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LIFE INSURANCE TAX LAW

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Panelists: HARRIS N. BAK*
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TIMOTHY F. HARRIS
Recorder: MARK M. HOPFINGER

- o Overview of tax changes
  - -- Stock and mutual
  - -- Large, medium, and small
- o Product impact (individual life and health, group life and health, annuities, reinsurance, etc.)
- o Implementation issues -- calculating tax reserves
- o Tax planning implications

MR. NORMAN E. HILL: The 1984 life insurance tax law, in essence, caused higher taxes for the life insurance industry. It did away with our time-honored Phase I, Phase II, and 818 (c) provisions, so that the new taxable base for most companies amounts to a form of statutory page 4 annual income. The main differences from statutory income are:

1. Reserve increases for tax purposes will probably be smaller than those in the annual statement.

2. There is a 20 percent carve-out which is not subject to tax.

There is also an additional tax on mutual companies, which amounts to an earnings differential tax. This can be expressed in terms of a nondeductible portion of dividends, which are deemed to be returns to owners. There is a fresh start so that the higher reserves which most companies held under the 1959 Act would be redone as of January 1, 1983. In this way, companies would not be unduly burdened by releases of the original, higher 1959 Act reserves.

MR. FRANK J. BUCK: I'm a life insurance actuary working for a large accounting firm with a strong tax department, so I've been involved heavily with tax reserves and recomputations of tax reserves.

We had implementation problems at the beginning of the year when we were performing audits of various life companies, both on a statutory

*Mr. Bak did not appear at this session. His speech was read by the moderator, Mr. Hill.

and a GAAP basis. We had to comment on whether new tax reserves calculated or estimated by life companies at that point were reasonable or not. Now, I'm actually helping a number of companies in their final recomputation of tax reserves. However, the suggested solutions I will make later will be from the point of view of a life actuary, not a tax expert.

I consider the implementation problems in three distinct groups. The first group consists of problems caused by system constraints. The marketing department wants to prepare a new life product immediately and can't understand why you need to satisfy some minor change imposed by the IRS. Also, some companies have problems in the data processing area requiring systems changes.

The next group consists of mechanical problems where data are not set up on the master file for the new type of reserves.

The third group of problems involves interpretation of the Deficit Reduction Act. So far, we have the Act itself and a Technical Corrections Bill. We are still waiting for regulations from the IRS.

The Act itself requires reserves to be recomputed for 1983 and 1984, on a contract-by-contract basis, which implies a seriatim basis. We have to take the greater of the cash value or the reserve on a minimum basis (the so-called 807 reserve), and this figure must not exceed the statutory reserve. In both reserve computations, any allowance for due and deferred premiums has to be excluded. Thus, we have two reserve computations to look at, net of due and deferred premiums, and the cash value. For most companies, these have to be computed for two years. I believe that the top fifty stock companies will have to do these computations (the cash value one too) for 1981 and 1982, as well, in order to come up with the earnings rate on that business.

At the time of year-end audits, I was impressed that a few companies had done a good job of recomputing tax reserves; some had done a full seriatim revaluation on a whole range of business. However, the other 95 percent of companies were nowhere near that stage and were all trying various approaches. These included modeling, grouping, and rough approximation, which varied from company to company. Only one company had recomputed its tax reserves on a full seriatim basis for all of its inforce. However, that was a small stock company with only five annuity policies on its books, one of which was incorrectly computed.

Rumors abound that the IRS will allow a certain amount of modeling. Models would have to be very accurate for the IRS to accept them. Originally, we expected that no modeling would be allowed. However, so many companies are modeling that I don't see how the IRS can ignore it. Many companies are using the seriatim approach on their major lines of business, and modeling some of the remaining small lines. Many companies have small lines of business, which the companies consider immaterial, so they are just entering tax reserves equal to statutory reserves, hoping the IRS doesn't notice them or will agree that the small lines are immaterial. We will have to watch carefully for IRS attitudes.

One approach to the problem of modifying existing programs with scarce electronic data processing resources is to use the current statutory reserve system, but, instead of using statutory factors, compare factors under a three-fold test: statutory, cash value, and the minimum 807 basis (these are terminal factors). Whichever of these three applies is entered into a new factor file. Then the company goes through the normal statutory valuation, which includes deducting due and deferred premiums, either on an accurate, statutory, or approximate basis. In effect, these companies assume that all policies were sold on July 1 and start from there.

Companies never expected they would have to keep the sort of records required for computing minimum reserves. The concept of statutory reserves is to protect company solvency. Since companies are encouraged to keep high reserves, states are unlikely to complain if a company's reserves are redundant. The 1984 Act has gone the other way, by requiring tax reserves to be as small as possible.

For products like credit life, sex is often not listed as a category on the application form. Even if so specified, it is not always entered on the master file. To fulfill the requirement for minimum reserves, it appears that sex codes must be considered. The 1980 CSO is a sex-distinct table, and previous tables have a mandate in at least twenty-six states to deduct three or six years from the listed age. Determining the sex of policyholders after the fact is not easy. I helped one company do a survey to see what portions were males and females. The only source was the policy record, which just had the name on it. Even then, it was not always clear whether the name was that of a male or a female.

Another area where companies have often made approximations is with joint life. Often, reserves held for a joint life case are worked out on a simple basis, such as a certain percentage of a single life case. This won't necessarily hold up in computing minimum standards under the new tax law. Once again, I have had to help with surveys to see what proportion of contracts are on a single life and a joint life basis.

I have put together a background paper for documentation on both these sex and joint life codes in the hope that the IRS will accept the company's approach.

