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FEDERAL INCOME TAXES--INSURANCE COMPANY PERSPECTIVE

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Recorder: AKIVA ZOHAR

Current topics involving insurance companies, such as:

- o Impact on product design
- o Allocation of capital and resources
- o Consolidation
- o Regulations
- o Product design
- o Company structure
- o Proposed or current legislative matters

MR. RANDALL MIRE: We are going to talk about taxation of the life insurance company. A number of panelists will discuss in more detail where the proposals for revision of life insurance taxation stand.

Mr. John T. Adney is a graduate of the Yale Law School. He currently is managing partner for the firm of Davis and Harman. He has worked extensively in the area of life insurance taxation and is one of the top life insurance attorneys in the United States (U.S.). He currently chairs the American Bar Association's subcommittee on life insurance products. He and Mr. Bill Harman were instrumental in obtaining the original Hutton Life Ruling on Universal Life which broke the road block that led to the launching of universal life. He has represented the Stock Information Group in a wide variety of areas. Mr. Adney was instrumental in formulating the legislation on the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the current law under whatever name you call it, the Deficit Reduction Act of 1984 (DEFRA) or Tax Reform Act of 1984 (TRA-84). He helped draft the Section 101(f) or 7702 provisions on the definitions of life insurance and the Section 809 provisions with respect to the Mutual Add-On Tax. He is currently working in a variety of areas on technical corrections and the proposals for revision of the tax law.

* Mr. Adney, not a member of the Society, is Managing Partner of Davis & Harman, Washington, D.C.

PANEL DISCUSSION

Mr. John J. Palmer is a Senior Vice President with Life of Virginia. Mr. Palmer has been heavily involved in the area of life insurance company taxation especially since the proposed revisions that eventually led to TEFRA and then to DEFRA. Mr. Palmer has served on the Tax Steering Deputies Committee on TEFRA and DEFRA, as the Chairman of the Task Force on Section 815, which is the Phase III Tax, on the Company Tax Subcommittee, and as the Co-chairman of the American Council of Life Insurance (ACLI) Task Force on 7702 (the definition of life insurance). He was heavily involved in the Section 809 and 7702 issues.

Mr. Steven W. Fickes recently wrote the Society of Actuaries' study note on Federal Income Taxation. He served on the faculty for the Society's Seminar on Federal Income Taxation and recently wrote the specifications for a microcomputer software program to calculate taxes under the current tax law. Mr. Fickes is heavily involved in a consulting relationship with a number of life insurance companies and related companies primarily in the area of international taxation, both from a U.S. and foreign companies' points-of-view. Obviously, that includes the subject of U.S. company taxation.

MR. STEVEN W. FICKES: In regard to life insurance company taxation, I will present an overview of TRA-84. Before you can be taxed as a life company, you have to first meet the definition, under the new tax law, of a life company. The definition didn't change much from the old tax law, except that now we have a two-pronged definition. Before you can be a life company, you have to be an insurance company. To be an insurance company, a business activity test requires that the activities of your company have to be at least 50 percent insurance related. That doesn't necessarily mean net income. There are a variety of tests such as the number of employees, the percentage of office space allocated to insurance activities and other similar things. Once you qualify as an insurance company, to be a life company, you rely upon the old 50 percent reserve test.

Let's assume we do qualify as a life company and can proceed to be taxed by TRA-84. The first characteristic of the new law is that it's taxation made simple; you simply take this new Life Insurance Company Taxable Income (LICTI) times 46 percent, and that's equal to your tax. LICTI is simpler than under the old law because we now get back to the way we all do our personal income taxes, as opposed to a three-phase tax system. To determine LICTI, you take your life insurance company gross income and subtract from that your life insurance company deductions. A couple of deductions are a little unusual in the 1984 Act as compared to the 1959 Act. First, for increase in reserves, we are using tax reserves, and second, dividends are allowed to be deductible for the first time without limitations (subject only to the mutual company add-on tax). There are other deductions--Section 806(a) and Section 806(b). My names for these are Big SLID and Little SLID, respectively. Big SLID is about to be demised, and Little SLID is going to get a little tinier, and so, after the new round of tax changes, we'll just be left with Tiny SLID.

The Special Life Insurance Company Deduction (Big SLID) is something that is also new. It is 20 percent of the excess of your tentative LICTI over the Small Life Insurance Company Deduction (Little SLID). Little SLID is 60 percent of the tentative LICTI below $3 million. It's phased out as tentative LICTI exceeds $3 million. Little SLID goes to zero by the time you hit $50 million. There are the marginal tax rates; on $3 million of income, you have a marginal tax rate of 14.7 percent which grades up to 36.8 percent for income in excess of $15 million. For those people who want to use Little SLID, there are a couple of requirements. First, you have to be an insurance company of $500 million of assets or less. Second, you count all members of the controlled group. Basically, the controlled group is all of the companies that are 80 percent or more owned by the same parent.

