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UNITED STATES LIFE INSURANCE TAX LAW

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- o Overview of tax changes
- o Company impact (including reserve issues)
  - Stock and mutual
  - Large, medium, and small
  - United States and Canadian
- o Product impact (individual life and health, group life and health, annuities, and so on)
- o Reinsurance

MR. JULIAN J. DUKACZ: My remarks will cover: (1) company effects of the new tax law, (2) tax reserve calculation options, (3) fresh start rules and strategies and small company election to forego, and (4) special rules for foreign life insurance companies.

The new tax law has had or can be expected to have a wide range of effects on companies including:

1. Increased efforts by companies to influence the National Association of Insurance Commissioners (NAIC) and state valuation standards such as:
  - a. surrender charges in the commissioners annuity reserve valuation method (CARVM);
  - b. prefunding cash value deficiencies in the commissioners reserve valuation method (CRVM);
  - c. more conservative rates and tables, especially for annuities;

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## PANEL DISCUSSION

- d. conflicting stock and mutual companies' motives: stocks preferring to avoid valuation strain, and mutuals preferring to hide surplus to reduce their add-on problem;
2. Implementation of update programs to minimize the "unavoidable" excess of statement over tax reserves;
3. Decreased emphasis in dividends and tax exempt interest which are less favorable due to a more adverse prorating formula and lower tax rates;
4. Decreased emphasis in tax shelters and reduced advantage of capital gain over income treatment;
5. Mutuals possibly expected to restructure their investment portfolios to reduce their mandatory securities valuation reserve (MSVR);
6. Greater investment in tax-deductible surplus strain (valuation or expense) especially by mutuals;
7. More company tax driven product designs, e.g., cash values close to statutory reserves, more risk passed to policyholders to reduce surplus levels, designing contracts to avoid deficiency reserves;
8. Review and revision downward of reserve and surplus philosophies and levels, again especially by mutuals because of the add-on;
9. Growing suspicion about quality of data used to support addback concept; growing frustration with socialization effect especially where the add-on reduces the dividend deduction by imputed income rather than part of real return; erosion in earnings rates; lower profit margins; big transactions, legitimate or manipulative, to affect differential earnings rates; possibly leading to eventual breakdown of add-on concept;
10. Uncertain pricing under the new law: problems of specials, differential earnings rate, and the allocation of add-on--special and small company deductions--repealed by Administration's recent proposals.

In regard to tax reserve calculation options, the new rules virtually eliminate discretion in setting reserves. However, a few options are available either as explicitly allowed elections or ambiguities in the rules which could be interpreted to some advantage. One option is the tax reserve method. For pre-1943 life or annuity business, there is a choice of state preliminary term methods or CRVM. For newer products with no NAIC standard, there is flexibility: the method must be consistent with prescribed methods. Another option is the prevailing rate of interest. For nonannuity contracts, either the interest rate for the year of issue or that for the preceding year may be used. The prevailing mortality table is a further option. When a table is changed, the old table may be used for up to three years. GA51 contracts use sex distinct tables or a 5-year age setback. GA71 contracts use sex distinct tables or a 6-year age setback. Pre-1948 issues use statutory

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tables. Adjustments may be made for risks not otherwise taken into account. Other assumptions and approximations used in reserve calculations include:

1. the timing of payment of premiums and benefits,
2. grouping/seriatim,
3. policy/calendar year comparisons,
4. mean/interpolated/exact values (choice depends on distribution of issue dates over the year),
5. mean values less deferred premiums/midterminals plus unearned premiums, and
6. group business issues prior to 1984 allowing discretion in determining the issue date in order to determine prescribed tables and methods.

Product design with the increased emphasis on the structure of surrender charges is still another option in tax reserve calculations.

The availability of reserve valuation options is important because it provides some scope for administrative relief as well as some opportunity for tax planning. Planning is important because reserves affect the fresh start, deductions, prorating, and a mutual's add-on.

Fresh start means that the tax reserve for any contract must be recomputed at January 1, 1984, as if the new rules had applied to that contract at issue. Any change in the method of computing tax reserves between 1984 and 1983 required solely by the new law is forgiven. Currently, all tax reserve rules are not entirely clear, so it's quite likely that 1984 opening reserves will be subject to audit and correction in a later year once final tax reserve rules are available.

If 1984 is still an open tax year, the tax return can simply be amended. If, however, 1984 is closed, the correction must be made in a later year according to the normal rules relating to changes in accounting/valuation methods modified to allow for the fresh start. The correction would be made as follows:

1. Calculate the fresh start correction equal to the corrected less the incorrect 1984 opening reserves.
2. Add the fresh start correction to the difference between the incorrect and corrected later year closing reserves.
3. Any balance is income (+) or deduction (-) to be spread over the following ten years.

While this correction procedure may be satisfactory for stocks, it might not be for mutuals because add-on for prior years will not be corrected. This could encourage a mutual to overstate 1984 opening reserves.

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As far as fresh start strategy is concerned, there can be opposing factors to consider. Opening reserves for old business come back into income eventually as business goes off the books; hence, low values are favored. However, for a mutual or a stock subsidiary of a mutual, opening reserves reduce the add-on; hence, high values are favored. Calculations must be made using projected tax reserve runoffs for different blocks of business as well as projections of add-on, tax and discount rates, and tax positions.

A small company (assets not more than \$100,000,000) can elect to forego the fresh start and use statutory reserves for pre-1984 business. Additionally, if taxable income is not more than \$3,000,000, the small company may further elect to use statutory reserves for new issues in the 1984-88 transitional period, revalued however, using a geometric 10-for-1 rule to the prevailing state-assumed interest rate. This election trades administrative savings and tax costs; e.g., larger opening reserves, smaller reserve increases, no cash value floor, for revalued reserves; hence, calculations should be made.

There are special rules for foreign life insurance companies. A foreign company that carries on a life insurance business in the U.S. through a branch operation is taxed on income connected with that business in the same manner as a U.S. company is taxed. However, where a foreign company's U.S. business surplus is less than a required amount, the deficiency is imputed to the company's U.S. business. Such imputed surplus gives rise to imputed income; for a foreign mutual company, it also gives rise to imputed add-on.

