. S. This case was tried in the U. S. Court of Claims and involves a determination of whether the company qualified for taxation as a life insurance company.

The principal items in question were the reserves with respect to individual and group credit life insurance policies. These policies specified that the reserves would be computed according to specific recognized mortality tables and interest rates. However, rather than compute the credit life reserves in accordance with the specified tables, Central National used the gross unearned premium method of computing the reserves. The method used was accepted by the State Insurance Department. Evidence showed that the reserves were never less than those which would have been computed on the basis of a mortality table.

The government contended that these reserves did not qualify as life insurance reserves because of the manner in which they were computed. They did not constitute reserves computed on the basis of recognized mortality or morbidity tables.

Although Central National used several arguments, the important one was that the amounts should qualify as life insurance reserves because they were estimated on a tabular basis. They also argued that, because the reserve actually held on the books and reported in the annual statement exceeded the amount that would have been computed on the basis of a recognized method, the taxpayer should at a minimum be allowed to treat a recomputation as an allowable reserve.

The interesting tax implication revolves around the argument that under section 801 of the code, a life insurance reserve must be "computed or estimated" on the basis of a recognized mortality or morbidity table. In past years there have been many arguments with the Internal Revenue Service over the meaning of the terms "computed or estimated". The Internal Revenue Service has always contended that the 2 terms are synonomous and merely acknowledge that any reserve calculation is of necessity an estimate. However, in this decision the court held that each term was purposely included and each had a separate meaning. The court indicated that "computed" signifies a more precise method and a more exact mathematical calculation, whereas estimated permits greater flexibility in making reasonable approximations of the result.

The case contains a substantial amount of detail discussion on how premiums are calculated using mortality and morbidity factors and interest rates. The court concluded, however, that although tabular factors underly a gross unearned premium reserve, it does not follow that the reserve is estimated on the basis of the underlying mortality and morbidity factors. Thus we have a continued recognition of the fact that an unearned premium reserve in and of itself would not be recognized as a life insurance reserve.

In its alternative argument, the taxpayer asserted that the unearned premium method was merely a means of approximating the reserves that would have been calculated on an appropriate table. They introduced substantial testimony and documentation to show the comparison of an actual calculation under the specified mortality and morbidity tables vs the amount computed under the unearned premium method. In all cases the unearned premium method was greater than the amount calculated under the authorized method. However, the court determined that the amounts of difference were reasonable and allowed the amounts to be included as life insurance reserves in the computation of the company's life insurance status.

Thus, we have authority in the Court of Claims at least, for recalculating reserves on an exact basis and having them allowed when an approximation has been used. I believe this argument may have substantial merit in the future. However, it is subject to the substantial caution that the case involved only the qualification issue, and therefore the Court may not have considered other aspects of the reserve that might be considered in other types of issues. Nevertheless, it is comforting to have a case of this type decided in favor of the taxpayer.

OTHER ISSUES

There are a number of other court cases and other issues in the cases I have discussed that have had significance during the year. I will not try to discuss those in detail but in the next few minutes will try to briefly summarize the basic issues covered. Then in the discussion period the panel will be glad to discuss them in more detail.

1. In the Lincoln National case, there were three other items which have some significance to other companies. With respect to the deduction a company may claim for non-participating contracts, the court held that Lincoln could not treat amounts received under reinsurance contracts

as being non-participating contracts. The only amounts qualifying for a deduction in such a situation were amounts arising out of the basic policy which is distinguishable from the reinsurance contract. Also with respect to reinsurance contracts, the court held that the company could deduct dividend reimbursements to the reinsuring company only on a cash paid basis and could not deduct an accrual for such dividends. On the other hand, with respect to retrospective rating credits, the court held that the company could deduct an amount accrued at the end of the year that would be payable in the succeeding calendar year. This decision is consistent with a similar case for property liability companies a few years ago but had been regularly contested in the life insurance industry.