A unique feature of this new tax law is the mutual company surplus tax which was designed to reflect the ownership differential between stock and mutual life insurance companies. In 1984, this tax worked out to be 2.87 percent of surplus. The mutual company surplus tax is based on a differential earnings rate which is the difference between the imputed earnings rate and the average mutual company's earnings rate. The imputed earnings rate was 16.5 percent for 1984, and, in the future, will be indexed to the 50 largest stock life companies. At this point, the companies that make up the 50 largest stock companies have to fill out numerous forms for the federal government. The differential earnings rate in 1984 was equal to 7.8 percent.

We also carry over the old policyholder surplus account from the 1959 Tax Act. This has been frozen at the 12/31/83 levels, and all after-tax income goes into this account. The same limitations still apply as they did under the old law.

MR. JOHN T. ADNEY: I want to focus initially on legislative proposals affecting Section 806(a) and Section 806(b). Section 806(a) provides for the 20 percent Special Life Insurance Company Deduction. Section 806(b) provides for the Small Life Insurance Company Deduction for those companies eligible to take this fairly generous deduction.

In the drafting of proposed regulations at the ACLI, the primary issue raised under Section 806(a) related to a distinction that the statute provides between "insurance business" and "non-insurance business." This is a distinction that you recognize instinctively but that is difficult to define. The drafters at the ACLI task force working on this, in making proposals to the Internal Revenue Service (IRS) and the Treasury on what the regulations might look like, struggled to come up with suggested language. Their proposal would basically provide a broad description and then a list of examples of what "insurance business" is. Everything else would not be "insurance business," the significance of the distinction being that the 20 percent special deduction applies to insurance-related income but not to noninsurance-related income.

The purpose underlying such a distinction was not to add complexity to the law, although that seemed to be a by-product of many things that were done in the 1984 Act, but rather to deny the special tax rate reduction (lowering of the top rate from 46 percent to, effectively, 36.8

percent) with respect to income that was not really related to the insurance business. The deduction was granted principally in order to lower the effective rate of tax on the insurance business, but even as the House Subcommittee worked on the matter and reconciled itself to doing this for a variety of reasons, there was a concern that, by granting this special deduction across-the-board regardless of the source of income, insurance companies would become umbrella organizations for "the whole world." Thus, rather than banks consuming insurance companies, insurance companies would try to consume banks and practically everything else in order to get the benefit of this special deduction. So this distinction was written into the law, and it's hard to say how it is going to be handled. I would guess that most people would be tempted to decide that profitable business is insurance related, while most deductions and losses aren't insurance related.

In this area, as in many, it will be a number of years before we see anything coming out of the IRS by way of broad regulations giving us further guidance under the 1984 Act. There are going to be some exceptions, but this area is not going to be one of them. The Small Life Insurance Company Deduction has the same kind of distinction written into it, and in addition, there are special affiliated group rules that could require some greater elaboration as well.

However, the thing that we are most focused on in Washington is not how to interpret those provisions but rather how to save them. You might think that an item enacted into the Internal Revenue Code in July of 1984 would not have been proposed for repeal by the Administration as early as November of 1984, but both the Special Deduction and the Small Company Deduction were proposed for repeal in both the November 1984 Treasury Department recommendations to the President and in the May 1985 presidential recommendations to Congress on tax reform.

Congress has already held extensive hearings on the president's tax reform proposals. The Ways and Means Committee is now proceeding with a markup of the proposals, and it is indeed a slow process. What has been coming back from the Committee staff is a set of options laid before the Committee which would, among other things, repeal the Special Life Insurance Company Deduction and severely restrict the availability of the benefit under the Small Life Insurance Company Deduction. Basically they are proposing to make the Small Company Deduction available to companies that have less than $100 million in assets, rather than $500 million in assets (affiliated group wide). Then they would cut the deduction back from 60 to 50 percent and make it not of the first $3 million of income but of the first $1 million of income, phasing it out at $5 million (rather than $15 million). So, it is a cutback at practically every turn for this deduction.

The Special Deduction is proposed for repeal in the context of an overall proposal which could lower the general corporate tax rate to a point below what life insurance companies would have as their top nominal rate with that deduction. Under current law, with the special deduction, that rate is about 36.8 percent. The Administration is proposing that all corporations have a maximum rate of 33 percent. Under the Ways and Means options list prepared by its staff, that rate is 35 percent. I suggest that we will see an upward creep in that rate as time goes along, but how much further up it will go I am not sure. I do think it has some natural limits if there is to be a tax reform bill at all.

Because of the proposed general rate reduction, the thought underlying the staff option was that the Special Deduction was no longer needed to serve its original purpose. That purpose was to limit the overall tax burden on the insurance industry based on certain historical trends and in light of the fact that competitors of the industry--banks, property/casualty companies, and other institutions--have enjoyed very low effective tax rates, and that some competitors have even been totally tax-exempt, namely, fraternal companies and Blue Cross/Blue Shield. Now, under the options being considered by the Ways and Means Committee is a general corporate rate that is below 36.8 percent and with proposals to tax Blue Cross/Blue Shield, to tax fraternals, to raise the tax burdens of the property/casualty insurance industry, and to give the banks their "day in court" so that, for the first time, they will effectively begin paying substantial rates of tax. The Special Deduction, I think, was striking staff and members alike on the Hill, as something that could be dispensed with. The industry doesn't see it that way; perhaps the industry doesn't really believe all of this is going to happen.

