

**RECORD OF SOCIETY OF ACTUARIES
1983 VOL. 9 NO. 1**

STRATEGIC TAX PLANNING

Moderator: PETER W. PLUMLEY. Panelists: QUINCY S. ABBOT, DOUGLAS N. HERTZ. Recorder: FRANK S. DERBAK

- . The impact of U.S. taxation and regulations on company organization and operating strategies.
- . The importance of tax planning with respect to all company actions.

MR. PETER W. PLUMLEY: It is my impression that after the end of this year nobody really knows what is going to happen in the tax area. I am very interested in hearing your views on how to plan strategically under these conditions. Our two panelists are Quincy Abbot and Doug Hertz. Quincy represents the stock viewpoint and Doug represents the mutual viewpoint, although today their presentations are not going to be quite so narrow-minded as simply stock and mutual viewpoints. Quincy is vice president for taxes with CIGNA Corporation. He is responsible for tax planning and compliance for approximately 400 corporations, which include life insurance companies, casualty insurance companies, mutual funds and real estate companies. Doug Hertz is second vice president and actuary of Massachusetts Mutual Life Insurance Company. He also has considerable background knowledge in the tax area.

MR. QUINCY S. ABBOT: Thank you Peter. In this era when everybody is talking about unisex, I am glad that you brought us together so we are not talking about stock and mutual but unicompny. The tax person's world is generally divided into two parts--tax compliance and tax planning. Tax compliance involves the interpretation and recording of events in tax returns after the events have occurred. In itself, tax compliance may involve much that looks like tax planning--research of tax laws, recasting or reinterpretation of transactions that have occurred and perhaps even some retroactive operational tax planning.

Today, however, our principal concern is not with the planning that may occur as part of the tax compliance process, but with true tax planning that involves the shaping of future results. At CIGNA Corporation, tax planning comes in three varieties:

Transactional Tax Planning

Transactional tax planning involves review of significant proposed but unconsummated transactions so as to assure the best after-tax result. Note that our focus is on increasing after-tax results. This is quite different from focusing on reducing taxes. For example, many life insurers could eliminate taxes by investing in state and municipal bonds, but after-tax income would go down significantly. Transactions that are routinely reviewed include:

- a. Non-standard investments, for example, real estate, oil and gas ventures, citrus groves, timber, and equity participations.

- b. Insurance products, such as pricing assumptions, contract language, proposed accounting entries including verifying the generation of audit trails, reserve formulas, and reserve computations.
- c. Corporate activities, such as acquisitions, divestitures, debt or equity financing, incorporation of foreign branches, financing of foreign subsidiaries, reinsurance, and expense allocations.

Operational Tax Planning

Operational tax planning involves the monitoring of certain key operational results and recommending actions such that favorable tax attributes are fully utilized and unfavorable tax attributes are avoided. Our operational tax planning monitors such items as:

- a. Capital gains and losses. Capital losses should only expire unutilized if there is a good reason. Capital gains are a resource that can make the realization of capital losses attractive, if surplus allows.
- b. Ordinary gains and losses. It is axiomatic that ordinary losses should be utilized at the earliest possible time. Again, they represent a resource that can be utilized to make the realization of ordinary income or capital gains more attractive.
- c. Foreign tax credits and foreign source income. Foreign source income as well as U.S. tax must be maintained at a sufficient level to absorb all foreign tax credits. The timing of dividend distributions from foreign subsidiaries and of investment income from foreign sources with a small tax rate can be keys here.
- d. Investment tax credits. These should not expire unused.
- e. Monitoring the relationship between taxable investment income and gain from operations. A gain from operations after all special deferrals that exactly equals taxable investment income makes maximum use of the special deferrals. Allowing special deferrals to expire unutilized is undesirable.

Strategic Tax Planning

Strategic tax planning involves significant changes in the environment within which a company operates. While transactional tax planning and operational tax planning operate within the boundaries of existing law, existing corporate structure, existing businesses and existing operational processes, strategic tax planning removes the boundaries. It asks what after-tax results would I like, what impediments are there to attaining this desired result, and how can those impediments be removed?

It is instructive to look at some of the strategic tax planning accomplished within the insurance industry over the past 25 years.

1. Using surplus to hold a subsidiary of a Phase I or Phase II positive company may result in a higher tax because of the marginal tax on assets and on dividends received. This was especially apparent in the

instance of an acquisition of a subsidiary by exchange of stock which brought about a significant increase in both surplus and tax. An impediment to the distribution of such a subsidiary to shareholders was the triggering of a Phase III tax on the distribution. The result was a series of amendments to Section 815 in the early 1960's that allowed first, certain newly acquired subsidiaries and then certain subsidiaries acquired before 1958 to be distributed to shareholders without incurring a Phase III tax. The spun-off subsidiaries were held in trusts for benefit of shareholders (called the "stapled stock" approach) until the 100 percent dividends received deduction to a holding company became available. I have often wondered why mutual companies did not invent a similar approach to resolve their subsidiary problem.