I came across credit life business in which a large portion was sold through agents who sell many small policies. To keep their records simple, the company recorded each agent's business on a monthly basis. It took the entire block of business from that agent, calculated an average age and duration, and entered only those two items on the master record. All other input records are no longer available. I don't know how the IRS will react to that.

One company, in all innocence and good faith, decided that it no longer needed its December 31, 1983, master file and destroyed it. Now, it must go back and make broad approximations.

There are many critical unanswered questions in interpreting the tax law. Many interpretations are coming through accounting firms, and some through actuarial firms and other tax experts. In general, most of the interpretations constitute educated guesses.

For permanent life insurance, cash values pose an interesting question: Do cash values, at any point, include gross unearned premiums or not? Some companies will state in their policy forms a set of cash values, and then add, in a later section, that there is a return of gross unearned premiums. It becomes even more difficult if the companies don't actually specify returning gross unearned premiums in the forms, but it is the companies' practice to do so. I have also seen some policy forms which actually specify that the cash value is X plus the gross unearned premium.

The new tax law specifies mortality and morbidity tables and interest rates, and also the Commissioners Reserve Valuation Method (CRVM) for life business. The law doesn't specify whether you can use curtate or continuous functions. Can a company, which has always used curtate functions, change to continuous in computing tax reserves? I see nothing wrong with doing so, but it is an issue.

Tax reserves must exclude deferred and uncollected premiums. Do you exclude those premiums when you're computing the reserve ratio for life company status purposes? Do you exclude them under the test for a small company status? The answers are probably, yes, although this is unclear from the tax forms.

Another problem among single premium immediate annuities is when the pricing interest rate exceeds the prevailing interest rate. To say that traditional reserves cause surplus strain may imply that there is an underlying net premium in excess of the gross premium. For tax reserves, some companies enter the gross premium, while others rely on the net premium.

Under the new law, if there is a choice of approved bases, companies should choose the one which generally gives lower reserves. A basis will give reserves that are higher in some cases, lower in others. The 1980 CSO includes both the select and ultimate bases and an aggregate table. The American Council of Life Insurance (ACLI) bulletin which specifies all these various bases suggests that for the majority of companies, the aggregate table will generally produce lower reserves. However, in many instances, especially with term insurance, the select and ultimate table produces lower reserves. Do you test these two 1980 CSO versions on a contract-by-contract basis? Do you use select and ultimate for term insurance and aggregate for other traditional policies, or do you use one basis determined by your guess of future splits of business?

One final problem I've seen concerns long-term disabled life reserves. What date determines the interest rate, the date of the original contract, or the date of disablement?

MR. TIMOTHY F. HARRIS: When life insurance companies were taxed under the 1959 Act, tax planning was challenging. We had three different phases of taxation and dozens of marginal rates. You could use reinsurance to move income among companies operating under different phases of the tax law. If your company fell into the "Phase II Positive" tax position, you could reclassify items from investment income to underwriting income, which was then taxed at a lower rate. For an actuary, the 1959 Act produced a large equation with many variables and several points of discontinuity. Marginal tax rates could be calculated by taking partial derivatives with respect to the various items.

This new tax act closes all the loopholes, reduces the size of the equation that we can work with, reduces the number of variables involved, and increases the taxes that we all have to pay.

Many of us, anticipating the new tax law, implemented some tax planning. This tax planning may have included late 1983 sales contests emphasizing production of new face amounts, reinsurance agreements, reserve strengthening, or even new products. All of these were supposed to take advantage of the forgiveness of the excess of reserves on the old tax basis, including 818(c) reserves, over reserves on the new tax basis. This excess came to be called the fresh start.

Now that the new tax law has been explained by the people who wrote it, and discussed at many seminars and meetings, we have a better idea of which excess reserves will actually be forgiven by the IRS. Now, we have to justify the planning done at the end of 1983.

Sales contests held at the end of 1983, placing on the books as much of the soon-to-be-forgiven reserves as possible, should be viable. There is no reason why the IRS would want to disallow this 1983 business, and even if they did, how would they segregate those policies from the ones that would have otherwise been sold?

The IRS has the authority to reallocate any item which has a significant tax avoidance effect through a reinsurance agreement (between affiliated companies for treaties existing prior to January 1, 1984, and beginning January 1, 1984, even between nonaffiliated companies). To the extent the item arises in an agreement that was amended after September 27, 1983, the agreement will be treated as new regardless of any previous favorable letter rulings.

If you strengthened any reserves after September 27, 1983, you will not only have to spread the resulting reserve increase over ten years, but you also will have to defer the implementation of this ten-year spread until 1985. For any reserve weakening, which when spread over ten years results in amounts of taxable income, this income will be excluded when the small company and the 20 percent special deductions are calculated under the new tax law.

For those who sold new products which were anticipated to take advantage of the fresh start, reserve methods on these new products will have to be similar to those methods on similar products that were sold in the past. Any amounts above or below this level will be treated as reserve strengthening or weakening.

The IRS seems to have anticipated everything that we might possibly have done in attempting to maximize our fresh start.

Those of you who report on a GAAP basis probably already have calculated or estimated your fresh start and reduced your GAAP deferred tax account by the taxes you otherwise would have paid on this amount. You may also have left a so-called cushion in this GAAP deferred tax account, to be released as you find out whether or not the IRS accepts some of your anticipated fresh starts.