In any event, there is a fight proceeding in Washington to save the Special Deduction. I don't know how it is going to come out, though I don't have a lot of hope that Special Deduction will be fully retained, and I think you have to ask yourself, in light of everything else that is happening, whether that is an adequate result. An even larger fight is ensuing to preserve the Small Company Deduction because the effect of its repeal would be far more drastic. Small companies, in many instances, would see more than a doubling of the amount of tax paid. There are over 200 companies in the category of losing this deduction under the proposal that's before the Ways and Means Committee. We are going to see a lot more fighting over that before everything is finished, and I would rate the chances of preserving that deduction as considerably better than those of the effort to save the Special Deduction.

The proposal to repeal the deduction for life insurance reserves seems dead. This deduction has been in the tax laws since time immemorial. The Administration has proposed basically to eliminate it (a resurrection of a proposal that was offered by the Treasury in 1983). The only thing that would have remained as a deduction was the increase in cash values under policies, if any, during the taxable year. This exception was included because life insurance policies, under the Administration proposal, were being viewed as bank accounts, and banks would not have had that increase as income (so neither should life insurance companies). Overall, this proposal was met with considerable skepticism on Capital Hill, primarily because Congress had just decided the contrary in 1983 and 1984. The 1984 Act introduced many rules to regulate the size of the deduction for life insurance reserves. The proposal to totally repeal this deduction struck the members and staff of the Ways and Means Committee as odd, and this has been reflected in the fact that the staff option pending before the Ways and Means Committee is to leave that deduction alone.

That is not to say that no part of the reserve deduction would change. There are proposals to change the taxation of property and casualty insurance companies that could have a spillover effect if certain of those proposals are adopted. The spillover on life insurance companies would primarily be in the area of accident and health insurance reserves, since these are frequently not treated as life insurance reserves but as unearned premiums or unpaid losses for tax purposes. If certain things are done, such as the proposal in the staff options to institute in 1989 a modified form of cash-basis accounting for claims, these would undoubtedly have a spillover effect on life insurance companies. I understand the property and casualty industry is working hard to avoid that result. We hope they will succeed.

MR. JOHN J. PALMER: There is quite a variety of sources of information on how to comply with the law to which you can look for guidance. These include the statute itself (DEFRA); the Congressional history (Senate, House, and conference committee reports); the DEFRA General Explanation ("Blue Book"); the Technical Corrections Act, of which a draft was released earlier this year; and a description (released as recently as September 25, 1985) of some proposed amendments to the Technical Corrections Act. There are also rumors about still further changes in the Technical Corrections Act. Ultimately, we presume, there will be regulations under the insurance provisions of DEFRA which will answer additional questions. All of the currently available sources are not unambiguous in the directions they give you.

The ACLI has been working since the law was passed to assist in the preparation of regulations. They have an elaborate structure of task forces, arranged by code section, to develop proposed regulations and to hold discussions of issues involved. Following their work would be instructive, at least in the sense of identifying issues that might have escaped you in your unaided reading of the law. It also shows you what kind of outcome you might expect, although it is to be understood that the ACLI will have something of an industry bias in the interpretations that it puts out. You would probably be unwise to accept an ACLI-developed position as being a clear guide as to what will eventually happen.

For actuaries, the biggest problem in the law is the recalculation of the reserves on what's come to be called the federally prescribed minimum reserve. The general idea is that this is to be the least reserve that the state requires you to set up--it's to be your tax reserve. This involves reference to prevailing state interest rates, prevailing mortality tables, and other tables. The ACLI sent a letter fairly early to the Treasury Department giving the results of its archeological research into what particular tables and rates applied to what particular blocks of business. This letter was dated October 4, 1984; many of you probably have seen it because the ACLI circulated it as a General Bulletin. The ACLI suggested that it was a matter of some urgency for the government to promulgate the results of this research so that companies could have some guidance as to how to fill out their 1120L's for 1984, and now their 8390 information returns.

Unfortunately that hasn't happened yet. I am told that a Revenue Ruling should be along shortly which should contain most or all of the points as they were expressed in the ACLI letter. But, of course, I assume that most of the people have already made some sort of a decision as to how to calculate their reserves. Included in the letter are not only the actuarial research matters but also some recommendations of tables where there is no clear state specification.