The relevant rules operate essentially as follows:

1. Required surplus equals the Secretary's Ratio times the total insurance liabilities.
2. Secretary's Ratio is calculated by the Treasury as the ratio of the excess of assets over total insurance liabilities to total insurance liabilities for U.S. companies using the aggregate preceding-year data for representative U.S. companies.
3. Total insurance liabilities exclude deficiency reserves and include:
  - a. life insurance reserves,
  - b. unearned premiums and unpaid losses,
  - c. discounted amounts not involving contingencies,
  - d. dividend accumulations, other amounts held at interest,
  - e. premiums received in advance, premium deposit funds,
  - f. contingency reserves for group term life and group accident and health contracts for retired lives and/or premium stabilization, and

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- g. other insurance reserves required by law.
4. Total insurance liabilities are determined on the NAIC statement basis, including excess interest reserves but excluding net deferred and uncollected premiums.
5. Surplus held equals assets held less total insurance liabilities.
6. Assets held are all assets held by the foreign company for its U.S. business valued as follows: shares and real property at fair market value. Other assets are at adjusted cost.
7. Imputed surplus equals any excess of required surplus over surplus held.
8. Imputed income equals imputed surplus times current investment yield.
9. Current investment yield equals the ratio of the foreign company's net investment income to its mean assets held as required to be shown in its NAIC statement.
10. A foreign mutual company's equity base is increased by imputed surplus; hence, there is imputed add-on.
11. Calculations are made separately for the general asset account and each segregated asset account. The Secretary's Ratio for a segregated asset account is deemed to be 1 percent. Offsets are permitted amongst surplus excesses and deficiencies for the various accounts.
12. Imputed income is included in gross investment income for purposes of company/policyholder proration.
13. Imputed income and any imputed add-on are included in the tentative life insurance company tax and, hence, affect the special deductions.
14. An increase in tax caused by imputed income may be offset in whole or in part by a reduction in the U.S. nonresident withholding tax on the foreign company's U.S. source income not connected with U.S. business. The latter is reduced by the imputed income. At present, it is uncertain whether a current reduction in the nonresident tax would be allowed where the business is in an operations loss situation. It's possible that only a carryover credit will be allowed.

In recent years, the Secretary's Ratio has been approaching 20 percent. With such a high ratio, required surplus is substantial. In the absence of planning, a foreign company can suffer significant amounts of imputed surplus, imputed income, and if a mutual, imputed add-on. Its imputed tax bill can be very large. Of course, Washington does not accept payment in imputed dollars, probably not even in Canadian

## PANEL DISCUSSION

dollars. Hence, the foreign company must plan if it hopes to remain competitive.

In terms of the tax formula, a large foreign mutual's taxable income exceeds that of a large domestic or foreign stock by 80 percent of the sum of the add-on plus the imputed add-on. It exceeds that of a large domestic mutual by 80 percent of the imputed add-on. A large foreign mutual's industry-wide competitive disadvantage is quite clear. A large foreign stock's taxable income exceeds that of a large domestic stock by 80 percent of imputed income. It exceeds that of a large domestic mutual by 80 percent of the stock's imputed income less 80 percent of the mutual's add-on. This could be positive or negative, so the relative competitive position of foreign stocks vis-à-vis domestic mutuals is not always clear.

A key to developing planning possibilities is the realization that the calculation and application of the Secretary's Ratio are consistent. That is, there is a great deal of socialization implicit in the Secretary's Ratio concept. The question is, what are U.S. companies doing that produces such a high ratio? A review of the NAIC balance sheets of U.S. companies will provide some answers. Once the business practices contributing to a high ratio are identified, the foreign company must consider implementing similar practices. The foreign company that chooses not to do so will pay heavily. Practices to implement are those that achieve the objective--reducing imputed surplus--without adversely affecting other parts of the tax formula, for example, the equity base and the resulting add-on. Determinations of equity base and imputed surplus involve common elements. In seeking strategies to eliminate one or both, the foreign mutual must recognize the interaction between them. For example, increasing statement surplus decreases imputed surplus but increases equity base. Decreasing statement surplus reduces equity base but increases imputed surplus. The real objective is to minimize the sum of statement and imputed surplus. However, even where a reduction in imputed surplus is offset by an increase in statement surplus, there is still a tax benefit since imputed income is reduced.

A simple formula analysis of the sum of statement surplus and imputed surplus expressed in terms of their common components and the relationships and interactions between them provides a useful means of devising, quantifying, and comparing the relative net effectiveness of different operational strategies aimed at reducing the sum of statement and imputed surplus.

In addition to operational strategies, there are structural strategies such as "stockalization," which is demutualization but with a more positive connotation. Stockalization could avoid add-on and imputed add-on but not imputed income. However, it is an extreme solution and one that is likely to be undone by future tax changes. A similar, but less extreme, approach for a foreign company is to incorporate its U.S. branch. A subsidiary of a foreign company is not subject to the Secretary's Ratio. In addition, it's not entirely clear that the add-on concept would reach a U.S. subsidiary of a foreign mutual not having a U.S. branch operation.

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For those who choose not to plan, there may be another approach, a constitutional challenge. In this connection the Congressional Committee Reports suggest that imputation of income may be unconstitutional. Of course, all Congress has to do is change to a reduction of deduction approach (as we have for the add-on), so this is not a long-term solution.

Clearly foreign companies, especially mutuals, can find themselves in a difficult situation under the new law, a situation that might well drive them to tears. However, tears are not enough, and such companies will have to plan if they hope to survive in the U.S. market.

MR. RANDALL P. MIRE: I want to concentrate on the impact of federal income tax on the cost of certain life insurance products from a stock company's point of view--specifically, the federal income taxation of the life company itself as opposed to any policyholders' taxation issues. I will also discuss federal income taxation from a mutual company's point of view. When I refer to the "new tax law," I mean the law passed in 1984, which goes by DEFRA or TRA-84 (Tax Reduction Act of 1984). How have the changes under TRA-84 affected the cost and, therefore, the pricing of individual life insurance? The answer to this depends heavily upon how companies priced their products before TRA-84, and that is quite a complex subject.

I will be discussing a number of different products, specifically the major products that have been sold in the last few years--universal life, excess interest whole life, traditional participating, and annual renewable term. We also are going to look at companies in different tax situations and see how the changes in the tax law have affected the tax costs to these companies and, therefore, the profitability and pricing of these products.

For each one of the plans, we have come up with a standard plan and have run the same plan of insurance with the same assumptions under the old tax law and under the new tax law to see what effect the change in the tax law has had.

We are going to look at the taxation of these products first under the 1959 Tax Act. Everyone seems to use different terminology. Actuaries tend to use Tax Situation A, B, and D, and accountants have their 1-2-3-4 terminology (slide 1). When I refer to Tax Situation A, I mean what many refer to as "Phase 2 Negative" or tax on gain from operations; Tax Situation B is the old "Phase 1," or tax on investment income; and Tax Situation D is the "Phase 2 Positive" with half tax on gain, and half tax on investment income.

Slides 2 and 3 show the standard assumptions we will use for each of the products. In general, we are looking at two ages, 35 and 55, male nonsmoker, \$100,000 policy, and a level 12 percent interest rate. (Most of these products will be interest-sensitive products.) We are using fairly standard lapse rates, a commission scale, and some industry-type expense assumptions.