In most cases, a stock company will wish to maximize its fresh start in order to release from future taxation deductions that have been taken for reserves up to this point. There may be situations, however, where you do not wish to maximize the fresh start. Exhibit I shows that reserves for a whole life policy at several rates of interest start and end at the same point but have different rates of increase in between. It is possible that you could save taxes by holding back somewhat on your initial fresh start, i.e., minimizing initial reserves and realizing somewhat higher deductions in the future under the new tax law. This will depend on the amount of reserves that you already have on the books for that product, the run-off of these reserves, and the anticipated new production. You have the option of not electing a new interest rate for one year and a new mortality table for three years. For your 1984 opening balance, this means that you can elect to use 1958 CSO mortality and 4.5 percent interest or 1980 CSO mortality and dynamic interest. Certain small companies even have the option of deferring recalculation of reserves on the new basis.

Mutual life companies have a somewhat different situation than stock companies, in that they are also paying a tax on what the IRS deems to be their return of profit to the policyholders. This, in practice, is a tax on the sum of surplus, mandatory securities valuation reserve, and the difference between statutory reserves and tax reserves.

A mutual company will probably wish to minimize fresh start, thereby reducing this tax base and its overall tax. A mutual company should also think long and hard about holding on to an asset that has a low after-tax yield.

Stock companies will wish to maximize fresh start, and mutual companies will demutualize and maximize fresh start or stay mutual and minimize fresh start. This choice for mutual companies is a major decision.

Although the new tax law has eliminated complexity in calculating marginal rates, you get some interesting results as shown in Exhibit II. These rates apply to the resulting tentative life insurance company taxable income (LICTI). Tentative LICTI is essentially statutory income adjusted for the difference between the change in reserves on a statutory basis and the change on a tax basis. Tentative LICTI is before the small company and the special 20 percent deductions of the

EXHIBIT I

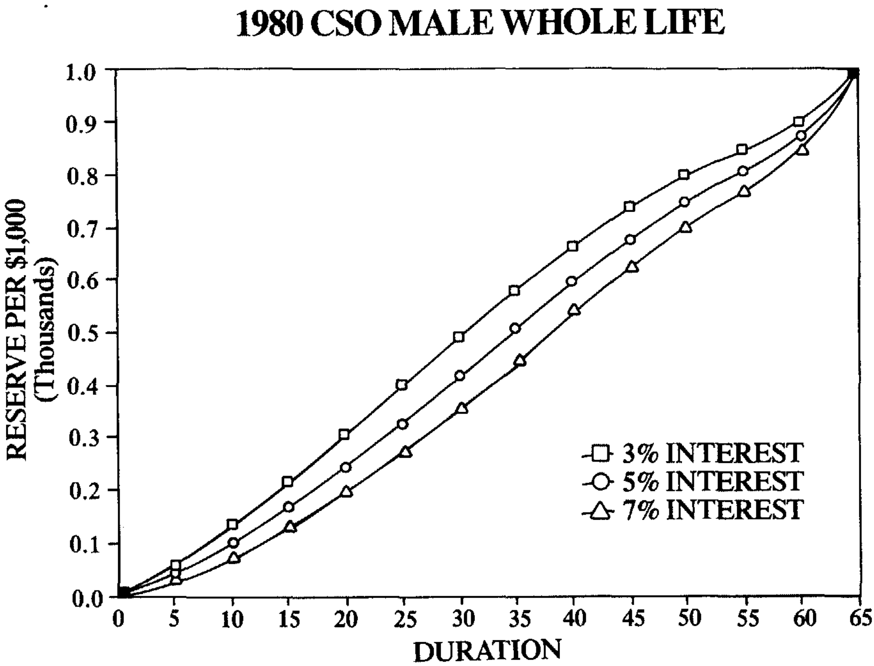
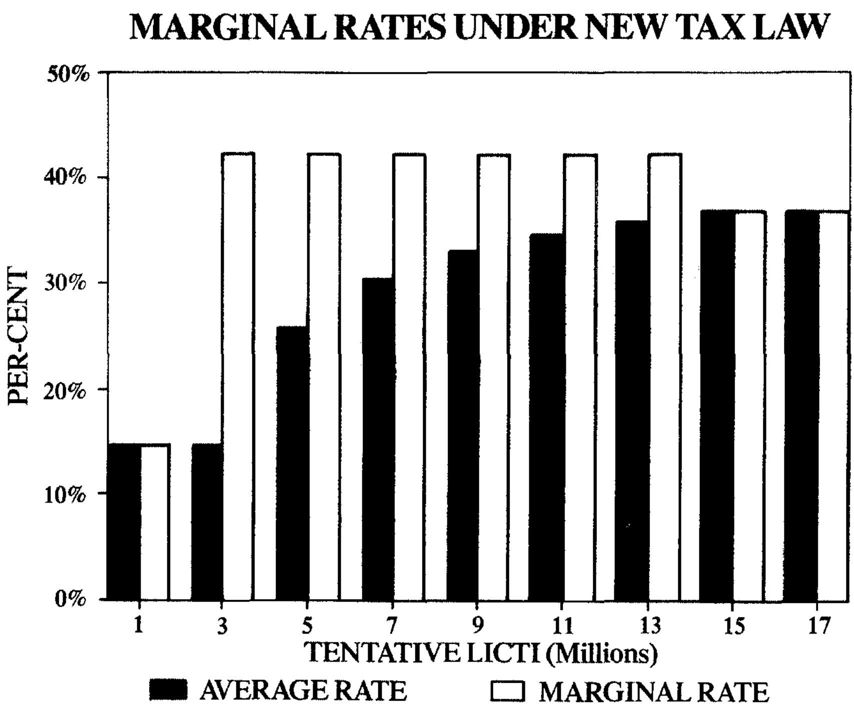