One of the unusual issues that has recently been raised is this question of which table prevails. The law says that one should use the most recent table prescribed by the National Association of Insurance Commissioners (NAIC) and permitted by at least 26 states. This was probably done within the context of life insurance, where "most recent" means lower mortality, which means lower reserves. In the case of annuity tables, it isn't necessarily the case that you get lower reserves with more recent tables. There is a possible interpretation that the 1983 annuity tables have been prescribed, in some sense, by the NAIC (although not yet adopted by 26 states as a mandatory minimum standard), so the argument goes that since a state will generally allow you to hold higher reserves, a 1983 annuity table reserve would then be permitted by a majority of the states. This point has been noted by the government, and we may find some addressing of it sneaking into the Technical Corrections Act or emerging in some other form, so I wouldn't rush off to do it that way assuming that you have put one over on them. ACLI draft regulations on all manner of reserve issues are fairly close to the point of being sent forth to the government. Generally they track the law closely, although they take a few liberal interpretations, where possible. For example, they take a fairly liberal view of the ability to group reserves for different contracts for the purpose of making the mandatory comparisons to cash values and to statutory reserves.

One set of issues has to do with qualified supplemental benefits and qualified substandard risk reserves. A supplemental benefit applies to a basic contract (such items as accidental death, guaranteed insurability, and so forth). The law permits you to use a statutory reserve rather than a federally prescribed calculation in getting the amount of the reserve for a supplemental benefit. It also allows you, if the benefit is also qualified, to make the comparison of the base policy reserve against the cash value without having first combined the base policy reserve with the supplemental benefit reserve. This can produce a higher total reserve for the contract if the base policy reserve plus the supplemental benefit reserve is less than the cash value. The conditions for a supplemental benefit being qualified are (1) that there be a separate charge or premium for the supplemental benefit and (2) that the benefit not be funded by the cash value of the base contract. The ACLI draft takes a fairly aggressive view of what these conditions mean. With respect to the question of whether a premium is separately identified, the normal method of judging would be to see whether you have a separate premium for the rider. The ACLI's position goes still further and provides that, if you can find in the internal records of your company an indication that there is an extra cost associated with the benefit, this would be sufficient justification for the charge being considered as separately identified.

On the question of whether or not the cash value is available to fund the supplemental benefit, the ACLI draft would suggest that having an operable automatic premium loan provision would not cause the benefit to fail the test. In other words, you could use an automatic premium loan to pay the premiums (including the rider premiums) and not have the contract be treated as funding the supplemental benefit out of the cash value.

The supplemental benefits are defined to include guaranteed insurability option, accidental death, disability income, waiver-type disability income, and convertibility benefits. The law provides for the Treasury Department to be able to add anything else they want to to this list. The ACLI draft suggests that any other supplemental benefit would be supplemental for tax purposes if the tax benefit of qualified supplemental benefit treatment were de minimis (if the benefit were supplemental to a Section 807(c) reserve contract and if the event insured against in the rider was different from the event insured against under the base contract). Thus, a term rider on the same insured as covered by the base contract couldn't count as a qualified supplemental benefit. I think the ACLI is also moving toward taking the position that paid-up additions would be treated partially as qualified supplemental benefits, that is, for the purpose of the aggregation for testing against cash value. The argument is that the tax effect is de minimis, and the cost of complying (the cost of relating reserves for paid-up additions to the base contract reserves before making the test) is prohibitively high.

On the similar provision dealing with qualified substandard risk reserves, the basic issues about aggregation are the same. The conditions are (1) that one must have a separate reserve maintained for the extra risk, such that a separate premium be charged for the extra risk, (2) that the net surrender value of the contract not be greater or less on account of the presence of this extra risk, and (3) that the net surrender value not be available to pay the premium for the substandard risk. Here again, the question is what is a separate charge? And a further issue, what is a separate reserve? The ACLI's position seems to be that internal working papers of some sort would again be sufficient to justify the separateness of the reserve and the separateness of the charge. Thus, if one could show that a standard risk reserve was smaller than the reserve on the contract with the extra risk, then there would be a separate reserve for the extra risk. I suggest that these positions are relatively adventurous, and I wouldn't assume that they are going to come to pass.

There are a number of questions relating to reserves arising with respect to variable contracts, particularly variable life. Here I can only note their existence. The Net Surrender Value is to be computed with regard to charges made on surrender but without regard to adjustments for changes in market value. For variable life, this means probably that the adjustments for market value changes have taken place prior to the date of surrender and that, therefore, they are not relevant at the time of actual surrender.

The question of minimum reserve standards for variable contracts generally are somewhat up in the air. How the Commissioners Reserve Valuation Method (CRVM) and the Commissioners Annuity Reserve Valuation Method (CARVM) applied to a variable contract seems to be fairly ill-defined. The task forces in that area have referred the matter to the ACLI's Actuarial Committee to try to obtain clarification on what exactly CRVM and CARVM mean with respect to variable contracts.

The question of whether or not the reserve for guaranteed minimum death benefits is a tax reserve is being raised again. There was a somewhat negative private letter ruling on the subject, but some people are of a mind to make another run at that issue.

While the interest rate and the mortality table require adoption by 26 states to become effective for computing tax reserves, the prescription of a reserve method by the NAIC takes affect immediately upon promulgation. No states need to actually adopt it. Thus, to the extent that the NAIC changes the definition of CRVM, for example, that change then becomes the tax standard. Last year there was an effort to change the reserve to provide for some prefunding of cash values in excess of calculated reserves--the so-called Sarnoff proposal. This year the NAIC's Actuarial Task Force seems to be making an effort to redefine standard valuation and nonforfeiture laws for universal life. To the extent that it succeeds in that, the definition of CRVM for universal life will change as will the tax reserve calculation for universal life.