## Tax Situations

A = Phase 2 Negative = 46% GO

B = Phase 1 = 46% TII

D = Phase 2 Positive = 23% (GO + TII)



## Standard Assumptions

	<u>Age 35</u>	<u>Age 55</u>
Class	Male, Nonsmoker	
Policy Size	\$100,000	
Interest	12%	
Lapse	20% ↘ 5%	15% ↘ 5%
Mortality	Nonmed	Medical

## Standard Assumptions

Commissions -- 100%(1), 5%(2-10), 2%(11 +)

Expense-	<u>Acq.</u>	<u>Maintenance</u>
Per Policy	\$30.00/80.00	\$20.00
Per 1000	1.00	--
%Premium	20%	2%

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For comparison, also look at some mutual companies. Under TRA-84, there is a surplus tax, which can be allocated in a variety of ways. One way is through target surplus whereby a mutual company shoots for a surplus of 7 percent of reserves; that is basically the way we look at the pricing of business for a mutual company. We are assuming that this is the mutual company's pricing objective, and that this is the amount of surplus that the mutual allocates to new business. We calculate the surplus tax on that basis.

The first product is probably the most popular product being sold today--universal life. We have taken a standard front-end loaded universal policy, and the specifications for the design of the product--the loads and the assumptions with respect to earned and credited interest rates are shown in Slide 4.

We look at companies that have designed this universal life product under the 1959 Act and see what the tax was on it. Then, we see what the tax was under interim TEFRA and then under TRA-84. This shows us how the company's profitability has been affected and how a company might have to revise the pricing of universal life depending on its old tax situation. This analysis is considerably complicated because, under TEFRA in particular, there were a number of unresolved tax issues. There was the question of whether excess interest was a dividend; there was the so-called phantom premium issue, whether the difference between guaranteed and current cost of insurance rates was a dividend; whether these policies qualified for the nonparticipating deduction; and for what sort of 818(c) adjustment these policies were eligible. So, whether or not a company is better off in calculating profit under the new tax law, as opposed to TEFRA, can't be answered until a decision is made as to how to price these products under TEFRA. Of course, companies were all over the lot, depending on how they interpreted these various tax issues.

A possible universal life policy under the 1959 Act might have been priced to yield a 5 percent profit margin--not an uncommon goal at that time. Profit margin is a standard pricing technique used by a number of stock life insurance companies whereby you merely divide the present value of profits by the present value of premiums at a discount rate equal to the earned rate in order to come up with the profit margin, or the "average profit" in each premium. This is probably the most common technique used by stock companies in the U.S. to measure profitability.

Included in the cost is the cost of federal income tax. This is a product priced at a 5 percent after-tax basis under the 1959 Act for a company in Tax Situation A (slide 5). What we have done under TEFRA is to calculate a best scenario. We take those unresolved tax issues and if everything goes right, we get a full 818(c), a nonparticipating deduction, and nothing is a dividend. So, under the best case scenario, the profits move up from 5 percent. We are testing ages 35 and 55 and, at age 35, margins move all the way up to 22 percent; at age 55 they also move up quite a bit. We have a second TEFRA best scenario, because there are two different possible nonparticipating deductions. Under best scenario 2, margins are in the 20 percent range at age 35.

## Universal Life Product Description

	<u>35</u>	<u>55</u>
Level Target Premium	\$6.50	\$22.50
First Year Load per 1000	4.15	9.55
Premium Load		8.0%
Guaranteed Interest		4.5%
Current Interest		10.5%
Earned Interest		12.0%

PANEL DISCUSSION

SLIDE 4

## Universal Life Stock Company (A)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	5.0%	5.0%
TEFRA -- Best		
1959 Act	5.0	5.0
\$19 818(c)	13.1	3.4
Nonpar (10% v)	<u>3.6</u>	<u>2.6</u>
	21.7	11.0
TEFRA -- Best		
Nonpar(3% Premium)	<u>1.2</u>	<u>1.2</u>
	19.3	9.6

## PANEL DISCUSSION

Suppose we lose all these issues. In a TEFRA worst scenario, everything is a dividend. There are no 818(c) and no nonparticipating deductions (slide 6). Profits actually go down to about the break-even point.

Under TRA-84 there is a reduction in the effect tax rate, and the profit margin slightly increases to 5.9 percent (slide 7). In this example, under the 1959 Act, we are pricing the way that I believe a significant number of companies were pricing at that time--assuming no 818(c) and no dividends. Of course, these were fairly open issues back under the 1959 Act.

In summary, the profit margin was 5 percent under the 1959 Act at age 35; under TEFRA, it was somewhere between 2 and 22 percent, a fairly wide margin depending on your interpretation of the tax act. Today, the margin is 5.9 percent. So whether you are better or worse off depends on whether you are measuring profits the way you were a couple of years ago or last year and what your interpretation of the appropriate unresolved tax issues is. There are similar results at age 55, only a little less dramatic because of smaller effects of 818(c). Under Treasury 2, the 5.9 percent would drop down to about 5 percent, and we would be back to where we were several years ago.

MR. DENNIS VAN MIEGHEN: Regarding 818(c), some companies are now starting to get in the audit cycle where their universal life products are being examined by the Internal Revenue Service (IRS). It's not uncommon to have a 3-5 year delay on an audit, so there's not a lot of experience to date. But we've had four or five companies that started issuing universal life in late 1979 and 1980 that have been subject to examination. It looks like there are going to be two attacks, and they are not consistent presently. One is that universal life represents term insurance and an annuity rider, and therefore, it's not life insurance. It doesn't qualify for 818(c) because it's not whole life; it's term insurance with an annuity. This is a breakout approach, if you will. Another attack is that, at the agent level, the IRS is allowing 818(c), but it is disallowing the differential between the cash value reserve and that portion of the reserve that is set up in Exhibit 8A in the U.S. annual statement as a CRVM reserve. That varies by company as to whether the company tried to calculate a separate CRVM reserve and then show an excess cash value in Exhibit 8G. But in that approach, the IRS is essentially allowing 818(c) but disallowing the differential between CRVM and cash value saying it's essentially a surplus reserve and not deductible. When we get through with all this, I think the IRS's attack will focus on whether a product with a cash value reserve as the total reserve before segregation has a recognized preliminary term or CRVM reserving method. In any event, I think you will see an attack trying to allow \$0 or \$5 at most, and it will probably end up in court because the dollars involved are very large.

In regard to financial statements for 1984 and how fresh start is computed and deferred income taxes are accounted for, almost every company I dealt with took the position of cushioning their financial statements for deferred income taxes that were to be brought down,

## Universal Life Stock Company (A)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	5.0%	5.0%
TEFRA -- Best	21.7	11.0
TEFRA -- Worst		
1959 Act	5.0	5.0
Interest Div.	(1.9)	(1.9)
COI Div.	<u>(1.4)</u>	<u>(2.9)</u>
	1.7	.2

## Universal Life Stock Company (A)

	Profit Margin	
	<u>35</u>	<u>55</u>
TRA 84		
1959 Act	5.0%	5.0%
36.8% Tax Rate	.9	.9
	<u>5.9</u>	<u>5.9</u>

PANEL DISCUSSION  
SLIDE 7



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and that for purposes of fresh start, universal life either qualified at \$5 or no 818(c) is allowed. If you didn't take that position on your financial statements and lost the issue, in the future you would have a hit to your income. Because of the way we did accounting for fresh start, 818(c) became a permanent difference. If you lost 818(c) and took the permanent benefit in the 1984 financials, then you've got to restore that as a permanent hit in future financial statements. Companies tended toward conservatism in their 1984 financials. I'm not sure they believed that they would lose the 818(c), but the thinking is that it is better to be conservative and not hit future financial earnings per shares.