2. In the Union Mutual Life Insurance Company case, the court again recognized the policy that an insurance company must include unearned interest income on policy loans in income at the time it is charged to the policyholder. This issue has been previously litigated and the taxpayer continues to lose on that particular point. Also in Union Mutual, the court considered the issue of whether reserves for unearned premiums on non-cancellable accident and health policies could be included in life insurance reserves. Because the company computed the reserve on a midterminal basis and added the unearned premium to its total life reserve, the company believed it was entitled to the full deduction. However, in a lengthy discussion the court determined that accident and health insurance was distinguishable from life insurance, because premiums are refundable whereas in a life contract a premium is not refundable. Thus, the unearned premium reserve is a casualty insurance concept and must be recognized separately from the additional reserve for accident and health insurance.

3. The Southwestern Life Insurance Company case in the U.S. Court of Appeals had a number of issues with what I consider to be improper results. As such I would prefer not to discuss them. However, because some of the issues are important I will mention them briefly. The court required Southwestern Life Insurance Company to continue recognizing agents balances as assets on the basis that no effort had been made to collect them and thus the balances could not be charged off. The Southwestern case required the company to include a number of other items in assets including mortgage escrow funds, amounts held by the taxpayer for employees, unearned interest on policy loans, participation interest in reinsurance pools, and the unamortized cost of insurance policies in force from another company. Only withheld federal income taxes which are held in trust were considered not to be assets. The Appeals Court reversed the District Court and held that the company was not entitled to any phase one deduction for excess interest on pension plans. In an item that has some significant tax implications the court held that assumption reinsurance transactions result in a capital asset whereby the cost of policies required must be amortized over the average life of those policies.

CONCLUSION

I think the current cases have done a great deal to help us in dealing with IRS controversies. Perhaps most important of all, they have shown that the judges can consider the complicated issues of insurance accounting and arrive at reasonable conclusions. This had been doubtful in some earlier cases.

The recent cases have re-emphasized the need for careful planning on the part of the insurance company taxpayers. The successful taxpayers are the ones that have carefully planned their actions, have fully documented the need for and the appropriateness of their action, and have carefully presented their tax cases.

Finally, the recent cases have provided a significant amount of new technical material which can form the basis for future tax planning and for sustaining past actions.

MR. VICTOR J. MODUGNO: I was wondering if these cases go to the Supreme Court.

MR. GRIFFITH: The Court of Claims cases can go to the Supreme Court but would only be accepted if there is a controversy of some type. In general, these cases are usually not accepted. This also applies to Appeals Court cases.

MR. CARL B. WRIGHT: Union Mutual Life and Southwestern Life applied for certiorari on the excess interest issue and it was denied. Both companies won at the District Court level but came out losers at the Appeals Court level. In regard to the guaranteed insurability issue, we set up that reserve when the product was first issued. I would defy anyone to know what the election rate was going to be, but maybe on a situation like that you learn not to set up those reserves or claim them until this experience can be entered which may change the computations.

MR. GRIFFITH: As we said in the other cases, they were challenging them because they did introduce a factor and in essence you did not.

MR. BEN H. MITCHELL: In the new NAIC amendments to the valuation laws there are some significant changes in regard to deficiency reserves. In effect, they end up being pulled back into a regular reserve and they lose the designations to the deficiency reserve. Do you have any idea how the Internal Revenue Service will respond to that, pulling what used to be a deficiency reserve back into a regular life reserve?

MR. GRIFFITH: I don't really have any idea how they will respond to it. It is my impression that when you start playing around with these definitions, then many questions can be raised as to other amounts. The Internal Revenue Code contains its own definition of deficiency reserves which they would probably have to adhere to for the moment, but as soon as you start moving something else out of that category, there has to be some question.

MR. ALBERT P. BURGESS: You have given us some hope through your comments concerning these court cases and how they have been decided. You have made statements to the effect that it would be acceptable to introduce factors other than mortality and interest in the calculation of these reserves if sound data is available. We are currently undergoing an audit and are being challenged with the so called industry audit issues, things like the guaranteed insurability and decreasing term reserve issues, and we are led to believe that as conclusive as these court cases have been that they don't apply to us. Is our only recourse to wait until someone has the case heard by the Supreme Court?