1980 CSO MALE WHOLE LIFE
RESERVE PER $1,000 (Thousands)
1.0
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0.0
0
5
10
15
20
25
30
35
40
45
50
55
60
65
DURATION
3% INTEREST
5% INTEREST
7% INTEREST

EXHIBIT II


MARGINAL RATES UNDER NEW TAX LAW
50%
40%
30%
20%
10%
0%
PER-CENT
1
3
5
7
9
11
13
15
17
TENTATIVE LICTI (Millions)
AVERAGE RATE
MARGINAL RATE

new law. Companies eligible for the small company deduction have one marginal rate if their tentative LICTI is 3 million dollars or less, another marginal rate (the highest one) if their tentative LICTI is between 3 and 15 million dollars, and then an ultimate marginal rate if their tentative LICTI is 15 million dollars or more. The reason the marginal rate from 3 to 15 million dollars is so high is because the small company deduction is reducing. Strictly from a tax viewpoint, it might be better to cut back on company operations and assets in order to drop to lower marginal rates. However, I know of no companies that have changed their operations so radically.

We still have under this tax law, as under the 1959 Act, the proration of tax-exempt income between the policyholders' share and the company's share. The IRS feels that part of any tax-exempt income earned by the company is actually required interest on reserves. On the new tax form, they reduce the increase in reserves by the policyholders' share of tax-exempt income. Under the new tax law, the calculation has changed somewhat since tax reserves are different and interest rates being used are different. A component has been added for the investment portion of policyholder dividends, and interest on debt has been excluded. The result, however, is much the same: Life insurance companies are effectively taxed on tax-exempt income. Exhibit III shows marginal rates for fully taxable income, tax-exempt income, and 85 percent tax-exempt dividends (three different LICTI ranges; marginal rates for a nonparticipating stock company). To determine whether or not a tax-exempt investment is best for your company, you will have to calculate equivalent yields using these marginal rates. John C. Fraser's paper "Mathematical Analysis of Phase 1 and Phase 2 of 'The Life Insurance Company Income Tax Act of 1959'" (TSA XIV, 1962, 51-138) provides the methodology to derive these marginal rates.

In passing the new tax act, Congress did correct a flaw in the 1959 Act, which had caused taxation of dividends paid to a life insurance company by a subsidiary. Under the 1959 Act, dividends of this type were prorated as if they were tax-exempt income. Under the new law, no part is allocated to the policyholders' share of investment income unless a portion of this dividend represents tax-exempt income earned by the subsidiary.

Congress attempted to close a potential loophole where a life insurance company might set up a downstream subsidiary, which could earn tax exempt income and dividend it up to the parent without having any of it allocated to the policyholders' share and thereby taxed. Under the new provision, however, a life insurance company with a life insurance subsidiary will have tax-exempt income allocated to the policyholders' share in each company if a dividend is paid by the subsidiary.

The mechanics of this are shown in Exhibit IV. Fully tax-exempt income earned by the subsidiary is split between the company's share and the policyholders' share, with a resulting tax on the policyholders' share. The subsidiary then pays a dividend to the parent company.

EXHIBIT III

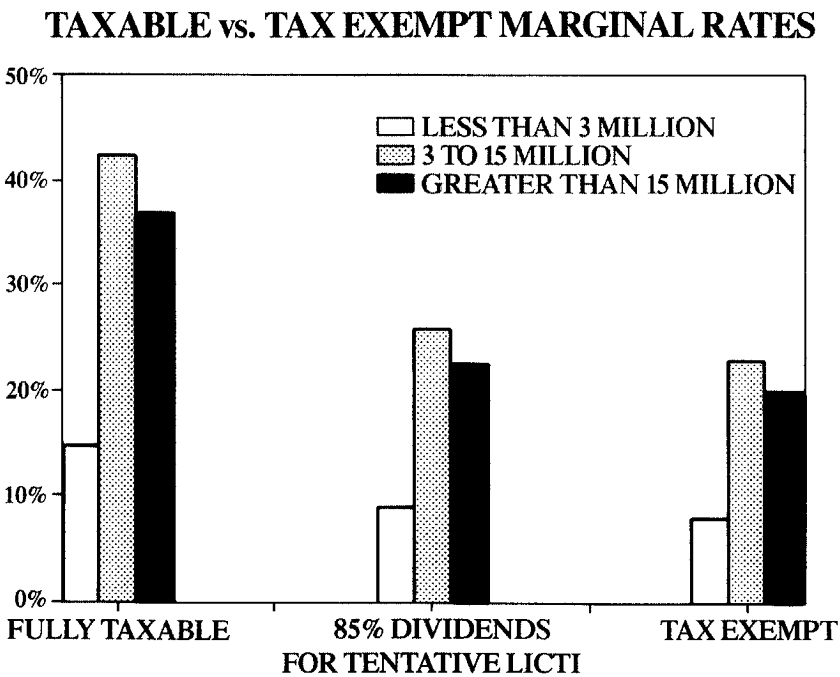
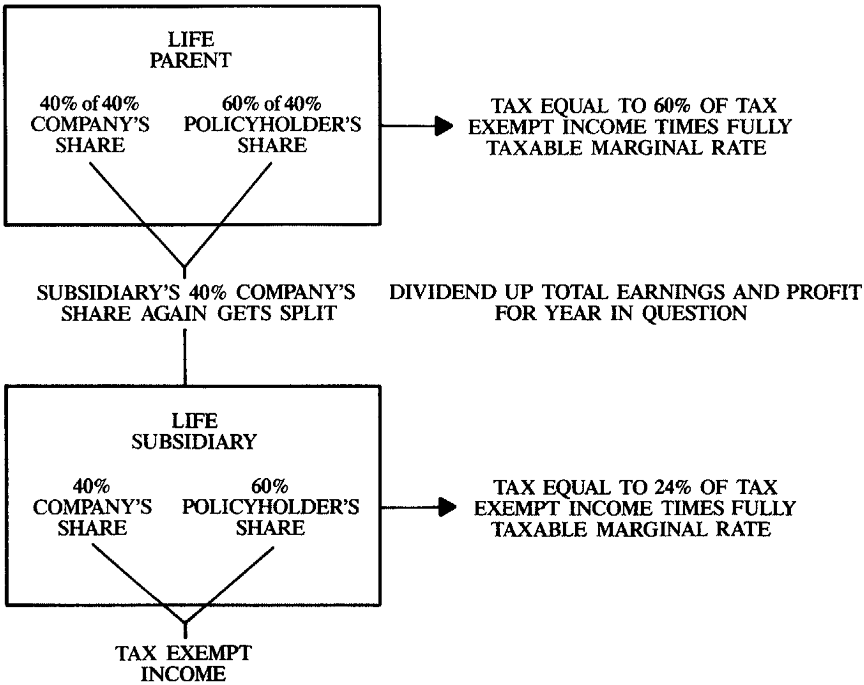