MR. ADNEY: The rules of Section 808 of the Code define "policyholder dividends" for tax purposes and provide for the deduction of dividends or, in the case of mutual companies, a limited deduction for dividends.

In regard to the Technical Corrections Act, when any major tax bill works its way through the Congress, DEFRA being no exception, there are numerous technical errors made, or changes of heart as the case may be, on the part of the staff and some members. Another bill rises to correct such errors as are perceived to exist. The changes made by this bill do not necessarily involve a rethinking of policy matters but rather the closing of holes, polishing of the rough edges, and so on. This is the technical corrections bill. On September 27, 1985, the Ways and Means Committee approved what is known as the Technical Corrections Act of 1985, to be sent along to the House floor. The Senate has not done anything yet with the Technical Corrections Act. What is proposed for technical corrections will show up as a title of the tax reform bill that is to be reported out by the Ways and Means Committee. If no tax reform bill is reported out, then presumably the technical corrections portion will be broken off from that process and begin to surface as a separate matter to be moved on through, though we are not likely to see enactment of the Technical Corrections Act with or without the tax reform bill, until sometime in 1986 at the least.

Section 808, in defining a policyholder dividend, now treats excess interest as a dividend. It incorporates a definition of excess interest that some have said could be read to state that, if a contract provides for excess interest, then every dime of interest credited under that contract, whether or not it is guaranteed, is excess interest and was, therefore, a dividend. This is not particularly important except for the proration formula, but in that context, this potential reading of the statute could result in double counting for proration purposes. The Technical Corrections Bill would straighten all that out in confining excess interest to be indeed just interest in excess of the "prevailing state rate."

In addition, Section 808 would be amended by the Technical Corrections Act to deal with an interesting situation that arose on the 1984 legislation with respect to the declaration of policyholder dividends. The 1984 legislation provided for a "fresh start" for policyholder dividend reserves as well as for life insurance reserves. The fresh start was that one need not take into income the difference between one's dividend reserve at the end of 1983, which presumably was being deducted for tax purposes, and the accrued dividends for 1984--accrued being the new test for dividend deductibility beginning in 1984. The technical amendment was prompted by the fact that some companies were beginning to change practices in their declaration of policyholder dividends. For example, there was an attempt to go beyond the fresh start and to get a little bit more by changing the date that dividends would be accrued on policies. By accelerating the dividends to enhance deductions, some companies sought to obtain tax benefits far beyond those which the Congress thought would be there.

Section 808, as would be amended by the Technical Corrections Act, provides that if business practices are changed to accelerate the accrual of dividends, there will be no such additional benefit. Under the Technical Corrections Act, if the accrual date of dividends on policies issued before 1984 is changed such that there is an acceleration of the deduction on the tax return, then there will be no additional benefit to that extent because that portion of the fresh start for dividends will simply be taken back; it will be lost _pro tonto_. This was a device largely to protect the revenue.

MR. PALMER: Proration of tax-exempt income was present in the 1959 Act, and it is carried over with some changes into the 1984 Act. It works in somewhat the same way as the proration formula did in the computation of policyholder/company share in the Phase II Gain from Operations calculation under the 1959 Act. It's based on the required interest using reserve rates and amounts actually credited. There are some changes, however. There is a change in computing the net investment income. To calculate the company share, rather than go through an elaborate set of conversations with your IRS auditors about what is an investment expense and what isn't, the 1984 Act took the view that investment expenses were 10 percent of gross investment income so that net investment income is 90 percent of gross investment income.

The Act also expanded the definition of the policyholder interest requirements. Policyholder interest is now the required interest on reserves, the deductible portion of excess interest and the deductible portion of amounts in the nature of interest, whether dividends or not, credited to policyholder or customer funds and a portion of policyholder dividends, excluding from dividends for this purpose amounts previously counted as policyholder interest and excluding amounts of premium or mortality charge adjustments on contracts with excess interest. In other words, the phantom cost of insurance deductions or other items of that nature are excluded. A fraction of the policyholder dividend is used to reflect the assumption that policyholder dividends can constitute a mechanism for paying interest back to the policyholder. That fraction is a so-called mini-fraction, and there is a formula for computing that as well. In passing, policyholder interest clearly includes interest on deposit funds, where the depositor is in the nature of a customer rather than a creditor; that is, the law now ignores the distinction that might have been present in the old law between, say, pension funds with permanent annuity purchase rate guarantees and those without permanent annuity purchase rate guarantees. It doesn't matter if the depositor is not a genuine lender: the interest credited to him counts as policyholder interest for this purpose.