MR. GRIFFITH: I would say that you are at least partially correct. I possibly presented too optimistic a view because there is continuing to be much controversy in these areas. The Internal Revenue Service itself has not acquiesced to these issues and they will continue to challenge them in the field. What I am suggesting is that if a case has been decided favorably in a particular court, to the extent that the facts of that case could be matched, you could go to that same court and be somewhat optimistic of obtaining the same result. However, I feel that litigation will be involved for a long time. It is not a settled issue just because one court decision has been favorable.

MR. ROBERT C. TOOKEY: On the matter of assumption reinsurance versus coinsurance, the issue tax wise had been settled by regulation or by precedent some time ago. The assumption reinsurance, in which everything was literally purchased and assumed, would require an amortization period on the premium whereas coinsurance was simply transacted between companies. We have now received some news and static from the fringes of the battlefront and I am trying to stay current.

MR. GRIFFITH: With regard to the assumption reinsurance, the regulations were issued some years ago that define it and I am currently aware of a number of situations in which the Internal Revenue Service is applying the same principles to a coinsurance contract. In other words, making you capitalize the cost and amortize it over a period of time. There is some possibility that they may be able to sustain that fact when you get down to the merits of it.

MR. HARMAN: To my knowledge this issue is coming up and it is a question that assumption reinsurance was originally viewed as a 100% transfer and with coinsurance there was sharing of the risk and then some people devised some in between arrangements. The Internal Revenue Service is trying to define on these in between cases whether it is coinsurance, in which the full deduction can be taken, or if it is closer to being assumption reinsurance, in which there should be some capitalization and amortization of whatever is paid. The type of agreement you are talking about is probably an in between case and they are not sure how to apply the two rules on each end to these type of cases. They seem to be tending toward a capitalization theory because most people would rather have a full current deduction than a spread.

MR. GARY CORBETT: In regard to the same reinsurance issue, I think what we are seeing is where the line is being drawn on a type of retrospective reinsurance arrangement where it is reaching back to the business previously written as opposed to going forward. In our discussions with the Internal Revenue Service they have confirmed one other case that all contracts written at the end of the year can extend back to policies written during that year. It applies back to prior years issues in that the expense allowance being paid by the receiving company is going to have to be capitalized and amortized.

In regard to how the IRS acquiesces to some of these court decisions, I can often understand them not acquiescing to even the Appeals Court decisions but it becomes very frustrating when they won't acquiesce to the Supreme Court decisions and be essentially told it doesn't matter what statutory accounting required.

MR. JULIAN J. DUKACZ: There was a recent ruling which held that annuity contracts without permanent guarantees would be entitled to a current earnings rate deduction and in so holding some of the rulings concluded that the annuity contracts in question were not in fact annuity contracts. Is anyone concerned about this conclusion or is there any need to be concerned? I see two reasons for concern, the possible implication to the policyholder and possibly harming companies who sell only this type of business.

MR. HARMAN: Let me say that I share your concern. The movement to get an interest paid deduction was made basically in the qualified pension area because there is generally a trust that is a tax exempt organization. So, if you set up a contract that is not a life insurance or annuity contract, any interest credited under it is credited to the trust. Since the trust is a tax exempt organization there is no current income. If you have a tax deferred annuity in the nontax qualified area and take out the guarantees which perhaps makes it a nonannuity contract, then you have a very serious problem to find a code section or a regulation of the Internal Revenue Service which says that interest credited by the life company and taken as an interest paid deduction is not current income. In other words, deferred treatment is placed in serious question and some companies have been concerned enough in this area that they take out the guarantees or reduce them down to the point of only a several year guarantee. The Internal Revenue Service seems to be taking the position that this is not a permanent rate guarantee, therefore it is not an annuity contract. It is a fine line to walk to say that it is interest paid and then go to the individual tax provisions and say that it is still an annuity contract with tax deferral.