TAXABLE vs. TAX EXEMPT MARGINAL RATES
50%
40%
30%
20%
10%
0%
LESS THAN 3 MILLION
3 TO 15 MILLION
GREATER THAN 15 MILLION
FULLY TAXABLE
85% DIVIDENDS
FOR TENTATIVE LICTI
TAX EXEMPT

EXHIBIT IV

ANALYSIS OF DOUBLE TAXATION OF TAX EXEMPT INCOME RESULTING WHEN A LIFE SUBSIDIARY WITH TAX EXEMPT INCOME PAYS A DIVIDEND TO ITS LIFE PARENT



TOTAL RESULTING TAX ON THE TAX EXEMPT INCOME ORIGINATING IN THE LIFE SUBSIDIARY IS 84% OF WHAT WOULD HAVE BEEN PAID ON FULLY TAXABLE INCOME

This dividend consists, in part, of the tax-exempt income which was earned in that year by the subsidiary. I have assumed that the dividend paid is equal to what is called "Earnings and Profit" for the year in question and is paid on December 31. This tax-exempt income, when received by the parent, is split out and allocated again between the policyholders' share and the company's share, with a second resulting tax on the tax-exempt income which was originally earned by the subsidiary. This yields a whole new set of marginal rates for situations when a life insurance company's subsidiary invests in tax-exempt income and then pays dividends to the parent. Possibly, only the parent should make such investments.

Exhibit V shows the viability of real estate as an investment at the marginal rates of the new tax law. The average yield of 7.4 percent after tax which would be comparable to a 12.9 percent fully taxable yield. Comparable fully taxable yields are 9 percent for the 14.72 percent marginal rate and 11.9 percent for the 36.80 percent marginal rate.

EXHIBIT V

ANALYSIS OF INVESTMENT IN REAL ESTATE
ASSUMING 42.32% MARGINAL RATE
PURCHASE PRICE = 1,000,000 BUILDING ONLY
CASH YIELD = 6% AFTER EXPENSES
PRESENT VALUES @7.5% AFTER TAX

-------------------STRAIGHT LINE DEPRECIATION-------------------

	Balance	Percent	Depreciation	Cash Yield	Tax	After Tax Yield	Comparable Pretax Yield
1	1,000,000	5.56%	55,556	60,000	1,881	5.81%	10.1%
2	944,444	5.56%	55,556	60,000	1,881	5.81%	10.1%
3	888,889	5.56%	55,556	60,000	1,881	5.81%	10.1%
4	833,333	5.56%	55,556	60,000	1,881	5.81%	10.1%
5	777,778	5.56%	55,556	60,000	1,881	5.81%	10.1%
6	722,222	5.56%	55,556	60,000	1,881	5.81%	10.1%
7	666,667	5.56%	55,556	60,000	1,881	5.81%	10.1%
8	611,111	5.56%	55,556	60,000	1,881	5.81%	10.1%
9	555,556	5.56%	55,556	60,000	1,881	5.81%	10.1%
10	500,000	5.56%	55,556	60,000	1,881	5.81%	10.1%
11	444,444	5.56%	55,556	60,000	1,881	5.81%	10.1%
12	388,889	5.56%	55,556	60,000	1,881	5.81%	10.1%
13	333,333	5.56%	55,556	60,000	1,881	5.81%	10.1%
14	277,778	5.56%	55,556	60,000	1,881	5.81%	10.1%
15	222,222	5.56%	55,556	60,000	1,881	5.81%	10.1%
16	166,667	5.56%	55,556	60,000	1,881	5.81%	10.1%
17	111,111	5.56%	55,556	60,000	1,881	5.81%	10.1%
18	55,556	5.56%	55,556	60,000	1,881	5.81%	10.1%
Sell After 18 Years				1,000,000	324,640	67.50%	117.10%
Average Annual Yield				817,774	94,680	7.40%	12.90%

Yields Are Comparable Pretax 9.0% for the 14.72% Marginal Rate and 11.9% for the 36.80% Marginal Rate