MR. MIRE: How companies priced is what I'm talking about with respect to the 1959 Act and 818(c). Almost all companies that we worked with, in effect, took 818(c) deductions in their tax return and have gone to great lengths to ensure the 818(c) deduction through varied devices. It is a major issue indeed as to whether or not they will succeed. In actual pricing of their product, very few companies relied on getting that 818(c) deduction; it was more of a windfall they hoped for when pricing.

A company in Tax Situation A was taxed on gain from operations, which is where most of the rapidly growing stock companies, smaller stock companies, and medium-sized stock companies were. Of course, not all stock companies were in that situation.

A company in Tax Situation D, that is, Phase 2 Positive, had half tax on gain, half tax on investment income. This is the way that many mature stock companies were taxed and the way that most home service companies were taxed under the 1959 Act.

The same product with a 5 percent after-tax profit margin for the company in Tax Situation A (slide 8) shows a slight loss, about break-even for a company in this tax situation. Under TEFRA, using our best case scenario for these unresolved issues, things get quite a bit better. Under the worse case scenario, things are still better, just not quite as good as best case TEFRA (slide 9).

Under the new tax act, of course, we come down to the same answer we did before--a leveled playing field (slide 10). No matter which scenario, everybody gets the same answers.

In summary, there is quite good news for companies that were taxed on this basis. They were about break-even under the 1959 Act; under TEFRA results are very vague; and they make a fairly decent return under TRA-84.

Almost all mutuals were in Tax Situation B under the 1959 Act (tax on investment income); under TEFRA, the vast majority moved to the equivalent of A, being taxed on gain from operations. For mutuals, there were problems under the 1959 Act (slide 11). For the same product on which the stock companies were making 5 percent, the mutual company would lose 10 percent. Obviously, that is why the mutuals were not selling universal life; they just could not afford to from a tax

## Universal Life Stock Company (D)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	(.3)%	(.8)%
TEFRA -- Best		
1959 Act	(.3)	(.8)
Geometric Menge	2.6	2.5
\$19 818(c)	<u>9.4</u>	<u>2.5</u>
	11.7	4.2

# Universal Life Stock Company (D)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	(.3)%	(.8)%
TEFRA -- Best	11.7	4.2
TEFRA -- Worst		
1959 Act	(.3)	(.8)
Geometric Menge	<u>2.6</u>	<u>2.5</u>
	2.3	1.7

# Universal Life Stock Company (D)

	Profit Margin	
	<u>35</u>	<u>55</u>
TRA 84		
1959 Act	(.3)%	(.8)%
No Nonpar Special	(2.1)	(1.5)
Tax on GO	7.4	7.3
36.8% Tax Rate	<u>.9</u>	<u>.9</u>
	5.9	5.9

## Universal Life Mutual Company (B → A)

	Profit Margin	
	<u>35</u>	<u>55</u>
	(9.6)%	(9.6)%
1959 Act		
TEFRA -- Best		
1959 Act	(9.6)	(9.6)
Tax on GO	14.6	14.6
\$19 818(c)	<u>13.1</u>	<u>3.4</u>
	18.1	8.4

## PANEL DISCUSSION

point of view. TEFRA obviously was extremely advantageous to the mutuals, under the best scenario changing this 10 percent loss at age 35 to an 18 percent gain. Even under the worse scenario, there was a move from huge losses to about break-even (slide 12). Under the new tax act, we are at 5.9 percent profit margin again. There is a surplus tax, and using the method I outlined earlier will bring us down to a 5.1 percent profit margin (slide 13). But, this surplus tax, in theory, represents a return to policyholders (stockholders); so, we are in about the same situation for stocks and mutuals.

To summarize, there is very good news for the mutuals with respect to universal life--huge losses under the 1959 Act turn into fairly decent returns now. Slide 14 summarizes the whole situation--the 1959 Act, TEFRA best and worse scenarios, and the new tax act.

If you took the same universal life policy and you changed the product to get back to that 5 percent after-tax profit margin either under TEFRA or the new tax act, what would the cash values look like? Depending on your interpretation of the best or worse scenario under TEFRA, there are either significantly better or significantly worse cash values compared to the original product. TRA-84 shows not much change; you get slightly better cash values than the original pricing. There are similar results for both ages 35 and 55 (slides 15 and 16). The next product to consider is excess interest whole life although it comes under a variety of names. It is called interest-sensitive whole life, irreplaceable life, and so on. It is basically a fixed-premium policy with guaranteed minimum cash values with the actual total cash values, in effect, reflecting the total interest return on the product. Taking a standard plan, we want to see how the taxes have changed for this product under the new law compared to the old law.

The standard product we are using is the most popular version of excess interest whole life, which is a high premium version--premium of \$13.82 at age 35 (slide 17). This is a so-called vanishing premium model where if you pay the premiums for a certain number of years, like six or seven, the policy will in effect become paid up. Once again, we are pricing a product to yield 5 percent profit margin after tax. Slide 18 shows an 8.7 percent profit margin because one of the things that drives this product is 818(c). The use of 818(c) on this product, in effect, leads to a huge negative tax is you get a deduction of \$21.00/\$1000 at issue (which, over the life of a policy, gradually "rolls back"). You could price this product at age 35 where you actually would lose money on a pretax basis and make 5 percent after tax. There are actually some situations where you can price this product and afford to give it away because of all the tax savings you would have. So, what we have done is introduce a bit of realism here. You say you have to at least break-even before tax. The tax savings are primarily due to 818(c). Under the TEFRA best scenario, things get even better! Under the worse scenario, profits go down, so whether you were better off under TEFRA depends on your assumptions about the unresolved tax issues (slide 19). Under TRA-84, things aren't as good as shown in slide 20. This product has been hurt pretty badly, moved from fairly profitable to only slightly above break-even and the culprit is no 818(c).