There is also a provision in Section 805 which deals with deductions generally that has some bearing on this. In general, a 100 percent dividend (that is, an intercompany type of dividend) is not subject to proration. But there is a special rule that tries to avoid the possibility of running tax-exempt investments into a subsidiary and then passing the results up through a nonprorated 100 percent deduction to the parent. This rule calls for identifying that portion of a subsidiary dividend which arises from tax-exempt investments and then prorating that 100 percent dividend to the extent that the dividend arose from those sources. This is done by a fairly complex mechanism looking to the earnings and profits of the subsidiary that give rise to the dividend.

While that sounds elegantly simple, there were a few loose ends that the Technical Corrections Act tried to address. It makes it particularly clear that amounts left on deposit are to be treated as producing policyholder interest. It also attempts to deal with the case in which the tax reserve is not the federally prescribed reserve, i.e., the reserve calculated on the prevailing interest rate. Rather it could be the cash value or it could be the statutory reserve, if the statutory reserve cap is in effect. The Technical Corrections Act calls for using some other appropriate rate in those cases, rather than the prevailing state assumed rate. It also further refines the definition of net investment income, that is, the 10 percent assumption for investment expenses. In the case of segregated asset accounts for variable contracts, it stipulates a 5 percent assumption. Some companies argue that we ought to use the actual investment expenses because they are fairly well exposed. There should be no problem using actual expenses, unless the government wants to stick with an audit-proof type of assumption such as 5 percent. This works a particular hardship on segregated asset accounts that invest in unit investment trusts. But perhaps there are some high-expense separate accounts, such as real estate, where it works to the benefit of the company.

Beyond this, there is still a question about the 100 percent dividend and the tracing of the source of dividends from a subsidiary, in the case where the subsidiary is a life insurance company (which presumably has already done a proration calculation before it delivers its dividends). If you were to then prorate that life company's dividend again, you would have, in effect, double proration. If you did no proration, then there would appear to be some manipulation opportunities, such as putting all tax exempts into the subsidiary to take advantage of a much more favorable company share in the subsidiary. A possible solution might be a combined proration percentage applied to both. I think the likely outcome is going to be something like providing that the dividends of the subsidiary will not be reprorated except to the extent that the proration at the subsidiary level is more favorable than the proration basis at the parent. This is something that may emerge in technical corrections or in some later form, but it is an issue that is being looked at and may well result in some action shortly.

MR. ADNEY: The Blue Book, from December 1984, suggested that loans from subsidiary life companies up to their parents could trigger Phase III tax distributions. The Phase III tax under the 1959 Act still applied to stock life insurance companies; the Phase III accounts are still maintained. Under the Blue Book interpretation, loans could very well be treated as distributions triggering the tax. That was an interesting piece of news, though I think the stock companies felt that that was somehow not part of the famed Stark-Moore Agreement that led to the 1984 Act. The result was that they asked the Congress to include in the Technical Corrections Act a provision saying that this interpretation wasn't so. As a result, the Technical Corrections Act says, as approved by Ways and Means, that loans are not indirect distributions triggering the Phase III tax provided that they are bona fide. It also says that even loans made bona fide before enactment of the Act are not indirect distributions. Exactly what they are, no one knows.

Another matter under the Technical Corrections Act relating back to the definition of a life insurance company is the treatment of deficiency reserves. The 1984 Act specifically put deficiency reserves back into the fraction for testing qualification of a company, but it appears that was all done quite by accident, partly as a result of the deletion of an old definition of deficiency reserves. It's good news that the Technical Corrections Act, without defining deficiency reserves, takes them back out of the life company qualification fraction, leaving the situation as it was under the 1959 Act.

Section 809 of the Code is the special set of provisions dealing with the mutual company tax. These are sometimes called the ownership differential provisions, which limit the deductions of mutual life companies for dividends and reserves so as to assure that there is at least a minimum level of tax on mutual company operations.

In order to put Section 809 into effect, the IRS issued Form 8390 and gave companies about two months to fill it out. It is a complex form, although, in all fairness, companies were on notice of its contents before the two-month period started. The form requires a lot of complex data to be reported for purposes of making Section 809 work.

The Form 8390 must be filled out by the top 50 stock life insurance company groups, presumably with one member in each group taking the lead (that is, there is an affiliated group filing rule). In addition, all mutual companies must file this form. The stock companies must fill out the form for 1981, 1982, and 1983--the so-called base period years--if they were part of the top 50 stock affiliated groups at that time.

All of these companies must file these forms to report data relating to stock company earnings and mutual company earnings, as the case may be, so that the Treasury Department can promulgate a figure known as the differential earnings rate, which is the difference between the average mutual company earnings rate as defined in the statute and an imputed earnings rate deemed by the statute, as indexed. The latter is the rate that mutual companies, as a group, are held to in determining their profits for federal tax purposes.

To put the matter in perspective, Section 809 works in this way: Each mutual life insurance company has its deductions for dividends and reserves cut back by an amount known as the differential earnings amount. That amount is computed from its equity base, which is somewhat like generally accepted accounting principles (GAAP) equity for stock insurance companies, but it is not GAAP equity. The need for this computation reflects the fact that mutual companies are being put on a stock-like model for tax purposes. Technically, the equity base equals surplus and capital plus the excess of statutory reserves over tax reserves, voluntary reserves, and various other items.

