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FEDERAL INCOME TAX ACCOUNTING - UNITED STATES

Moderator: LOUISE S. GOLDMAN
Panelists: CHARLES D. FRIEDSTAT
PATRICIA L. GUINN
LOUIS M. WEISZ
CHARLIE T. WHITLEY
Recorder: JOHN J. RUTTER

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- o Product line allocation
- o Stock and mutual company considerations
- o Generally accepted accounting principles (GAAP) deferred taxes
- o Accounting for life/life and life/nonlife tax consolidations
- o Tax sharing agreements among affiliated companies
- o Reinsurance agreement impact
- o Conflicts, if any, between tax planning and solvency considerations.

Mr. Charlie T. Whitley will give a brief overview of the tax law change, highlighting those areas that would particularly impact on accounting.

MR. CHARLIE T. WHITLEY: Phase I, Phase II, and 818(C) are gone as well as the primacy of National Association of Insurance Commissioners (NAIC) accounting rules. The language in the new law is almost identical to these old laws, but the results of Section 811 (the accounting section) are almost totally opposite. We have the primacy of federal tax accounting rules with the all events test, which has been expanded by the 1984 Tax Act. If all events have occurred fixing the liability, and the liability can be determined with reasonable accuracy, then economic performance has occurred. There are certain exceptions to the requirement of the economic performance in the case of recurring items.

However, the Congressional Committee Reports points out that commissions don't have to be capitalized according to GAAP. The reserve attributable to deferred and uncollected premiums is disallowed unless those premiums are, in fact, accruable as income, or required to be accrued as income. If uncollected premiums are accrued, then the reserve will stand. Section 811 also contains a rule calling for no double counting.

Perhaps the next level of significance in accounting matters is the authority to reallocate related-party reinsurance, which is in Section

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845. The secretary may reallocate if there is significant tax avoidance effect. That reallocation can be with respect to one of the parties -- one-sided accounting in that the other company may not be subjected to reallocation. The related-party reinsurance is a continuation from the Tax Equity and Fiscal Responsibility Act (TEFRA).

Reimbursable dividends are treated as an expense of the reinsurer and as income by the originating company. Dividends are defined to include everything that anyone ever thought might be a dividend. The definition of returned premiums excludes any of those dividends. No experience rated refunds are treated as returned premiums. Intercorporate dividends which are funded with tax-advantaged income are not deductible.

For noninsurance business conducted by a life insurance company, you effectively would be consolidating a life company in a nonlife subsidiary. Within a controlled group, there is the allocation of special and small life insurance company deductions across that controlled group. Policyholder dividends, such as excess interest and phantom premiums, are to be treated as dividends paid to the policyholder and returned to the company as premium -- a wash situation but with a modest effect in proration. The Security and Exchange Commission (SEC) 809 topics include average equity base, the definition of statutory reserves, and the various adjustments from statutory to tax equity base determination. Consistency of adjustments is not clear. For example, is the deficiency reserve increase eliminated from the gain from operations? It is clear that the deficiency reserve is a voluntary reserve and is a part of surplus.

Another tax accounting concern is the equity of a stock subsidiary of a mutual company, or the equity of a stock company jointly owned by two or more mutual companies.

MS. GOLDMAN: Under the 1959 Act, many companies used marginal rates to allocate tax by line of business. Are companies still using marginal rates?

MS. PATRICIA L. GUINN: Assessing tax to a company's various product lines using marginal rates or another approach is not as complicated as it was under the 1959 Tax Act, principally because that tax involved a multiphase tax system. Under the old tax law, one could not necessarily apply the tax provisions to each line of business separately and expect to reproduce aggregately the total company tax. The new tax law abolished the multiphase approach, and the basic tax rate now is 36.8 percent or 80 percent of 46 percent of taxable gain from operations. This taxable gain from operations resembles the company's statutory gain. So a company easily can assess the tax on a marginal change in the gain attributable to a particular line of business. The marginal tax is 36.8 percent of the marginal gain.

For some companies the results are not quite so easily calculated: (1) certain small companies, (2) mutual companies, and (3) companies or lines of business within a company with a significant proportion of

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tax-advantaged investment, such as common and preferred stocks and municipal securities.

As the small company's taxable income increases from 3 to 15 million dollars, its tax rate increases from about 14.7 to 36.8 percent. Since this tax rate is applied to the full taxable gain, each dollar of taxable income in excess of 3 million dollars is being taxed at a marginal rate of 42.3 percent.

Mutual companies suffer complications with the equity or surplus tax that they must pay. This will be discussed later.

When there is a significant proportion of tax-advantaged investment, complications arise depending on the company's share and policyholder's share calculations of certain investment income. A life company is permitted to deduct only the company's share of preferenced investment income. This prevents the life company from taking a deduction twice, since it is assumed that the policyholder's share of this income has been sheltered from tax through the reserve increase deduction. But the mathematics of the tax law work such that on a marginal basis, a dollar of this tax-advantaged income attracts a nonzero tax; the result will be that the after-tax yield on such investments may be less than that for a fully taxable item of investment income.

MS. GOLDMAN: Let's discuss some of the alternatives for allocating tax by line of business.