2. Prior to 1964, if a life insurance company were owned by a holding company, 15 percent of the dividends received by the holding company would be taxable to the holding company. Consolidated returns could not be filed between the holding company and any life insurance company subsidiaries so as to eliminate the dividends from income. This impediment was solved by changing the law to allow a 100 percent deduction for dividends received from wholly owned life insurance companies and other subsidiaries.
3. The property and casualty industry has traditionally gone through cycles of underwriting gains and underwriting losses. The traditional operational tax planning approach is to hold investments in tax-exempt bonds during the underwriting gain part of the cycle and in taxable bonds during the underwriting loss part of the cycle. While this operational tax planning technique did utilize most operating losses, it did not utilize them in the most efficient manner to produce the highest after-tax income. Strategic approaches to this tax planning dilemma have included:
 - a. Acquiring or being acquired by a company with a large amount of taxable income so as to utilize fully and currently underwriting losses while still maintaining the after-tax efficiency of investing in tax-exempt bonds.
 - b. Change the law so as to allow the property and casualty losses to be utilized against life insurance company taxable income. The desirability and technical feasibility of such a change in the law was first put forth as a strategic tax planning idea in 1970. After six years of effort, it was passed into law in 1976 with an effective date of 1981 and a few other semi-crippling amendments such as allowing no loss offset during the first five years that a non-life company was affiliated with a life company and limiting the loss offset to only 35 percent thereafter. An unfulfilled desire of the strategic tax planner is to remove the 5-year rule and move the 35 percent to 100 percent so as to accelerate the time for taking the offset deductions. This example illustrates the long time frame that must be adopted by the strategic tax planner.
4. Continually examine the corporate structure. Corporations may be placed in the structure so as to permit or to forbid consolidation with

other corporations or they may be formed to realize state tax reductions. Certain lines of business may be written more efficiently in a separate corporation. For example, loss reserves on accident and health business may be invested in tax-exempt bonds and receive the full benefit of the tax exclusion feature if the accident and health business is written in a property and casualty insurance company rather than a life insurance company.

The purpose of strategic tax planning is ultimately to enhance after-tax business results. A side effect frequently is disruption and change in the business operations. If the costs of implementing the the strategic tax planning option are more than a small percentage of the strategic tax planning savings, proceed with caution. The business disruption may cause more losses than the tax savings. All tax planning must enhance the results of business efforts. It must not create a weight around the businessman's neck that will destroy the business operations while saving taxes. Strategic tax planning, if well done, can significantly enhance operating income results. If poorly done, it can have the opposite results.

MR. DOUGLAS N. HERTZ: It is a pleasure to be here today with Peter and Quincy. I accepted the invitation, not because I feel I am uniquely qualified on the subject, but rather out of the hope that if I were on the same program, some of their magic might rub off on me.

The sad fact is mutual companies generally have a long tradition of doing little or no tax planning, including strategic tax planning. Only recently has this pattern of neglect begun to change.

Historically, everyone at the typical mutual company treated taxes as inevitable, dull, and probably unimportant. The company was a hopeless Phase I taxpayer. This had an influence on investments and on product pricing which was basically managed fairly well, but the environment that created the situation was not questioned. There were acknowledged problems such as in the early 1970's when there arose a background of muttering about the Menge deduction sometime turning down. Also, some companies felt the pension deduction was not working as well as it should. But little was done to address these issues. In fact, neglect of taxes was so pervasive that many mutuals didn't even have a Section 818(c) election in place until sometime in the mid to late 1970's. Subsidiaries didn't exist, or if they did, lay idle. Tax planning focused heavily on such matters as allocation of expense to investments and qualifying various miscellaneous reserves as life insurance reserves. Probably the areas we managed best were investments, where marginal rate calculations put a few companies into tax exempt investments but kept most others out, and the allocation of taxes for product pricing work.

The reasons for this quiescent attitude are not clear. Perhaps sometime long ago the level of tax was so low that it simply didn't matter much. Perhaps it was felt that nothing meaningful could be done about it.

Late in the 1970's, things started to change. Some companies found the pension reserve deduction in Phase I was becoming inadequate due to ordinary policy loans. Others discovered the Phase I joys of combining high

yield interest paid business with pension reserve business and did enough of the business with this so-called "double dip" effect to actually alter the shape of their company. This was, in a sense, strategic product tax planning.