## Universal Life Mutual Company (B → A)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	(9.6)%	(9.6)%
TEFRA -- Best	18.1	8.4
TEFRA -- Worst		
1959 Act	(9.6)	(9.6)
Tax on GO	14.6	14.6
Interest Div.	(2.9)	(2.8)
COI Div.	<u>(2.1)</u>	<u>(4.3)</u>
	.0	(2.1)

## Universal Life Mutual Company (B $\blacktriangleright$ A)

	Profit Margin	
	<u>35</u>	<u>55</u>
TRA 84		
1959 Act	(9.6)%	(9.6)%
Tax on GO	14.6	14.6
36.8% Tax Rate	<u>.9</u>	<u>.9</u>
	5.9	5.9
Surplus Tax	<u>(.8)</u>	<u>(.8)</u>
	5.1	5.1

PANEL DISCUSSION

SLIDE 13



# Universal Life

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act		
Stock (A)	5.0%	5.0%
Stock (D)	(.9)	(1.0)
Mutual (B)	(9.6)	(9.6)
TEFRA (Best / Worst)	18.1	8.4
Stock (A)	21.7 / 1.7	11.0 / 0.2
Stock (D)	11.0 / 1.6	4.0 / 1.5
Mutual (A)	18.1 / (.1)	8.4 / (2.4)
TRA 84		
Stock	5.9	5.9
Mutual	5.1	5.1

# Universal Life

## △ Cash Values for Same Profits

### Age 35

	$CV_{10}$	$CV_{20}$	% of $CV_{20}$
Base Plan	\$58	\$201	100%
TEFRA			
- Stock A Best	69	240	119
- Stock A Worst	52	175	87
TRA 84			
- Stock	60	207	103
- Mutual	59	202	100

**Universal Life**  
**△ Cash Values for Same Profits**  
**Age 55**

	<u>CV<sub>10</sub></u>	<u>CV<sub>20</sub></u>	<u>% of CV<sub>20</sub></u>
Base Plan	\$200	\$651	100%
TEFRA			
- Stock A Best	239	833	128
- Stock A Worst	161	464	71
TRA 84			
- Stock	206	680	104
- Mutual	201	655	101

## Excess Interest Whole Life (EIWL) Product Description

	<u>35</u>	<u>55</u>
Guaranteed Whole Life		
Level Premium (7 year vanish)	\$13.82	\$38.06
Surrender Charge (% premium)	200% ↗ 0% (20 years)	
Premium Load	None	

## EIWL-Stock Company (A)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	8.7%	5.0%
TEFRA -- Best		
1959 Act	8.7	5.0
\$19 818(c)	(.9)	(.3)
Nonpar (10%V)	<u>4.6</u>	<u>3.5</u>
	12.4	8.2

## EIWL-Stock Company (A)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	8.7%	5.0%
TEFRA -- Best	12.4	8.2
TEFRA -- Worst		
1959 Act	8.7	5.0
\$19 818(c)	(.9)	(.3)
Interest Div.	(2.9)	(2.7)
COI Div.	<u>(.8)</u>	<u>(1.8)</u>
	4.1	.2

## EIWL-Stock Company (A)

	Profit Margin	
	<u>35</u>	<u>55</u>
TRA 84		
1959 Act	8.7%	5.0%
\$0 818(c)	(8.7)	(2.7)
36.8% Tax Rate	<u>.0</u>	<u>.3</u>
	.0	2.6

## PANEL DISCUSSION

Excess interest whole life is quite different from universal life; it is very high in profitability under the 1959 Act, hazy but probably quite profitable under TEFRA, and down to very little profit under the new tax act.

These two products basically have been competing head to head. So, how does universal life stack up against excess interest whole life with respect to the federal income tax issue. We have taken universal life and excess interest whole life, more or less like the ones we described earlier, and priced them to yield 10 percent profit margin pretax (the same pretax profit margin for both products) to see how they fare on an after-tax basis. The interest-sensitive whole life product had the advantage under the 1959 Act--universal life at 5.4 percent and excess interest whole life way up at 14 percent primarily due to 818(c). Under TEFRA, there is a wide range, but excess interest whole life still, on average, has an advantage. Now, we get the same profit margin at age 35 under TRA-84. At age 55, the changes are not quite so dramatic. The excess interest whole life didn't have quite as much advantage under earlier tax laws, and, the playing field is level under TRA-84. We are back to the same profits on an after-tax basis.

A large part of the popularity of the excess interest whole life policy was due to two factors. One of them is that it had a tremendous tax advantage up until the passage of TRA-84, and that just disappeared. The second reason is that, as a practical matter, most of these excess interest whole life policies are back-loaded. You could hold substantially lower statutory reserves under the excess interest whole life policy than under a comparable back-loaded universal life product. The new NAIC model bill put these products on a much more even footing. Now the advantages either disappear or become quite small. I would no longer expect the very substantial inroads on universal life sales from this excess interest whole life product that we expected at one point.

Slide 21 shows how a standard vanilla participating whole life policy has fared under the changes in the tax act. This is a participating policy being sold by a mutual company, and instead of profit margin, we have looked at profitability along the lines of a mutual company's pricing. Here, we are looking for an asset share at the end of the twentieth year of 105 percent of reserves (under the 1959 Act). We have now gone through the same sort of procedure as with earlier products, but instead of looking at profit margin, we are looking at asset shares (slide 22). Under TEFRA, the asset share moves up from 105 percent to something in the 138-140 percent range. Under TRA-84, the results are a bit more mixed (slide 23) but quite improved. This is before the surplus tax but clearly much better than the 1959 Act and probably a little better than TEFRA, although not quite so clear. However, you have to assess some sort of surplus tax in the answers, depending upon how you allocate that tax (slide 24). This is a standard surplus tax assessment we talked about earlier which would bring the asset share levels down to maybe, on the average, the same as TEFRA, but mixed.

There is another method whereby instead of assigning a 7 percent target surplus, you run a standard profit test and let the surplus fall



## Par Whole Life Product Description

	<u>35</u>	<u>55</u>
Level Premium		
Whole Life	\$13.82	\$38.06
Cash Values	58 CSO, 5.5%, Min.	
Reserves	58 CSO, 4.5%, CRVM	
Dividends	Paid in Cash	
Interest	11%	
Profit Objective	105% Asset Share	

## Par Whole Life Mutual Company

	Asset Share	
	35	55
1959 Act	105 %	105 %
TEFRA		
1959 Act	105	105
Tax on GO	48	63
\$19 818(c)	(2)	(1)
22.5% Dividends	(13)	(29)
	138	138

## Par Whole Life Mutual Company

	Asset Share	
	35	55
1959 Act	105%	105%
TEFRA	138	138
TRA 84		
1959 Act	105	105
Tax on GO	48	63
\$0 818(c)	(16)	(10)
36.8% Tax Rate	10	16
58 CSO 6% Reserves	(15)	(9)
	132	165

# Par Whole Life Mutual Company

	<u>Asset Share</u>	
	<u>35</u>	<u>55</u>
1959 Act	105%	105%
TEFRA	138	138
TRA 84		
Before Surplus Tax	132	165
7% Target Surplus	(16)	(15)
	116	150
Accumulated Surplus	(4)	(14)
	128	151

## UNITED STATES LIFE INSURANCE TAX LAW

out to be what it is (slide 25). Under that approach you get a lower charge for tax, and the net asset share is higher. The surplus tax allocation is in the mind of the mutual company's actuary as to how he is going to price this product.

What has the tax act done to term insurance? Over the past several years, term insurance has meant annual renewable term and, as a practical matter, graded premium whole life (slide 26). Again, we have taken a standard product, except that we have assumed much higher lapsation as has been appropriate for term insurance--a 25 percent lapse rate in all years (slide 27). We also have looked at the profit objective more along the line of what I think these products really have been priced at, which has been to break even over ten years on a pretax basis. Slide 28 shows typical premiums for this sort of product.