MR. LOUIS M. WEISZ: We might view each line as a separate company looking at the books for tax adjustments. If a company is heavy in real estate, there could be a lot of tax adjustments for expenses which are amortized on a tax basis, or for book to tax accounting for differences in depreciation. Another example is the accrual of discount on bonds where the deferral is taken and the income is taxed as a capital gain when the bonds mature or are sold.

When viewing each line of a mutual company as a separate company, you must consider the surplus and the equity tax. You could look at the historical statutory surplus, but this would ignore the fact that some lines may not be able to operate as independent companies because they just wouldn't have enough surplus. The corporate operating bodies would have to give them surplus to make some of the guarantees and to provide for their risk capital.

Some companies may also use a corporate line. My company is in the early stage of investigating this, and if you use a corporate line, you may or may not do it for statutory purposes. New York has some limitations as far as what you can do for statutory purposes.

If you cannot use it for statutory purposes, obviously you would have to reallocate what had been allocated in your corporate line. Would you allocate the equity tax to the corporate line or to the product lines? You can argue each way. You might end up with the only equity in the corporate line being the free surplus, which is not needed to cover the risks in your product lines.

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If you have a corporate line, you may put certain types of investments in that line, such as risky ventures that the company might not otherwise try and the product lines may not want. You might put the common stocks in the corporate line as well.

You should allocate your tax in proportion to your pretax gain by line, but with some adjustments. You need to replace your statutory increase in reserves with your tax increase in reserves. Mutual company dividends have to exclude the increase in dividend liability. Additionally, there are imputed dividends added back into dividends but which come in again to premiums. These include excess interest and the imputed dividends on term and universal life coverages equal to the difference between the maximum guaranteed premium rate and the premium rate that is charged to the policyholders. Adjustments have to be made for the tax exempts, equity surplus, and capital gains and losses.

MS. GOLDMAN: Mr. Whitley, how does your company allocate its taxes?

MR. WHITLEY: We essentially treat each line of business as a separate company, starting with the GAAP income, estimating timing differences and permanent differences such as fresh start, and so on. We develop a taxable income for each division and apply the 36.8 percent rate to that. There is then a modest differential between the sum of those several pieces and the total previously determined tax. Proportional adjustment takes care of that.

MR. JAMES E. KILMER: One additional factor in the marginal rates occurs if a company has a bit of nonbusiness income; there will be some 46 percent income. Another deviation from the 36.8 percent rate is on the market discount bond accrual; there would be untaxable GAAP income. We accrue that at a 28 percent rate in allocating by line because that accrual will ultimately be at that rate. A loss company wouldn't have a 20 percent deduction; the 20 percent deduction goes only to the gainers, so that loss companies have a 46 percent marginal rate.

MR. WRIGHT: I would have expected the marginal rate on a loss to be dependent upon the year you carry that loss to, and to say that it is worth 46 cents on the dollar suggests the taxable income adjustment doesn't apply to it.

MR. KILMER: I'm talking about our losses in subsidiaries rather than our losses in line. But the 20 percent deduction for the gain company is reduced by the 20 percent that is attributable to that loss company. Thus, for a corporate group as a whole, you have a 20 percent deduction that is based on the whole tentative life insurance company taxable income.

MS. GOLDMAN: Section 809 reduces certain deductions of mutual life insurance companies. Does everyone view that as an add-on tax? Is there some other alternative?

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MR. WEISZ: The intent of the tax law is to view that reduction as part of an equity return to the policyholders; it's an add-on tax. A normal business corporation or stock life insurance company has been taxed on the income before paying any dividends to stockholders, so to the stockholders, there is a double taxation of dividends they receive. With mutual companies, the income used to pay dividends has not been taxed when paid out to the policyholders, and the policyholders have not been paying tax when they received it.

The basis used to measure the equity tax under the 1984 Tax Act, may have been chosen because it's a convenient way to measure the tax, even though it's not necessarily the best way to measure the equity return in terms of the capital invested.

Are there any real equity returns going back to some of the product lines like the group insurance or pension lines, or to individual interest-sensitive products like universal life and single premium deferred annuities (SPDAs)? There really isn't much of an equity return, and the prices of these products charged by stock and mutual companies would be relatively close. Yet, within a mutual company, there has to be capital to support these products, and if there is capital, an equity tax is created.

MS. GUINN: Should the tax be allocated above or below the line? Should it be allocated to operations or to surplus? After talking with a few mutual company actuaries, my impression is that the majority intend to allocate the tax to operations possibly because below the line allocations traditionally have been limited to extraordinary items and for statutory reporting purposes; therefore allocation above the line or to operations might be required. For internal financial reporting purposes, a company might take a different approach. For example, if the company has some free surplus in excess of that allocated to various product lines, it may wish to allocate some portion of the equity tax directly to this surplus, rather than to the product lines.

MR. CARL B. WRIGHT: We determine the surplus needed for each line of business. To the extent that we have a tax on surplus, we allocate that portion of the tax to that line of business. To the extent that we have any free surplus or "management capital" left, we would allocate that tax to that line. This is done above the line because we are looking at the possibility of establishing a corporate line for the surplus that is not allocated to the lines of business. To determine what surplus you are going to allocate to the lines of business, you should look at the risk characteristics of each line and decide how much surplus you need to handle the unusual adverse deviations in your risk.