This equity base is then used to determine the company's tax by multiplying it by the differential earnings rate, which yields the amount of the dividend and reserve deduction cutback. The components of the differential earnings rate are determined segment-wide for both stock and mutual companies. The segment-wide rate relating to stock companies is the imputed earnings rate, a figure put into the statute at 16.5 percent for 1984, and this is indexed for later years with movements in the profitability of the top 50 stock life insurance company groups. The need to determine this index is the reason why the top 50 stock groups have to fill out the Form 8390. The differential earnings rate is that imputed rate minus the aggregate average mutual company earnings rate for the whole mutual segment. The mutual rate is determined by finding out, largely on an annual statement basis, what mutual companies earnings are as a percentage of their equity, for example, what is the mutual segment's aggregate gain from operations, before taxes and after dividends, expressed as a percentage of the segment's aggregate equity.

That rate is subtracted from 16.5 percent (as indexed), and the difference is then multiplied by the equity base. This is the differential earnings amount, the limitation on deductions, sometimes called r add-on amount.

MR. PALMER: Obviously the biggest problem with doing the information return is the recomputation of reserves. One basic step is to substitute tax reserves for statutory reserves in computing the earnings rate. For those stock companies fortunate enough to have been tapped as one of the top 50, this involves a recalculation of reserves on the newly defined tax basis. In order to get the increase in reserves for 1981, it will be necessary to recalculate reserves as far back as the earliest point, 1980. This was a very heated issue between the stocks and the mutuals as to the degree of precision that would be required in doing these calculations for back years.

Stocks argued that because of the physical impossibility, that is, lost records, what records there were not being in machine-accessible format, inordinate cost, and so on, they were unable to recalculate the reserves precisely. The mutuals were concerned over unauditable approximation calculations made by stocks who were interested solely in getting the return out and/or raising the mutuals' taxes. The current form and instructions represent the final compromise on all these issues. They call for a display of the tax and statutory reserves in various cells by product category and subcategory. The intent appears to be to allow the IRS to do a desk audit, in effect, by examining how the ratios of tax to statutory reserves change over time, for what are presumed to be homogeneous cells, so as to detect any anomolies or manipulation that might have occurred. The form calls for exact calculations, meaning as exact as you did your 1984 reserves for 1120L purposes. For the base period, you can use approximations, but you have to show that exact calculations are not possible or are inordinately costly. There is a standard approximation technique prescribed which uses the ratio of year-end 1984 tax to statutory reserves as a ratio to apply backward to statutory reserves for the previous years. This would have to be adjusted if you had made a change in the statutory reserve basis for some cell during those periods. The standard approximation is bound to be wrong, in general; that is, it's wrong to assume that such a ratio will be constant for the entire duration of the contract. Therefore, it's somewhat wrong for a four- or five-year period. It may be a relatively small error with respect to total reserve, but it could be a relatively much larger error with respect to increase in reserves in a particular year.

Why not use the 1/1/84 ratios? I think the mutuals felt that the 1/1/84 reserves as recalculated would be perhaps distorted because of fresh start recalculation motivations. They prefer the 12/31/84 even though this would have the result of producing an estimated 1/1/84 reserve that is different than the one actually calculated for other purposes. A company is actually able to use an alternative approximation if its accompanied by an actuarial certification that the alternative method of approximation is free from bias and if it's able to demonstrate why this alternative approximation is preferable to the standard ratio approximation. This option flows from an argument that stock companies had made for relying on the actuary, in general, to make approximations.

The mutuals didn't go for this. One of their papers asserted that the professional standards of actuaries generally offer no more or less protection against inaccurate computation of reserves than the protection offered by the professional standards of lawyers, accountants, or other preparers of life company tax returns. If you make an alternative calculation, the IRS will then be in the position to make its own pick, behind closed doors, as to which particular calculation of reserves it will use. It's worth noting that the IRS doesn't have any extra staff to cope with the added burdens of the 8390 reporting. Thus, I suspect, they will rely heavily on this desk audit process. Talking to some of the IRS people who will actually be doing the auditing, it seems clear that they will tend to accept ratios that look normal and tend to question ones that don't. In spite of this, I suggest that you might want to examine closely the degree to which the standard approximation is appropriate. The error can be significant. Also consider that, because of the arithmetic average calculation for the stock companies, the smallest of the 50 stock companies weighs in just as heavily as the largest of the stock companies. That is, 2 percent of its rate goes into the final rate.

Another significant issue besides this calculation is voluntary reserves. Voluntary reserves are to be added back to equity base. The form asks you to describe anything you think is nonvoluntary other than the basic Section 807(c) reserves, the policy dividend reserves, and the deficiency reserves, and describe it in sufficient detail to allow the IRS to judge whether it's voluntary or not.