The potential Phase III tax continues to be a problem for stock life insurance companies and a severe problem for credit insurance companies. Under the 1959 Act, Congress set aside an account for shareholders, which included earnings after tax. Congress also set aside an account for policyholders, which included certain untaxed earnings. If more was paid to shareholders than was in their account, you dipped into the policyholders' account and were hit with a Phase III tax on these previously untaxed amounts. The policyholders' surplus account was frozen as of the end of 1983 with respect to increases, but it is still subject to decreases should the shareholders' surplus account be depleted. The policyholders' surplus account is also still subject to the maximums that applied under the 1959 law, and in applying these limits, it may be necessary to calculate reserves as under the 1959 law. Any resulting Phase III tax is at the full corporate rate, presently 46 percent. The shareholders' surplus account is increased by taxable income and special deductions plus the dividends-received deduction and the company's share of tax-exempt income. It is reduced by dividends paid to shareholders, or under the new law, any amounts constructively received by shareholders. Stock life insurance companies will still have to maintain a positive shareholders' surplus account in order to avoid being subject to a Phase III tax.

This presents a major problem to credit insurance companies, since not only has the Phase III tax been retained, but use of reinsurance for any type of tax planning has been eliminated. Most credit insurance companies, which generate more accident and health unearned premium reserves than life tax reserves, will no longer be able to borrow life tax reserves from other insurance companies in order to qualify as life insurance companies or to avoid maximums in the policyholders' surplus account. As things now stand, unless some type of relief is given to these companies, many of them will have huge tax liabilities several years down the road.

The new tax reserve basis included in the Administration's "tax simplification" proposal is limited to cash values of policies. The ramifications of such a drastic change on the life insurance industry would be unfavorable. The proposal taxes policyholders on the inside build-up of cash values on life insurance policies and annuities. In addition, it eliminates the small company and the special deductions from the present tax law. This then increases everybody's marginal rate to the full corporate rate (which might be 33 percent).

Tax planning should not be an isolated function; it should be an integral part of a company's business plan. It should be considered when developing new products, when making investments, when considering an acquisition or divestiture, and especially when formulating a company's strategic plan.

MR. HARRIS N. BAK: As universal life insurance increased in popularity, the IRS became concerned about its potential use to avoid taxes on savings. The so-called inside build-up had always been tax-free under Section 72 of the Code for both life insurance and annuities so long as the cash value was not withdrawn. For annuities, several changes eroded this special treatment: taxation of withdrawals on the last in, first out (LIFO) basis rather than a "cost recovery basis," a 5 percent tax on premature withdrawals, and treatment of policy loans as withdrawals.

The tax treatment of annuities has been attacked because of a perception that these contracts are primarily tax-sheltered investments which do not have the kind of social benefit for which Congress provided special treatment.

For life insurance, however, the benefits are more sacrosanct. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) introduced a definition of life insurance for flexible premium products. In essence, it provided a minimum amount of insurance (net amount at risk) in relation to the savings element. The law was unclear as to the penalties for failure to qualify. Since the death benefit was included in Section 101, it was not unreasonable to assume the death benefit would be taxable like it is for annuities. Under Section 101(f), the proceeds of flexible premiums contracts are excludable from income if the contracts meet test A or test B:

A. CASH VALUE ACCUMULATION TEST

$${}_tCV_x - A_{x+t} \cdot \text{FACE}$$

B. "ALTERNATE TEST" - must satisfy both (1) and (2)

(1) GUIDELINE PREMIUM - $\sum$ GP $\leq$ Larger of (NSP@6%, NAP@4%)

(2) CORRIDOR TEST

DEATH BENEFIT $\geq {}_tCV_x$. PERCENTAGE (P) BASED ON ATTAINED AGE

P = 140% TO AGE 40, GRADES TO 105% AT AGE 75.

CV = Cash value, before surrender charges
NSP = Net single premium
NAP = Net level annual premium
GP = Gross premiums

The Deficit Reduction Act of 1984 (DEFRA) tightened the rules and explicitly provided a penalty. The tax for disqualified policies is on the "living benefits" -- the increase in cash value rather than on the death benefit. Perhaps taxing the death benefit is illogical even for a disqualified policy since the premium for the coverage was never deductible. Consequently, the new provisions were relocated from Section 101 to Section 7702. In summary, the changes are:

1. Net death benefit proceeds (DB - CV) tax exempted

2. Inside build-up is taxable if policy is not "life insurance"

   TAXABLE INCOME = NCV + COI - GP

   NCV = net cash value, after surrender charges
   COI = cost of insurance
   GP = premiums, less dividends

3. Applies to all policies, not just flexible ones

4. Corridor percentages increased: 250% to age 40, grading to 100% at age 95

Two related questions arise from the new law: which test is easier to meet, and how does the new law compare to the first law? Table 1 makes a case that the new law has little practical effect on how much cash value one can accumulate tax-free. It compares the two tests for a "typical" universal life policy. A male age 45 wishes to accumulate the maximum cash value on $100,000 face amount.

The cash value accumulation test allows him to accumulate a cash value that does not exceed the paid-up value of a $100,000 policy at this attained age. This allows him a generous $35,139 at the end of year one (Column H), but only $59,126 in the 20th year. The alternate test is based on the premium limitation (Column D) and the corridor test (Column F). Given the premium limitation, he will not run into a corridor problem until the fifteenth year. It is clear that by the tenth year, the allowable accumulation becomes higher under the alternate test. Similar results arise for issue ages 25 and 65.

Furthermore, since the corridor percentages under DEFRA and TEFRA converge at higher attained ages and since the early duration limits are limited by the guideline premiums, the new law should not impact universal life sales as much as might be expected.