How are you going to calculate the dividend portion of the excess interest, since you relate it not to the excess over the underlying or minimal guarantee that's in the contract, but to the prevailing state interest rate.

MR. WEISZ: You're only talking about the excess interest on a product like universal life or SPDA. You know what your total interest

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rate is, and you can just split that up. You have to split the products by year of issue in order to determine what the interest rates are, and you can make some reasonable approximation to it. The only real effect on your tax is the effect on the prorating for your tax exemptions.

MR. WHITLEY: We will work off of the reserve amounts and make the estimations.

MS. GOLDMAN: What are some of the considerations involved in allocating surplus for purposes of the equity tax?

MR. WEISZ: If you have measured statutory surplus by line, you might use that. But this may not be anywhere near your risk surplus by line. For example, some lines may be in a deficit statutory surplus position. You could crudely allocate surplus in relation to reserves or assets, maybe with some weighting by premium for group insurance lines, which have a surplus need but virtually no reserves.

MS. GOLDMAN: What types of practical problems have you encountered in allocating surplus?

MR. WEISZ: We've encountered problems with our group insurance lines. My company went into group in the early 1950s. Our group pension reserves are close to half the total company reserves now. Most of the company's surplus was probably generated by the policyholders who are no longer on the books. The majority of the surplus is for the ordinary lines. The group pension surplus is probably somewhat under the amount of surplus needed to be a freestanding organization. In our group life and health lines the products have been cyclical and are trying to recoup their surplus from a deficit position now. So we've got some problems if we try to use the statutory surplus by line. For 1984, we used an approximation for our group lines, and we're moving toward using a risk surplus by line which would allocate a portion of the surplus. Presumably, the rest of the surplus would go into some type of a corporate account. Then for statutory purposes we would have to reallocate that.

MS. GUINN: I'm not convinced there is justification for allocating surplus for tax allocation purposes in a different manner which you would for other corporate financial purposes.

So, how do you allocate surplus in general? There probably are as many different allocation methods as there are actuaries. The two basic camps are those who would prefer to see surplus allocated on an historical basis and those who would allocate it by needs.

The historical surplus for a line is the sum of the gains that it has made over past years. You end up with some lines having much surplus and other lines having negative surplus. If a line has negative surplus, it must borrow surplus from another line of business. It must then produce results to pay back that surplus and pay the tax on the borrowed surplus.

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You could allocate surplus to the various lines in proportion to their need to maintain surplus to support their operations. If you allocate by need, each line would have some surplus because no line can operate without it.

MR. CHARLES D. FRIEDSTAT: Whether or not a line with negative surplus should pay negative tax might be analogous to the issue concerning companies that are part of a consolidated return or intercompany tax-sharing agreements between a mutual company and a subsidiary. If a subsidiary is in a loss position, how is the tax allocated?

MR. WEISZ: On the other hand, you can argue that if a line has negative surplus, it has caused the equity tax of the mutual company to go down, so the corporation, the other lines, and the negative surplus line should all share in that. If every line had that attitude, though, the company would be out of business.

I would allocate a negative tax if the company is in a positive tax paying position. If the company is not paying any tax, it will get a loss carry forward or a loss carry back, and the lines would have to have their negative tax deferred.

MR. CLEMENT B. PENROSE: My company tracks the historical accumulation of surplus by statutory line of business and uses that as a starting point in the allocation of the equity tax among the statutory lines. We then make the adjustments to get to the tax basis equity. We make adjustments in some of our internal management reporting where we report not by statutory line but by strategic business units, and there we attempt to adjust the starting point to required surplus by those strategic business units.

MR. GILBERT W. HART: In addition to taxing this surplus, what else has changed since pre-1984? Almost all companies were using a generation method for allocating investment income, identifying surplus by line of business to allocate investment income and to determine the tax on the line of business after it contained that investment income. If you are now imputing surplus to a line that doesn't have it, are you giving it more investment income on that surplus?

MR. WRIGHT: If you look at a product like SPDA, you immediately have a deficit in your account when you set up the gross deposit as the initial cash value. So we have recognized, as we move toward segmentation of assets, that the asset base going with the SPDA is not its actual fund amount. That is, the net funds available after commissions and expenses are insufficient, so the gross amount credited to the cash value should be held. You have to borrow from surplus, and you need to pay that back with a return. With SPDAs, you must associate the needed risk surplus with that line of business. Since it obviously doesn't have any historic surplus and still may not have any positive surplus because of the rate of growth and the commissions and issue expenses associated with it, it would be (1) borrowing surplus from the general surplus of the company, (2) repaying that surplus, and (3) getting the surplus tax that would go along with that.

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MS. GUINN: In other words, you're allocating the investment income on the assets that you've attributed to the gross fund plus the risk surplus. You allocate that full investment income to the line, but then you charge it back because part of that surplus has been borrowed.

MS. GOLDMAN: Within the major product lines, how can this equity tax be allocated equitably by product?

MR. WEISZ: Are you actually returning and crediting an equity return to your policyholders? If so, you could allocate the tax in proportion to the equity return. You might view an equity return as the return of redundant premium and the balance as equity return to participating life insurance. Should you assign the equity tax only for those durations when you've got positive surplus? If you try that, you may have to wait many years before assigning tax to policies, and much of the surplus may have been created by generations of policies which are no longer on the books.