The product has been priced, in essence, to break even pretax (slide 29). The key issue for many companies is whether they took the 818(c) into consideration. If you assume that the \$19/818(c) is available because this is a whole life policy, you move from break-even to a 34 percent profit margin at age 35. Maybe companies weren't pricing that way, but they could use this potential tax gain as a justification for pricing on a zero break-even basis. The phantom premium might have been a negative, but only slightly under TEFRA. The upshot of this is that this type of advantage now has disappeared, and if you price annual renewable term on a zero pretax basis, that is what you are likely to make after-tax. You cannot count on these windfalls to bail you out. Of course, these products have had much greater problems than adverse taxation, but you might look at the new tax laws as the nail in the coffin with respect to graded-premium whole-life/term products, since there is no hope of tax benefits bailing out the poor experience on these plans.

In regard to traditional or semitradeional products, indeterminate premium whole life probably was the most popular product sold by stock life insurance companies prior to universal life (slide 30). This was a traditional whole life policy where premiums were not guaranteed. Slide 31 shows the same sort of calculations as used previously for Tax Situation A. This product depended heavily on 818(c), was break-even pretax, and made 12.5 percent after tax, due to high tax gains. Under TEFRA it had mixed results, and TRA-84 did not help out at all compared to the profits under the 1959 Act. Now, it's gone in the opposite direction to considerably larger tax bites and lower profitability.

Slide 32 emphasizes how much these products were hurt. At age 35, you would have to increase the premiums from \$7.80/\$1000 to \$11.24/\$1000 just to get back to your old profit level. There are other reasons why this sort of product has all but disappeared, but if there was anybody who had any ideas about continuing to try to sell this successfully, that premium increase is the nail in the coffin. There are similar results for a company in Tax Situation D (slide 33); you don't get hit quite as hard, but taxes really hurt.

Slide 34 shows a summary of which products have been helped and which products have been hurt. Suppose we have a typical stock

# Par Whole Life Mutual Company

	<u>Profit Margin</u>	
	<u>35</u>	<u>55</u>
1959 Act	.5%	.3%
TEFRA	10.0	4.5
TRA 84		
Before Surplus Tax	4.8	5.6
7% Target Surplus	1.6	4.2
Accumulated Surplus	4.6	4.6

PANEL DISCUSSION

SLIDE 25

## **GPWL/ART Product Description**

**Plan:** Increasing Premium Whole Life  
Indeterminate Premium  
10-Year Re-entry

**Cash Values:** \$0 During First 10 Years

# **GPWL/ART Profit Test Assumptions**

- Standard, Except 25% Lapse  
All Years
- Profit Objective -- 10 Year  
Breakeven, Pretax



**GPWL/ART**  
**Product Description**  
**Current Gross Premiums per \$1,000**

<u>Year</u>	<u>Age 35</u>	<u>Age 55</u>
1	\$1.53	\$3.34
2	1.75	4.40
3	2.03	5.56
5	2.69	8.23
10	4.75	16.06

## GPWL/ART

	Profit Margins	
	<u>35</u>	<u>55</u>
Pre-tax	.0%	.0%
\$5 818(c)(2)	8.9	3.3
\$19 818(c)(2)	33.6	12.5
Phantom Premium	(1.8)	(9.1)

## Indeterminate Premium Whole Life (IPWL) Product Description

	<u>35</u>	<u>55</u>
Level Premium Whole Life		
Current Premiums per 1000	\$7.80	\$24.43
Cash Values	58 CSO, 5.5%, Min.	
Reserves	58 CSO, 4.5%, CRVM	
Interest	12% $\blacktriangledown$ 10%	

## IPWL -- Stock Company (A)

		Profit Margin	
		<u>35</u>	<u>55</u>
1959 Act		12.5%	12.5%
TEFRA			
	Best	16.0	14.5
	Worst	8.4	10.0
TRA 84			
	1959 Act	12.5	12.5
	No 818(c)	(10.9)	(3.3)
	36.8% Tax Rate	.3	1.6
	58 CSO 6% Tax Reserves	<u>(6.0)</u>	<u>(1.7)</u>
		(4.1)	9.1

PANEL DISCUSSION  
 SLIDE 31

## IPWL - Stock Company (A)

Change in Premium to Keep  
12.5% Profit Margin

Age 35 \$7.80 ↗ \$11.24!!!

Age 55 \$24.43 ↗ \$26.60

## IPWL -- Stock Company (D)

	Profit Margin	
	<u>35</u>	<u>55</u>
1959 Act	2.2%	10.0%
TEFRA	4.4	11.4
TRA 84		
1959 Act	2.2	10.0
\$0 818(c)	(7.9)	(2.4)
No Nonpar Special	(2.1)	(1.2)
Tax on GO	9.4	2.8
36.8% Tax Rate	.3	1.6
58 CSO 6% Tax Reserves	<u>(6.0)</u>	<u>(1.7)</u>
	(4.1)	9.1

## After Tax Profit Margins -- 10% Pretax Stock Company (A)

	1959 Act		TEFRA		TRA 84	
	35	55	35	55	35	55
UL	5.4	5.4	22.1/ 2.1	11.4/0.6	6.3	6.3
EIWL	14.1	8.2	15.6/ 7.3	11.4/3.4	6.3	6.3
IPWL	16.3	8.7	19.8/12.2	11.7/6.2	.4	4.6

## PANEL DISCUSSION

company which was taxed on gain from operations under the old Act and which was pricing on a 10 percent pretax basis. How have their products been helped or hurt? We have looked at universal life, excess interest whole life, and indeterminate premium whole life.

Under the 1959 Act, there was a big advantage for excess interest whole life and indeterminate premium whole life. Universal life was hurt quite a bit. Under TEFRA, there are numbers going all over the lot, and which was better or which was worse depended tremendously on your interpretation of those unresolved tax issues. Under the new tax act, clearly universal life and excess interest whole life have moved into parity. The profits for indeterminate premium whole life are lower basically because the assumption is that the tax reserves are lower than the statutory reserves. So, there is an additional tax bite here, whereas for excess interest whole life and universal life, the assumptions are that these reserves are the same. These answers, of course, will vary depending upon the actual relationship between tax reserves and statutory reserves. That was for a company in Situation A. For a company in Situation D, selling universal life and a traditional product, we see the relative advantage flip flop from one product to another as shown in slides 35 and 36.

Slide 37 shows a comparison of universal life which is, in effect, stocks versus mutuals. All prices are on a 10 percent pretax basis. Under the 1959 Act, a stock company in Situation A is doing just fine; a stock company in Situation D is about break-even, and the mutual company is losing a lot. There is confusion under TEFRA. Under TRA-84, there is a level playing field. The only difference between the stock and the mutual is the surplus tax; and the results are quite comparable, depending on how they are allocated.

That is the summary of the effects of the new tax law versus the old tax law with respect to pricing your business. Throughout, we have talked about profit margin. Profit margin along with return on invested surplus probably are the two basic measures which have been used by stock companies for pricing individual life insurance. A number of companies have used profit margin as a basic goal and try to shoot for 5 percent or 10 percent profit margin. They knew that if they got that, the return on invested surplus and the other measures would be fine, so they didn't have to take a hard look at the other measures.