MR. HILL: In 1982, a group of us went to the IRS offices in Washington. Representatives of the IRS showed us voluminous files of newspaper clippings, which contained advertisements for various high cash value life products using phrases like "Beat the Tax Collector with Deferred Benefits." This caught their eyes and influenced Treasury input into the 1984 law.

There were other policies sold under the 1959 Act which might have been considered unprofitable on a pretax basis. Due to reliance on the 818(c), however, these would become profitable on an after-tax basis. These types of policies are no longer viable.

When you test your policies for compliance with the 1984 Act, you had better test all aspects of the policies. Today, it is not uncommon to sell combinations such as male nonsmoker, male smoker, female nonsmoker, and female smoker, with the first being the largest. If everything qualifies under the male nonsmoker subset, that does not mean that you qualify under all subsets.

MR. JAMES E. KILMER: There is a provision in the law where companies are supposed to gross up premiums by so-called phantom premiums and likewise increase dividends by phantom premiums. I don't see that it accomplishes anything for stock companies. Although tax liabilities are going to be the same, it could be a major administrative item to comply with. Are any of your clients grappling with that yet?

MR. BUCK: No. For most companies, these sorts of policies form a small part of their total business, and they are not bothering on the grounds that it is immaterial.

MR. JULE L. GEHRIG: We have phantom premiums related to universal life risk charges, which we have tabulated on our yearly renewable term policy. We include them as dividends and premium, which washes. It has only a minor effect on the policyholders' share. Since we have little tax exempt or 85 percent dividend, the total effect means that we are doing a lot of work for a few thousand dollars worth of tax.

I don't worry about job security. With these new tax laws, I'm never going to have to worry about a job. There are two possible consequences of what I've done related to the 1984 tax law. Either I will retire before any questions are raised, or the company will never let me retire, stating that I caused their predicament.

We completed our 1984 tax the third week in January. Our board meets the fourth week in January, so that I was forced to meet their schedule. I'm not going to say that you would find no areas to disagree with, but many questions are undecided. I finally took the approach that whatever was undecided, I would decide in my company's favor, and we would complete our tax on that basis.

MR. HARRIS: Based on what you know now, have you made any revisions?

MR. GEHRIG: I made only one change. I didn't know that capital gains should be included with gross income and the policyholders' share.

FROM THE FLOOR: One problem I have is with female/male. We came out with a universal life product on January 1, 1983, and since then, it has represented 90 percent of our new business. On this plan, only a small percentage is other than male nonsmoker. Since I did not have all the needed facilities, I made no further split based on materiality.

One point in our favor is that our cash values are usually high, grading to net level in twenty years. In my opinion, there is no question that these are higher than tax reserves. Therefore, I have not made a seriatim comparison.

Under the old tax laws, the IRS said that if reserves were not calculated in accordance with recognized methods, tables, and interest, they were thrown out. What are they going to do now? If they don't like the reserves, will they still throw them out? Given the widespread use of conversions and exchanges today, many old blocks of permanent business would be decreasing. If the IRS threw out these reserves, they would be lowering taxable income. A mutual company, of course, would also have its ownership differential adjusted.

MR. BUCK: I think they will get you to recompute it on an approved basis.

MR. HARRIS: It seems that if they disallowed the reserve, you would have a larger fresh start. It would have to go someplace.

MR. BENJAMIN G. PETERS: The law allows you to make adjustments to your mortality assumptions based on adjustments in your statutory valuation mortality. If you issue a case substandard, then you would value it on substandard mortality. I was wondering about the argument that "male versus female" means that one is substandard and the other is not. If you reflected this classification in your statutory valuation, you should also do so for taxes and vice versa.

MR. BUCK: The basis must be what is approved in twenty-six states. 1958 CSO mortality for females was approved on a three year setback basis for a long period of time, and then on a six year for a short period. You still have to compare three factors, so it may not have much effect. If it does, the IRS is going to want you to reflect it. Overall, you cannot exceed your statutory valuation. However, I believe you must reflect male/female differences in the 807 reserves.

MR. PETERS: My company was tempted to treat females and smokers as substandard, but we decided not to. I have heard it mentioned, but I'm not sure if it is being attempted in the industry.

MR. RICHARD JUNKER: With TEFRA, there was a limit on the amount of excess interest that could be deducted from amounts accrued in the year-end reserves. The new Section 807 is similar. Now, in the dividend section, you calculate all excess interest as being that in excess of the amount based on prevailing interest rates. Does this mean that you are deducting amounts both under and over the prevailing rate? Does this extend the deductible amount, especially for universal life and deferred annuities? What are companies doing to calculate this?

MR. BUCK: I believe that item will be rectified by a Technical Corrections Committee.

MR. DANIEL J. KUNESH: On universal life, especially a back end-loaded product, it is quite likely that the CRVM reserve, as defined in the new model regulation, would be higher than the cash surrender value. Since, at year-end 1984, six states have passed the regulation, what advice can be given to a company in establishing December 31, 1984 start-up reserves -- cash surrender values or CRVM reserves?

MR. CHARLIE T. WHITLEY: The law indicates the method is determined by the National Association of Insurance Commissioners (NAIC), not by the majority of states.

MR. HILL: The "Blue Book," interpreting the law, indicates that the NAIC should govern. It should be noted that the NAIC's actuarial group wishes to revise the cash values section of the regulation. While one might argue that the regulation's status is in question, the safe approach would be to keep reserves on CRVM, as defined in the regulation.