You could allocate a tax as a charge against the interest earnings, say, of so many basis points, or you could assume that this is another expense like overhead. If you charge the tax within a product line to its surplus, you're giving your products a free ride, but the surplus gets an exorbitant tax. There are some problems on the product allocation considering that some of the products may have little price differential between mutual and stock companies or considering a nonparticipating product, such as GICs.

MS. GUINN: Why allocate the tax within product lines? The only reason would be if you are going to reflect the tax in either pricing or the dividend scale. Simply as an exercise, it doesn't seem worth the effort. In a recent survey we conducted, to which sixteen mutuals responded -- most of them companies with over 5 billion dollars of assets -- all but one reflect the equity tax in pricing, so in practice they must be allocating the tax to product lines. But then you have to define what a "product" is. One definition is that it requires different surplus from the line as a whole.

MR. WRIGHT: About a year ago, I was asked the question, "How are we going to reflect this in our pricing model?" First, we devised a somewhat simpler method. We calculated a marginal tax rate on the gain including the surplus effect, of 37.7 percent. In pricing the product, if we have a negative gain that year, we give the product a tax credit at 37.7 percent. We then charge a tax of 2.9 percent on the initial surplus. In the product development pricing of the product, we charge that tax against the actual negative surplus in there. How then do we reflect this in the fact that the product had to borrow the surplus? Part of the return element that comes out of that product eventually will return that surplus along with the tax on it. In our pricing, we deduct an amount which the product had to pay back, or actually a return of a piece of management capital, which actually was part of its loss in that year. So, over time, these things balance out, but we have reflected them in our pricing of new products. We're trying to determine how to reflect this surplus tax in our dividend scales on our old business.

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MR. WEISZ: Our individual actuaries have put a charge of so many basis points in our dividend scale for all old individual life business.

MR. FRIEDSTAT: Financial Accounting Standards Board (FASB) Technical Bulletin 84-3 talks about the treatment of the fresh start adjustment. Mutual companies are paying a lot more attention to reporting on some basis other than statutory, and deferred tax issues come up in their internal financial statements.

Deferred taxes are established in relation to timing differences. Certain items are reflected in taxable income in a different accounting period than they would be in the GAAP financial statement. Requirements about reserve calculation is the most material item that came out of this Act.

Prior to 1984, tax reserves were generally based on statutory reserves with an adjustment of \$19.00 or, prior to 1982, \$21.00 per \$1,000.00 of net amount at risk. The GAAP basis reserves were generally lower than the reserves on the tax return. Therefore, a deferred tax was set up for the difference in the reserves on a tax basis versus the GAAP basis.

One of the principal changes in the new law is that the difference between the tax reserves at December 31, 1983 and January 1, 1984 was forgiven. The primary issue of Technical Bulletin 84-3 was how to treat the tax effect of the drop in reserves on the GAAP financial statements.

The conclusion might be summarized in four steps. The deferred taxes, which were previously provided on timing differences and were effectively eliminated by fresh start, had to be reflected as a reduction in 1984 Federal Income Tax expense. This isn't reported as an extraordinary item but as a normal item of operating income. Thus, in comparing income statements between 1984 and prior years, there is an abnormal drop in taxes due to the reflection of this in normal operating income.

MR. WEISZ: Was that disclosed anywhere in a footnote? How much of that was a release?

MR. FRIEDSTAT: Yes, the effects of the reversal had to be shown as a separate component of the income tax expense. It was not an extraordinary item shown separately below. It was part of operating income, but there was disclosure. In addition to that disclosure, the reversal originally was supposed to be reported entirely in one accounting period. Because of the timing late in the year, some companies reflected the reversal in the third quarter, but most companies waited until the fourth quarter to show this all in one accounting period. Basically, this was a one-time credit.

Other considered approaches would have spread the takedown of that deferred tax liability into future accounting periods in relation to how those timing differences would reverse. There was also some discussion about freezing the liability, saying in essence that no change should be

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taken into account in future periods. However, this tax law was a change in tax rate, and the one-time credit method prevailed. That is what has been adopted by companies that report on a GAAP basis. In implementing Technical Bulletin 84-3, first you should determine your timing differences -- the difference between your tax and GAAP reserves. Then you have to determine the effective rate that was applied to those timing differences in coming up with the deferred tax liability. Certain timing differences were tax-effected at different rates. An item of market discount might have been tax-effected at 28 percent because that's going to reverse at a capital gains rate. Certain other investment income differences might have been set at the marginal tax rate applicable to the particular company at the time the deferred tax was established. This can be rather complicated for a company that may have taken the position that they were going to be Phase I for a certain number of years into the future and therefore not set up deferred taxes on gain from operations timing differences in all years.

MR. WHITLEY: We had a problem getting a fix on the unamortized reserve timing difference itself as well as the effective rate. We calculated a weighted average rate, total deferred taxes standing and total timing differences, and came up with about 20 percent. It was necessary to account for having a net operating loss. Most of us will revise this calculation this year to get the actual facts.