Under TRA-84, that has changed dramatically. A number of companies, because of 818(c), had large tax benefits in early years and, under the new tax law without 818(c), don't get those tax benefits. The point is that profitability was more front-ended under the 1959 Act for many companies, and now it is not. To give you an example, we took an interest-sensitive whole life product, profit tested under the 1959 Act and under the new tax act to yield 8 percent after-tax profit margins. It achieved exactly the same profit margin under both acts on an after-tax basis (slide 38). However, if you look at the break-even year (i.e., the year that the asset share exceeds the reserve), this product used to break even in three years. Now, it takes seven years to break even. Similarly, under the 1959 Act, the product had 80 percent return on invested surplus; under the new act, it has 20



## After Tax Profit Margins -- 10% Pretax Stock Company (D)

	1959 Act		TEFRA		TRA 84	
	35	55	35	55	35	55
UL	.3	(.2)	12.3/0.8	4.8/0.8	6.3	6.3
IPWL	7.7	4.5	8.2/8.2	7.6/7.6	.4	4.6

## After Tax Profit Margins -- 10% Pretax Mutual Company (B↗A)

	1959 Act		TEFRA		TRA 84	
	35	55	35	55	35	55
UL(Par)	(8.8)	(8.8)	18.5/0.4	8.8/(1.7)	5.5	5.5
ParWL	(2.5)	(.3)	8.4/8.4	4.2/ 4.2	(.3)	3.8

## After Tax Profit Margins -- 10% Pretax Universal Life

	1959 Act		TEFRA		TRA 84	
	35	55	35	55	35	55
Stock (A)	5.4	5.4	22.1/2.1	11.4/0.6	6.3	6.3
Stock (D)	.3	(.2)	12.3/0.8	4.8/0.8	6.3	6.3
Mutual	(8.8)	(8.8)	18.5/0.4	8.8/(1.7)	5.5	5.5

## EIWL Profit Results

	<u>1959 Act</u>	<u>TRA 84</u>
Profit Margin	8%	8%
Break-Even Year	3	7
Return on Investment	80%	20%

PANEL DISCUSSION  
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percent. The point is, don't just focus on profit margin in pricing. You need to take a look at the pattern of the profit, year by year, as well.

Similarly, a number of companies have relied on profits of in-force business, either consciously or unconsciously, in pricing their new products, and the profitability of in-force business has changed fairly dramatically as well. Once again, this is due to changes in the tax law (slide 39). Profits rise dramatically for a company in Tax Situation A with the present value of future profits for a vanilla whole life policy at various durations under the new tax act. This is basically because, under the 1959 Act, you have tax reserves which are substantially higher than statutory reserves; as those tax reserves are released, a huge tax bill is generated that drives down the values of in-force business. Under the new tax law, you have exactly the opposite situation; tax reserves are lower than statutory reserves. The net effect is an increase in the value of in-force business. So, if you actually wanted to, under the new tax law you could utilize some of this value of in-force business to subsidize new business.

MR. ALLEN D. GREENBERG: Mr. Dennis Van Mieghe is a member of the ACLI Tax Subcommittee. Over the past several months that group has been trying to come up with some form of regulations that would at least clarify the situation for companies involved in reinsurance. Mr. Van Mieghe will focus primarily on the current status under Section 845(b) and what actions might be appropriate.

MR. VAN MIEGHE: What we call the "Draft Section 845 Regulations" is our "wish list" of what we'd like to see the regulations define as to what a significant tax avoidance effect under Section 845 is. The Congressional Committee Reports give some general guidance as to what is or isn't good reinsurance transaction, but they don't give any clear cut safe harbors. They mention several characteristics of reinsurance agreements, some of which tend to be thought of as characteristics that will not cause a change by the IRS and some of which may. They are generally:

1. The age of business. The older the business, the more likely the IRS will question it. The newer the business, the less likely the IRS will question it.
2. Character of business. Term insurance is thought of in a better light from the IRS point of view than deferred annuities or level premium whole life.
3. The existence of experience refunds. This one is going to be the toughest provision. In the past with financial reinsurance, most agreements had experience refund provisions. Every Section 820 modified coinsurance reinsurance agreement written from at least 1979 on had experience refund provisions. If there was profitability over and above the fee, it went back to the ceding company. The existence of experience refund provisions that tend to limit economic risk between the ceding company and the assuming company will be frowned upon.

## Value of Inforce Business Guaranteed Cost Whole Life Issue Age 35

<u>Policy Duration</u>	<u>1959 Act</u>	<u>TRA 84</u>	<u>Increase</u>
5	\$ 26.64	\$ 38.91	46%
10	34.33	49.18	43
15	40.24	55.63	38
20	44.59	60.16	35

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4. The duration of the agreement. Longer reinsurance agreements tend to be thought of as having good characteristics. Shorter durations are thought of as being questionable.
5. Termination rights. Rights for the ceding company to recapture are not looked at favorably.
6. The relative tax position of both parties. This is very important. If there is a reinsurance agreement between a so-called large life company and a small life company (respectively, one that's subject to a 36 percent rate and one that's subject to a 14 percent rate), that will be frowned upon.
7. Reinsurance between life and nonlife companies. Transferring accident and health reserves from life to nonlife to get a play on the 36 percent versus 46 percent rate for a casualty company will be frowned upon.
8. Phase III.
9. Qualification as a life company.
10. The relative position of both parties to the reinsurance agreement will be very important.
11. U.S. versus foreign. That will be important.
12. Financial reinsurance. Two companies in exactly the same situation paying exactly the same marginal tax rates on investment income, and the same overall tax rate, might not be questioned because there's no tax to be collected. But that is an unusual situation in what I call financial reinsurance. The financial situation of both parties is an important factor. If both parties are solvent, and if neither one needs surplus relief, that's not helpful. If you have a company that borders on solvency, or to maintain its existence it must get surplus relief, that's helpful.

The Subcommittee has been trying to work in some safe harbor provisions. There are about seven or eight safe harbor provisions that we'd like to see in the regulations. There is still disagreement within the Subcommittee as to how aggressive these regulations that eventually will be forwarded to the Treasury Department should be, however.

MR. GREENBERG: We think the biggest problem facing companies that have any interest in reinsurance right now is that nothing is clear. There is a complete vacuum, and we believe, perhaps cynically, that this is what the Treasury wants. The IRS probably wants companies to be afraid to do reinsurance. Therefore, the most important thing is to get some proposed regulations to the Treasury as quickly as possible. If the Treasury is unwilling to respond, there is precedent for us to seek legislative relief saying that Section 845 is very unclear, and regulations are needed. Hopefully, the effective date can be changed to the date regulations are finalized. There is substantial disagreement within the ACLI that this should be the strategy, but

## PANEL DISCUSSION

certainly a large number of companies agree that this approach may have the best chance; 845 is in the Code and chances of repeal are virtually nonexistent.