MR. JAMES F. REISKYTL: Disqualifying a reserve was anticipated in the law: you cannot do it. One might argue also that reserves could be calculated on the Northwestern Mutual table, so they would not be from a recognized mortality table and would fall under a gross unearned premium test. The Blue Book anticipates that and states that you cannot disqualify a reserve by your failure to calculate it correctly. You must calculate reserves using CRVM, the interest rate table, and so on.

The Blue Book also makes cash value size clear. The intent of the drafters is that cash values should include any amounts guaranteed in your contract. If you guaranteed gross unearned premiums, one could argue that they are part of your cash values.

As to curtate and continuous functions, I believe you can use continuous functions, but if you had not been using them previously, you will be subject to a ten-year spread. Again, this is a matter of interpretation.

MR. KUNESH: What is the impact, from a tax planning standpoint, of the new single premium life product, designed as a sort of substitute for single premium deferred annuities? There is no charge for mortality at any time as far as the contract holder is concerned, nor is there any expressed maximum mortality charge. Instead, a lower interest rate is credited on the fund. There is excess interest credit on a current basis but not guaranteed.

MR. HILL: It is subject to tax reserves for universal life contracts, which effectively include mortality charges.

MR. KUNESH: Suppose you sell group universal life, providing for increases in the amount of insurance corresponding to salary increases. Are there any special problems with the automatic increase provisions of 7702?

MR. HILL: Each certificate must be continuously tested for the relationship between death benefits and cash values. You might get different results, depending upon whether these incremental death benefits and cash values go into different certificates.

MR. JOHN A. STEDMAN: What is the meant by the prevailing state rate for supplementary contracts not involving life contingencies?

MR. HILL: In my mind, there is still a question about whether the original issue date or the inception date of the supplementary contract governs.

MR. KENNETH J. CLARK: Section 845A, which deals with related party reinsurance transactions, was in effect before January 1, 1985, because it replaced a similar provision under TEFRA. Section 845B, which applies to unrelated party transactions, became effective for treaties after January 1, 1985. Is this correct?

MR. HILL: Yes, that is correct.

MR. REISKYTL: The date of 845B for unrelated parties is January 1, 1985. However, if you think reinsurance treaties before that date, particularly those in 1983 and 1984, will escape, I wouldn't want to be your lawyer.

MR. KILMER: Have any companies looked at substandard extra reserves when they are computed on a tabular basis? When we did our first calculations under federally prescribed rules, those reserves came out higher than our statutory reserves. That was true for paid-up business, and for all but earlier durations of premium-paying business. Has anyone else had similar experience?

MR. BUCK: I've seen some companies produce higher substandard extra reserves than statutory reserves.

MR. HILL: Last April, several large companies were claiming that they did not intend to complete their reserves this year, at least on a nonmodeled basis. Their intent was to complete reserves on some basis and then try to catch up gradually, maybe by 1986, and hope that results would mesh. From what I have heard today, at least two companies plan to be done this year on a complete refined basis. I don't know if that means that we are getting more comfortable with the 1984 Act, or that a different mix of people attended this session.

TABLE 1

COMPARISON OF CASH VALUE GUIDELINES UNDER SECTION 7702

(A) POLICY YEAR "T"	(B) ATT'ND AGE X+T-1	(C) GUIDELINE AGGREGATE SP6%AP4%*T	(D) MAX GP PER YEAR C(T)-C(T-1)	(E) POL VALUE BASED ON ACCUMULATED GP	(F) CV LIMIT BASED ON CORRIDOR $100,000/COR%	(G) ALTERNATE TEST = SMALLER OF (E) AND (F)	(H) CASH VALUE ACCUMULATION $100,000*Ax@4	(I) ADVANTAGE OF ALTRNT TEST (G)-(H)
1	45	$21,861	$21,861	$21,315	$47,847	$21,315	$35,139	($13,824)
2	46	$21,861	$0	$23,169	$49,261	$23,169	$36,231	($13,062)
3	47	$21,861	$0	$25,195	$50,761	$25,195	$37,347	($12,152)
4	48	$21,861	$0	$27,413	$52,356	$27,413	$38,488	($11,075)
5	49	$21,861	$0	$29,834	$54,054	$29,834	$39,652	($9,818)
6	50	$21,861	$0	$32,491	$56,180	$32,491	$40,841	($8,350)
7	51	$21,861	$0	$35,399	$58,480	$35,399	$42,052	($6,653)
8	52	$21,861	$0	$38,581	$60,976	$38,581	$43,283	($4,702)
9	53	$21,861	$0	$42,068	$63,694	$42,068	$44,531	($2,463)
10	54	$21,861	$0	$45,888	$66,667	$45,888	$45,794	$94
11	55	$21,868	$7	$50,081	$68,493	$50,081	$47,072	$3,009
12	56	$23,856	$1,988	$56,648	$70,423	$56,648	$48,363	$8,285
13	57	$25,844	$1,988	$63,894	$72,464	$63,894	$49,669	$14,225
14	58	$27,832	$1,988	$71,896	$74,627	$71,896	$50,989	$20,907
15	59	$29,820	$1,988	$80,749	$76,923	$76,923	$52,325	$24,598
20	64	$39,760	$1,988	$142,303	$83,333	$83,333	$59,126	$24,207
25	69	$49,700	$1,988	$252,568	$86,957	$86,957	$65,897	$21,060
30	74	$59,640	$1,988	$469,717	$95,238	$95,238	$72,389	$22,849
35	79	$69,580	$1,988	$960,636	$95,238	$95,238	$78,070	$17,168