We are still interested in that original number, December 31 versus January 1. When we're all through, we find that we have four components. A certain amount of fresh start reserve differential is allocable to the net operating loss. We report purchase GAAP so that our fresh start is effectively locked up in purchase GAAP to dribble in. Remaining then is a permanent difference between the GAAP reserve and the new tax reserve.

MR. FRIEDSTAT: There is a cap on what is considered a reversible timing difference according to most interpretations of 84-3. Picture a situation where you start out with your tax reserves at December 31, 1983 significantly above your GAAP reserves. Assume that your January 1, 1984 tax reserves wind up below your GAAP reserves. The amount of one-time credit that you can reflect in your GAAP financial statements is only the difference between your tax reserves at December 31, 1983 and your GAAP reserves. The full fresh start adjustment may not be reflected. That is the permanent difference, and it will roll through in future accounting periods.

MR. WHITLEY: To date in our case, that which affects income in future periods will be much greater than the one-time credit.

MR. FRIEDSTAT: In one case I worked on, we were very close to the cap, but we were able to take the full takedown. In other situations, the one-time credit has exceeded the amount that we were able to take-down.

It's going to vary among companies based on how GAAP benefit reserves were established. Companies that took one position on annuities

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might have vastly different GAAP benefit reserves than other companies. You do not net the deferred acquisition cost asset in the reserves. You compare reserves to reserves, so you could have significantly different treatment of this one-time credit depending upon your GAAP approach to certain products.

Most companies had to deal with another item on this take down related to certain 818(C) issues concerning graded premium products and universal life. This wasn't a problem on the GAAP financial statement just prior to 1984. If you took the position that you were entitled to 818(C) credit for your current tax provision, you set up a deferred tax equal to the difference between your tax and GAAP reserves. Then, at least under a GAAP statement and to some extent under a statutory statement, you had fully reflected a tax provision for this difference.

However, with this take down of the fresh start adjustment, we're no longer in that situation. We eliminate these 818(C) timing differences and companies have to make an assessment about the likelihood of whether, upon audit, they will receive this tax treatment. In some cases, companies shifted part of that deferred tax to a current tax liability. In other cases, companies may have locked up a cushion in their deferred tax provision. Most companies try to take a conservative approach to this so that they will not be faced with a significant effect on their taxable income in future periods. Some companies may have been influenced by the desire to maintain a certain consistency in their reported GAAP earnings from period to period.

MR. WHITLEY: Tax is tax and having provided for it, if you may subsequently need it, it's not desirable to have it in surplus.

MR. CHARLES M. UNDERWOOD II: Our fresh start was limited to two products, neither of which was fully defined by the law, and one of which wasn't fully defined by the ACLI recommendations either. We have to file our tax return before September because we're consolidated. We just came up with another half million of fresh start benefits. Our parent company decided to spread it over the year by factoring it into our effective tax rate. It's always in the same year, so on an annual basis, it fully complies with Paragraph 5.

MR. FRIEDSTAT: We all had to base our fresh start estimate for financial statement purposes on estimates of tax reserves. What happens when we complete our tax return or when we have additional data, and we find out that our estimate of the fresh start adjustment and the deferred tax take down is a little bit different from what we put in the year-end financial statement? Is this a change in estimate or an error?

Except for situations involving a misuse of available accounting and tax information, this is viewed as a refinement of an original estimate. The accounting rules state that this generally would be reported as a change in estimate and would flow through your 1985 accounting period.

An example of an error situation might be that you erroneously assumed how the tax reserve was going to be calculated under the new law.

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But if, estimating the fresh start adjustment, you used all the correct interpretations but just made a poor estimate, and the estimate produced a difference that would flow through the subsequent accounting period, it would not be considered an error. Materiality would obviously enter into the case. Your tax provision is always an estimate, and differences between the actual taxes and the tax provision flow through in subsequent accounting periods. The main thing is, if it is not material, this would probably be treated as a change in estimate and would flow through the subsequent accounting period. I'm not sure what the rules are for spreading it throughout the year versus reflecting it in the period upon which the difference is discovered, but generally unless your situation is deemed an error, you're following the appropriate guidelines.

MS. GOLDMAN: What new GAAP issues were raised by this new law?

MR. FRIEDSTAT: One of the big differences that will have an effect on a number of companies is the look-forward provision. Under the prior accounting pronouncements, companies were allowed to look forward when setting up their deferred tax provisions. Thus, if a company was Phase I and had certain gain from operations timing differences and was able to state that they would be Phase I at the time of reversal for those differences, the company could justify not setting up a deferred tax in relation to those timing differences. Under the new law certain paragraphs of prior accounting pronouncements possibly will be deleted and this look-forward provision will no longer be a part of the act. In other words, you have to do a "with and without calculation." You have to do a tax return calculation based on your GAAP financial statement, see what the differences are and classify them as permanent differences, then tax-effect the timing differences.

This is significant because of the special life insurance company deduction and the small company deduction. With the situation in Congress, it is likely that the 20 percent special deduction may be reduced or eliminated in the future. Another situation is that a company may be a small company for tax return purposes with income of less than 3 million dollars. On its GAAP statement, it might have higher income and have to apply a somewhat higher marginal tax rate in order to compute the tax provision based on GAAP. Basically, most companies are following the concept that you cannot look forward to future periods to see the rates at which these timing differences will reverse. Most companies are now taxed on the gain from operations and are doing a "with and without" calculation without consideration of what the rate will be when these future timing differences will reverse. That's a major change for a number of stock companies that have been able to state that they would be Phase I either in every future year or in a certain percentage of future years.