Now, all of this is prior to two or three weeks ago. The very survival of the insurance industry could be at stake with Treasury 2! Something like whether we can reinsure nonexistent business that we are not going to be getting anyway may become a moot point for a while. But certainly prior to the bombshell of Treasury 2, (a bombshell because it was almost unchanged from Treasury 1), there may no longer be a wide consensus that we should try to attack the problem of Section 845 this way. The real problem we have is that the ACLI is divided on what kind of regulations we should propose. My personal feeling is to be as aggressive as possible on anything that we can philosophically defend.

MR. VAN MIEGHEN: There are several hundred Arizona-domiciled companies (basically credit reinsurance) that qualify as life insurance companies for tax purposes only because of the structure of their reinsurance agreements. The only way they avoid Phase III taxes is to pick up additional premium income from fronting companies. These are primarily captive companies of automobile dealers and banks. Most of these companies qualify as life companies because the business they produce is then ceded by the fronting company. The accident and health (A&H) business is ceded on an earned basis. In other words, these companies don't pick up reserves for A&H unearned premiums because those reserves are carried by the ceding company (the fronting company), but the credit life business is ceded on a written basis so that the life reserves end up down at the captive level. There is plenty of authority under Section 845 for these agreements, which have historically worked for years and years, to be attacked. It was the subject of a Supreme Court decision about ten years ago. My best guess is that these agreements will be attacked under Section 845(b). These captive companies have some interesting arguments. Many of them would be insolvent if they took the A&H business on a written basis because there would be a surplus strain. The commission strain is being carried by the fronting company, so if A&H were taken on a written basis there would not be enough capital and surplus in these companies. Thus, there is a business purpose other than taxation as to why some of these agreements are on an earned basis instead of a written basis. Also, if the IRS say, for tax purposes, did treat these agreements as if they were on a written basis, the company would not be a life company. Would it then impute a higher commission expense because taking it on a written basis results in more reinsurance commissions earlier? The company might end up with a loss even though it was a casualty company in the earlier years. The resolution of that question will be very interesting to see as this law evolves. If the IRS restructures transactions, will it give greater deductions for credit A&H to the assuming company than were otherwise generated under the structure of the agreement?

I am somewhat pessimistic that we will ever see regulations that say anything. It's my personal opinion that the Treasury Department would like to see uncertainty in the reinsurance area. If there is a set of



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regulations that set forth definitive standards and safe harbors, then the thought is that the insurance industry would find a way to manipulate its tax. If there are no regulations that say anything, then you will have a difficult time pricing reinsurance agreements. You may not even do them for tax motivation, if you have uncertainty.

MR. JOHN G. TURNER: I'd be interested in comments any member of the panel has on the impact of Treasury 2 on individual life insurance product design.

MR. GREENBERG: This is probably initial pessimism, but the feeling I get is that if it remains unchanged, essentially there will be two types of products: annual renewable term insurance of some kind and variable universal life insurance. All other forms of individual life insurance will have onerous tax consequences compared to the current tax environment. This truly represents a serious threat to the insurance industry.

There is one improvement in Treasury 2; the Treasury Department has indicated that, even though there's no cash value, the reserve for an immediate annuity should be deductible. So, that particular business would not be killed. It would be otherwise very difficult to take in millions of dollars of premium income, have expenses, and have no deduction for the millions in reserves. I would think that for companies that write a lot of immediate annuities, the tax bill would bankrupt them in one or two years.

MR. VAN MIEGHEN: One other thing in Treasury 2 that's different is the treatment of nonlife reserves by life insurance companies, essentially A&H claim reserves. For casualty companies, there's a concept in Treasury 1 and 2 of a qualified reserve account. This concept under Treasury 2 is extended to life insurance companies for their nonlife reserves which are primarily the claim liabilities for A&H business. Essentially you would be forced to discount and end up with a permanent nondeductible item. The qualified reserve account approach to discounting forever disallows the discount element as a deduction. So that if you end up with an actual claim payout of \$1,000, and the discounted reserve for it is paid, say, as \$950, you only deduct \$950; you never deduct \$1,000. It's a permanent disallowance. This aspect is probably almost as bad or maybe worse than not allowing any deductions for life insurance reserves except the cash values. You may come up with a worse answer than, for example, term insurance reserves; the life reserves would not be deductible until the claim is paid. That may be a better answer than having to discount A&H claim reserves where the discount element is permanently nondeductible. That, unfortunately, was put in Treasury 2 at the last minute.

MR. ROY GOLDMAN: Relative to the regulations on Section 845 that you are discussing in your committee, Mr. Greenberg, are you considering the captive reinsurance situation in credit insurance, or are you going to be more general?

MR. GREENBERG: With very few exceptions, the regulations that we are proposing make definitive the suggestions that appear currently in

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the Congressional Committee Reports on 845. Where they say "tend to" we change it to "will." There are one or two issues that we address, but for captive reinsurers, there's a separate section within the subgroup that is dealing with the related-party issues. Mr. Van Mieghe n is in the section dealing with unrelated companies.

MR. VAN MIEGHEN: Of course, this is unrelated if you are dealing with, say, a Prudential which is dealing with an Arizona company and which is fronting for the company.

MR. GREENBERG: By captive you mean having reinsurance with the captive of an unrelated parent company. One of the suggestions we had which we thought was the mildest of all was that to the extent that you reinsured (with an Arizona captive reinsurer as a typical example), and that if it were not for the impact on qualification or Phase III tax and every other facet of the reinsurance was fine, that qualification or Phase III alone would not be a determining factor. If the exact same reinsurance deal between any two other parties was fine, then it would also be allowable in this situation. I preferred a stronger approach, more in keeping with the philosophy of Representative Fortney H. "Pete" Stark of California, that the new act was not intended to trigger, in any new or different way, Phase III tax. Therefore, reinsurance for the purpose of avoiding Phase III tax should be allowed. The feeling has been, however, that this approach simply suggested direct tax avoidance, although it is consistent with the earlier commentary on DEFRA.

MR. VAN MIEGHEN: As I recall some of the earlier drafts, we specifically addressed Phase III and qualifications of life company and had some strong language in there. The latest drafts don't specifically mention Phase III or qualification. You'd have to read the other sections and say by inference these agreements should be good although there is no direct mention of it.

MR. GREENBERG: It's basically that you meet the tests. If your reinsurance agreement meets the tests in the proposed regulation, then the Phase III or the qualification question doesn't arise. It is either a legitimate transaction, or it is not a legitimate transaction.

MR. VAN MIEGHEN: No matter what comes out, I think the Phase III credit life issue will be left up in the air. I expect questions to be raised on qualification of credit life companies. I guess I see more antagonism at the IRS agent level and at the appellate level on credit life companies. They don't seem to like this type of entity. They seem to have an impression that it's a gimmick. That it is not the law per se; that it is just an attitude. The attitude is negative, and any time you have a negative attitude, you are going to find issues raised.