A notable strategic tax planning move was the campaign initiated by the Northwestern Mutual to update its inforce individual contracts to a four percent valuation interest basis. This might be the most public tax planning move ever in our business--the rewriting of potentially over a million contracts--largely for the purpose of obtaining a more favorable reserve deduction. The payoff on that campaign continues today, as a side effect was to reduce policyholder dividends which are now fractionally deductible. Other companies have followed along this same path despite a more difficult ruling stance at the Internal Revenue Service (IRS). We can credit this as an imaginative pioneering tax planning effort.

Finally, the late 1970's saw the arrival of modified coinsurance with a Section 820 election as a tax planning device. This had a dramatic effect in the mutual side of the industry because it cut taxes and woke up everyone to the fact that we had tax problems and that something could in fact be done about those problems.

Present circumstances dictate a radical shift from our prior practice of neglect. Taxes are acknowledged as a major product pricing factor--the largest single expense category at many companies--and must be managed for competitive survival. New products with uncertain tax status under an obsolete law are becoming established in the market. The near term shows only uncertainty in the tax area. Like it or not, we are all involved in strategic tax planning, even if it is just on a "follow the leader" or contingency basis.

One area where change is evident at mutual companies is in the use of subsidiaries. For a variety of reasons, stock organizations have always used subsidiary structures. Mutuals in the past few years have started showing considerable interest. Surely taxes have been a major factor in this. Some of these subsidiaries are belated responses to old problems: the structure of the 1959 act encourages mutuals to place Group Life and Health business in a casualty subsidiary; pension business is better off split out in a subsidiary for some companies. Today, subsidiaries of mutuals are often set up to market new products which may work "tax magic." For many companies, these subsidiaries are viewed as defensive measures--developed to maintain flexibility in an uncertain world.

This movement into subsidiary activity will itself create new needs for tax planning. One obvious example is in the decision whether or not to elect consolidation. This creates an opportunity to make a possibly irrevocable election in a game for which the rules have been "in process of drafting" for over a decade. For Peter and Quincy, such decisions are old-hat. Mutual company people must now suffer the nervousness of novices.

The most important area for strategic tax work at present is legislative. Our present stopgap legislation expires at year end.

We hear ominous sounds from Washington regarding how our industry and its clients should be taxed. Our industry badly needs the certainty of permanent tax law so that we can all get on with our business. Because of the present legislative uncertainty, the key word for the near future would seem to be flexibility. We must prepare ourselves not only to influence the form of the law, but also to adapt to whatever comes. This involves operating under considerable uncertainty and preparing on a contingency basis to do things we may not much wish to do. From my viewpoint, it is exciting but difficult to give advice in an atmosphere in which "what is life insurance" is truly an open question.

MR. JAMES R. THOMPSON: Mr. Hertz mentioned that mutuals are using subsidiaries for new products. Could you give me specific examples?

MR. HERTZ: A number of mutual companies are using subsidiaries to market Universal Life, Variable Life, indeterminant premium products--products essentially on which the question of policyholder dividends is a live issue. At a mutual company, whether any one product has a dividend or not is irrelevant. Under the 1959 act, a mutual company is hopelessly a Phase I taxpayer. If you are going to write non-par business, you want it written in a subsidiary where it can have the tax benefits associated with that kind of business.

MR. ABBOT: Doug, I might challenge whether any company is hopelessly a Phase I taxpayer if you really are doing strategic tax planning. At one point I thought we were hopelessly a Phase I taxpayer, now we are hopelessly a Phase II positive taxpayer because of the strategic tax planning project.

MR. DANIEL J. KEATING: Do you believe there will be a long-term tax law passed before the present stopgap legislation expires? What are the prospects that the current stopgap law will be continued indefinitely?

MR. ABBOT: When you look at the agenda that the Treasury, Senator Dole, and Congressman Stark have laid out starting with a reexamination of inside buildup and you see that the industry is unlikely to agree on a package in the near future, very likely there will be another stopgap tax law enacted before 1983 expires. Since 1984 is an election year, it is unlikely to be the year in which substitute tax legislation is undertaken. That takes you into 1985 with a new Congress, maybe a new President, and a new era in which to work at it. My best guess now would be 1985 for a permanent law.

Doug, do you have a better crystal ball?

MR. HERTZ: No, I do not. I agree with your timetable.

MR. PLUMLEY: I see turmoil going on in the whole financial services industry, with the life insurance, banking, and mutual fund industries stepping in each other's turf. The "permanent" legislation that will emerge two to three years down the road is very apt to bring the life insurance industry closer to other financial intermediaries in the area of taxation. I wonder if Quincy or Doug have any comments on that.