Many companies also had to consider a provision in the law that described certain conventional coinsurance arrangement which were entered into in 1982 or 1983, and how to reallocate the fresh start adjustment upon recapturing those agreements after the effective date of the new law. If a company knew it would recapture business it had

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ceded in the past, and some fresh start adjustment would be reallocated at that time, should it reflect that now? Again, the absence of the look-forward provision would indicate that you should wait until the actual transaction occurs. Depending on the facts and circumstances and the type of reinsurance arrangement, a company certainly might find it difficult to take a big fresh start adjustment this year and then, if this business is recaptured in a later year, reverse that and reallocate some of that fresh start back to the ceding company.

MR. FRIEDSTAT: The dividend fresh start is not just for policyholder dividends, so it's not for just the stock companies that write participating business. The definition of dividend encompasses excess interest and the conclusion is that there was no take down of deferred taxes. In essence, the liability that was set up at the end of 1983 for policyholder dividends which were deductible in the tax return had no timing difference. However, in future accounting periods, there is going to be a difference in the timing during which the dividend is reflected between your financial statement and your tax return so that difference will come into your deferred tax calculation.

MR. WRIGHT: Does it make any difference if the dividends are decreasing? Your participating business may be going off very rapidly because you are rewriting it into universal life. For example, your apportioned dividends deducted on your 1983 return reflected what you expected to pay in 1984. In 1984 under the old rules, you would have set up the 1985 apportioned dividend, which would have been lower. But now, because of the change in the law, you're going to deduct the dividends you deducted in 1983 a second time. In other words, you are going to actually benefit from the "forgiveness" provision.

MR. FRIEDSTAT: There is a double deduction. I'm sure the IRS is going to scrutinize the amount you established at the end of 1983 because, if that amount was overstated, it would not generate taxable income the next year.

MR. WHITLEY: Suppose you do have a declining dividend, but the whole thing is gone in ten years. Then you'd have an extra deduction over that ten year period, as you've already observed.

MR. FRIEDSTAT: There are some issues about the interplay of operation loss deductions. Assume we have had some prior operating losses which have been used to take down the deferred taxes. We have reflected the benefits and the effects of these tax return operating losses on our GAAP statement, and as a result, we have offset them, at least partially, in the deferred tax liability. We looked at the cap on the reserve timing differences. Also, how much of that deferred tax have you already written off the books because of the reflection of that tax return operating loss?

MS. GOLDMAN: States require that intercompany tax sharing agreements treat each affiliated company as if it had filed a separate return. How do companies accomplish this in their agreements?

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MR. FRIEDSTAT: There is some flexibility, but generally when you have a holding company or a parent company and a subsidiary, the subsidiary is almost always treated as if it were paying taxes to the IRS. In other words, if it was in a tax paying position, it would pay its share of the tax to the parent. If it was in a loss position and on a separate company basis, it could carry back that loss of prior years and might immediately recover that tax. If it did not have prior gains to offset the current year's loss, then generally it would not get credit for that loss immediately. I've also seen situations where a company gets partial credit. To some extent these intercompany tax sharing agreements may be influenced by management's desire to keep cash in the holding or parent company rather than the subsidiary.

MR. KILMER: We would like to see more cash going to the loss subsidiary, so our tax sharing agreement allocates negative taxes to a subsidiary helping the surplus of the loss subsidiary in that regard. We do have to make a specific election in the tax return to do that.

MR. FRIEDSTAT: If you want cash in a subsidiary, you may adopt that treatment. Some companies may find it difficult getting money out of the subsidiary, especially under the prior law where there could be some tax impact on money being transferred as dividends. Certainly under prior law there may have been the desire to keep more cash in the parent company.

MR. TIMOTHY F. HARRIS: Our parent company took advantage of the subsidiaries' tax losses. We didn't reimburse the subsidiaries for their tax losses until they had taxable income, at which point they could have used those tax losses. We felt that we had to do that if the subsidiary's state of domicile treated nonreimbursement as a dividend from the subsidiary to the parent, which then got into some of the dividend restrictions in that state.

MR. FRIEDSTAT: There may be some relevant state restrictions. Even where there are not, the parent company generally acts as if it were the IRS, so it would give money back to the subsidiary because of that operating loss only if it had taxable gains either in prior years or in future years.

MS. GOLDMAN: On the annual statement, would you show zero tax until it's used, or would you show the actual negative tax?

MR. HARRIS: The subsidiary has a tax receivable for the money that we owe them. We have a liability for the money that we owe them.

MR. WHITLEY: That implies a negative tax.

MR. FRIEDSTAT: It implies that you have reflected the negative tax on your financial statement. You're not paying the cash, but you are reflecting it for financial statement purposes.

MR. HARRIS: Is that then the correct way to handle it for statutory statement purposes?

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MR. FRIEDSTAT: The accounting should be consistent with the basis of your agreement. What you describe implies that there might be an inconsistency between the way you're interpreting the operation of the agreement, and the way you've treated it on the financial statement.

MS. GOLDMAN: How does the mutual company handle the equity tax attributable to the life company subsidiaries? Whose tax do you think this equity tax is, the mutual companies or the stock subsidiaries?

MR. WEISZ: You can argue it both ways. The tax law now may discourage mutual companies from buying or owning stock subsidiaries. Prior to TEFRA, there was a rash of activity from mutual companies to either buy or set up new subsidiaries. The stock companies owned by the mutuals have an equity tax, which other stock life companies do not have. This, in effect, means that the mutuals can't issue products any more favorably in the stock subsidiaries than in the parent. In reality, the tax exists for the subsidiary because of both the parent and the subsidiary. It is due to the parent because without being a mutual company and the owner of the subsidiary the tax wouldn't exist. The parent can get around the tax if they own less than 80 percent of the stock of the subsidiary and hold less than 80 percent of the voting power.

MS. GUINN: Suppose that the ownership of the subsidiary was such that the tax was imposed. Philosophically, maybe only participating policyholder business should be assessed with the tax. But it might be simpler to assess the tax to the subsidiary because it will eventually have to pay it. Even if we say that it is the participating policyholder's surplus invested in the subsidiary, the company is going to want the return on that surplus to also include a return for paying back the tax. So one way or another the products sold by the stock subsidiary are going to have to be able to support that tax.

If the subsidiary was overcapitalized and had more surplus than it needed to support its operations, perhaps the tax on the free surplus might be allocated to the corporate line of the subsidiary or the corporate line of the mutual company.

MR. GOLDMAN: Does New England Life have subsidiaries?

MR. WEISZ: We have a couple of stock subsidiaries; one, which is an operating company, we bought several years ago. For the present, we've chosen to keep the equity tax in the parent. But the fact that an equity tax is created is probably going to force the mutual parents to keep minimum capitalization in their subsidiaries to avoid the equity tax.

MR. FRIEDSTAT: Some stock subsidiaries were established in relation to interest-sensitive products, either to help in allocating investment income or because that was the only tax effective way to write some of these products prior to the new tax act. Is there a move to eliminate some of these subsidiaries? The original reasons to establish the subsidiaries may be no longer the predominant reasons, and it may be just as appropriate to have the business all together in one company.

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MS. GUINN: We've talked to a few companies who no longer needed subsidiaries and were looking at what they might be able to get for the subsidiary and its licenses versus certain tax considerations upon the sale of it. Other mutual companies may find that they don't want to sell their subsidiaries because they have other reasons for having the subsidiaries. For example, some companies are using these subsidiaries to write through alternative distribution outlets apart from the main sales force of the parent mutual company.

MR. HART: If you assume that the mutual company will be writing the same amount of business, whether it writes it in the subsidiary or in the parent, is it paying more taxes as a group if it writes the business in the subsidiary?

MR. WEISZ: It's not paying more taxes if it writes the business in the subsidiary, but it is paying an equity tax in the subsidiary. The subsidiary creates an equity tax. It's as if the subsidiary were part of the mutual company parent, not as if it were like other stock life insurance companies.

MR. HART: But moving the business back into the parent won't reduce the tax. Something unfair may have happened in the legislative process.

MR. WEISZ: If you collapse the subsidiary into the parent it would reduce the equity tax because the statutory capital and surplus of the subsidiary is just an investment on the part of the parent. So you reduce that investment; there is no capital and surplus of any subsidiary; and the parent has reduced the equity tax.

MS. GOLDMAN: Doesn't the company still have those assets?

MR. WEISZ: The company has those assets, but it doesn't have the equity tax in terms of its statutory equity on which to build.

MS. GUINN: If you collapse the subsidiary, doesn't capital and surplus of the subsidiary now become capital and surplus of the mutual?

MR. WEISZ: No. Under the equity method of accounting, the value of the subsidiary would be the purchase price plus any good will. If it were paid to the subsidiary, that goodwill would be amortized over a period of ten to twenty years. When the goodwill has all been amortized, the difference between the value of the subsidiary and what's on the subsidiary's books would be the mandatory securities valuation reserve.

MR. FRIEDSTAT: I think for statutory purposes goodwill is determined based on statutory equity. Good will is amortized over a period of years, but I believe that the carrying value on the parent company is going to be not only the original capital and surplus, taking into account the amortization and goodwill, but also the change in equity due to any earnings or losses of the subsidiary. You wind up excluding the amortization of any goodwill. You have statutory capital and surplus as a carrying value, and if that would collapse, the

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surplus is still going to be surplus of either the subsidiary or the parent.

MR. WRIGHT: I'm familiar with one situation where the problem is who gets charged the tax. This particular company has all its group business, all its individual health business, and most of its pension business downstream, and the parent is a mutual company. It is very profitable in its downstream company. Tax is created in the parent company that doesn't belong to the parent. So the individual and participating policyholders are getting hit with one sizable surplus tax that is really attributable to those subsidiaries. It sounds like an allocation problem, but how do you get the tax charged to the source? If you charged the subsidiaries for the tax, you have a dividend. That may be fine now under the new law because you get 100 percent deductibility of that dividend, nevertheless it's an allocation problem. Unless you arrange to have those subsidiaries pay for the tax, it could have a potentially adverse effect on the dividends that you are able to pay your participating policyholders. If you collapse the whole thing in the absence of goodwill, you still have the tax, but at least now you have all the people who are contributing to it at the same place, and you can allocate it to the source.