MR. ABBOT: A representative of the Treasury has spoken about a "level playing field" across all financial institutions and so have some persons on the Congressional staff. Right now we have probably an "uneven playing field" to our advantage since the earnings of the insurance companies that are devoted to paying insurance costs are not taxable to policyholders.

MR. RALPH H. GOEBEL: We have an irreplaceable life type product that on the surface is a straight ordinary life policy. You can also look at it as a type of Universal Life product where the fixed premium builds up at a relatively high interest rate such as ten percent. Charges are deducted for mortality. We are wrestling with how to reserve it and how to handle it for tax purposes. Our present view is to consider the excess interest over that guaranteed as a dividend which is recycled for more premium. We hold two reserves: a CRVM reserve based on the 1958 CSO at four percent and another for the cash value on surrender which is the difference between the fund accumulation at the ten percent rate and the fund accumulation at the guaranteed rate. For tax purposes we add \$19.00 a thousand to the CRVM reserve. Does anybody have any thoughts on these procedures?

MR. HERTZ: It sounds similar to a traditional participating straight life contract with a dividend accumulation fund. But I gather that the interest earned on the excess interest fund is not currently taxable to your policyholder. Are you sheltering that in the contract?

MR. GOEBEL: We don't think that it is taxable to the policyholder.

MR. ABBOT: I would leave the opinion up to your tax lawyer.

MR. THOMPSON: Mr. Abbot, please elaborate on or give an example of the way expense allocation would fit into the transactional type of tax planning.

MR. ABBOT: If you are in a company whose tax base in part is on taxable investment income, then obviously you want to scrutinize your expense allocations and allocate the maximum amount to investment. For example, Liberty National's court case. They had an incentive plan determined as a percentage of profits and then allocated to individuals in proportion to salaries. The natural way to allocate that would be in proportion to salaries. You might end up with five or ten percent allocated to the investment department. But if you only have that expense because of the investment profit, and let us say all of your profit was taxable investment income for the year, maybe you can allocate all of it to investments. As a matter of fact, they made that stick in the court case.

Also, if you have a multi-corporate organization of life insurance companies and non-life insurance companies, both domestic and foreign, there is some point at which allocating expenses from one entity to another entity produces a higher marginal tax deduction.

MR. THOMPSON: The 1980 Valuation law is being passed in many states. What impact will this have on strategic tax planning?

MR. HERTZ: A number of companies are writing indeterminate premium contracts to avoid holding a high level of deficiency reserves. The disagreement about whether the excess of maximum premium over actual premium

charged should be considered a policyholder dividend will be eased by the new valuation standard. You will not have to guarantee levels of premium that you sincerely have no desire ever to charge.

MR. PLUMLEY: Deficiency reserves seems to me like a good example of poor strategic tax planning back in the 1950's. The industry was given a choice when the 1959 act was being developed of either excluding or including deficiency reserves as life insurance reserves. The industry chose to exclude them because they were expected to run off and excluding them would reduce the Phase II tax that would be paid primarily by the stock companies. I think if the industry had done a better job of strategic tax planning, it might have foreseen that deficiency reserves would not disappear in a few years but there would be further deficiency reserves as mortality improved and premiums came down. Unfortunately the industry did not do this. As a result, we have had a reserve excluded which would have been much better included.

MR. DAVID W. COOK: One of the features of the new valuation law has to do with strengthening the reserves on guaranteed interest contracts and other types of funds. The IRS has published a ruling that characterizes this excess as a deficiency reserve which can not be considered as a reserve for tax purposes. I do not think that is really a deficiency reserve because it does not have anything to do with present values of future premiums. I wonder if the ruling will be upheld?

MR. ABBOT: This is not a matter of the IRS but of the Congress as part of TEFRA (Tax Equity And Fiscal Responsibility Act of 1982). The Treasury representative who insisted on this provision believed that it was all right to deduct the interest when the interest accrued, but to set up the reserve would be deducting the interest before the interest accrued which should not be allowed. I doubt that the provision will be removed from the law.

Peter, you raised one question in your introduction about how to set premiums and establish positions under the degree of uncertainty that we have in the tax law today. We know the tax formula for this year but are not sure what it will be in future years. This is a classic case of decision making under uncertainty. There are many ways of approaching it. The only way I am satisfied with is looking at what happens if current law continues and what happens if the worst possible thing happens. You then hand the range of possibilities to management and ask them how much risk they want to take. There is no real answer that I have found.

MR. PLUMLEY: I wonder if this uncertainty will shift the emphasis away from tax-oriented types of products and more towards the basics of life insurance?

MR. ABBOT: Entirely possible.

MR. PLUMLEY: That would be a healthy thing.