MR. FRIEDSTAT: While you can't do anything about older products, if this law is going to be around for a while and you're going to keep your subsidiary, you need an overall philosophy because if you're going to push down the tax of the subsidiary, it may be appropriate to account for that in your product pricing.

MS. GOLDMAN: How is passing down the equity tax for statutory reporting consistent with the subsidiary showing tax only to the extent of separate return filing?

MR. WEISZ: It's really not consistent, but Mr. Wright's example shows how unfair it can be to not pass it down. The only solution I can think of would be if there is enough health business in the subsidiary to classify it as a nonlife insurance company or a casualty insurance company. But it couldn't be guaranteed renewable or noncancellable business. You could have other types of individual health and all your group health.

MS. GOLDMAN: Would you treat nonlife subsidiaries differently than you would treat life subsidiaries?

MR. WEISZ: I don't believe that the nonlife subsidiaries create the equity tax. It's only for the life subsidiaries under 809 or 811.

MR. WRIGHT: Is that because you exclude the equity base of the nonlife companies from the calculations, and you only include your life subsidiaries?

MR. WEISZ: Yes, or you sell off 21 percent of your stock life subsidiaries and avoid the equity tax.

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MS. GOLDMAN: Don't you believe if the mutual company did not invest in a life subsidiary, it would have invested in some other type of vehicle which would have created equity within the mutual company? Perhaps the only equity tax that the subsidiary produces is the difference between the annual statement holding value and the equity figured on a tax basis.

MR. WEISZ: The equity does exist for the life subsidiaries. But the parent is going to make a hard decision on whether it really wants to bear this or pass it down to its subsidiaries, effectively charging the subsidiaries for the tax in the return required from them. There is no solution. This may have resulted from some hard and fast lobbying by the stock industry prior to the enactment of the 1984 Act.

MS. GOLDMAN: Can or should the equity tax be handled differently for financial statement purposes than for product development purposes?

MR. WEISZ: You could keep the equity tax in the parent for financial statement purposes in the parent and require that the subsidiary have a higher earnings rate than usual.

MR. FRIEDSTAT: With the mutual companies' growing interest in having internal financial reporting statements, one major goal is consistency between the financial statement and pricing assumptions. If not achieved, it's going to be difficult to see where you're going, and certainly all companies are now giving more consideration in their pricing to federal income taxes.

I have heard the argument that this is just an allocation question. With the increased motivation to try to understand what your earnings are and relate them back even to a product basis to see whether your pricing assumptions are being met, you have to have that consistency.

MR. RICHARD JUNKER: We see a large share of new business being issued on universal life, and in a mutual company it's not participating in the traditional manner. Our traditional participating business is going off the books, and it may be all gone within ten years. Now if we're allocating our equity tax by product line, after five years we may have everything hitting on a small number of participating plans. What will be the allocation of equity when you think of the stock versus mutual distinction? There really won't be any difference in five years between mutuals and stocks if there is no real participating business.

MR. WEISZ: To keep the equity tax on your remaining participating business is totally unfair if that's going to be a dwindling block. As a corporation, you're going to have to absorb that tax some other way. One possibility is to charge it against your surplus, which is not necessarily the best approach. Another is to charge it against all your products; for example, as an overhead expense by taking so many basis points off the investment return you might otherwise credit to the products. Additionally, your universal life products are going to be creating a dividend element under Section 808 of the tax law by the excess interest piece and the difference between the guaranteed premium on term insurance and the rate you actually charged.

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MR. JUNKER: From the government's point of view, as far as a basis for branding mutual companies as being required to pay that equity tax, there won't be any genuine retention by the mutual companies of income that they feel should be taxed. Structurally, the companies are identical after this.

MR. WEISZ: This is a serious problem if this happens for a majority of the industry. The mutual industry will go back seeking tax relief. It's not fair, in the ultimate extreme of your example, if all of your participating business goes off the books. If all but one policy goes off the books, are you going to hit that policyholder with your 2 million dollar equity tax?

MR. JUNKER: Exactly. The whole premise of the tax law falls apart.

MR. MICHAEL R. TUOHY: If Indianapolis Life gets down to one policyholder, I'd like to be that policyholder even if I'm paying 2 million dollars in tax. Basically, I'll own the company. Once I disappear then the company is no longer a mutual and wouldn't have to pay mutual company tax.

MR. WEISZ: Is your universal life totally nonparticipating or really just participating but you pay no dividends?

My company is domiciled in Massachusetts, and we can only issue participating life insurance -- no nonparticipating even through a subsidiary.

MR. TUOHY: The point is who owns the profits from this universal life business? It's the participating policyholders who are left in the mutual company, and you tax them harder because they do not get taxed on the distribution as if they were shareholders. I don't see the argument. You are paying a bit more tax inside the mutual company because the profits are being distributed to policyholders who don't pay tax on those profits.

MR. WEISZ: I doubt that the profits are going to be distributed to the policyholder. They're going to be kept for the corporation in terms of its surplus needs and requirements.