Capital gains and losses on a realized statutory basis are to be added into the statement gain for purposes of computing their rate. The final issue, which is still outstanding as reflected in a letter from Secretary Pearlmen at the Treasury as of October 8, 1985, providing additional instructions for 8390, has to do with the treatment of accrual of market discount. The question is whether statement gain, which on a statutory basis includes accrual of market discount, should be adjusted to remove that accrual of discount for purposes of this calculation. The stocks suggest the accrual of discount should be removed; the mutuals suggest it should be in or, it it's taken out, that the equity base should be reduced by the aggregate amount of accrual of discount on the books. The supplemental instructions in the October 8, 1985, letter ask each company to provide information sufficient for the IRS to make the calculation either way. That is, to do a computation with and without accrual of discount and to provide information about the aggregate amount of accrued market discount unrealized to date so that the IRS can factor that in if it wishes. This is an issue which will be settled at some time before February 15, 1986, when the ultimate rate should be promulgated.

MR. MIRE: The proposed changes in the law differ from the current situation and the recent past, and this is going to affect the pricing and competitiveness of individual life insurance products.

These five different patterns represent the five different tax acts: The 1959 Act (which is what was being used in the early 1980s), TEFRA (the immediately prior act), the current act (DEFRA or TRA-84), and the two major proposals in effect right now (the so-called Treasury II or Reagan I approach and the Ways and Means Committee proposal that has been dubbed Rosky I after Congressman Rostenkowski).

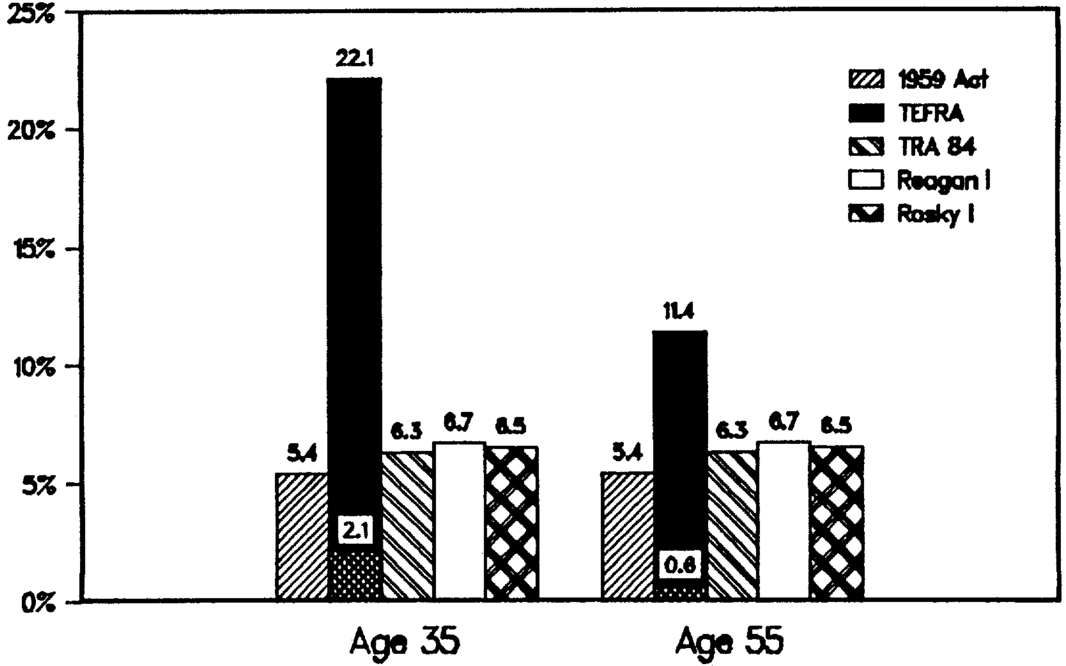
The first example (Slide 1) is a universal life policy, which is probably the most popular product being sold. This product is for ages 35 and 55. We've got a standard universal life product which has been priced to yield a 10 percent profit margin on a pretax basis. By profit margin I mean the standard technique used by most stock life insurance companies; i.e., you take the present value of future profits and divide that by the present value of future premiums arriving at an average percentage of profits in the premiums. These products have been priced at 10 percent pretax; we've then assessed taxes against them to arrive at an after-tax profit margin. Under the 1959 Act, we used what I would call basic pricing (the method used by most stock companies at that time), which was to assume no Section 818(c) deduction and no policyholder dividends being paid, basically resulting in a 5.4 percent after-tax profit. Under TEFRA, we had a wide variety of unresolved tax issues. Slide 1 represents a range of profitability anywhere from 2 percent under a worst scenario up to 22 percent under a best scenario. If everything goes right, you make a lot of money, and if everything goes wrong, you have a huge loss. Most companies probably thought they were up in the middle area, somewhere so as to cause profitability. Today, that same product would now be at a 6.3 percent profit margin. From the two current proposals, there would not be a lot of change--either 6.7 or 6.5 percent. At age 55, there are similar results. This is for a stock company which is in tax situation A under the 1959 Act; that is, it is taxed on gain from operations.

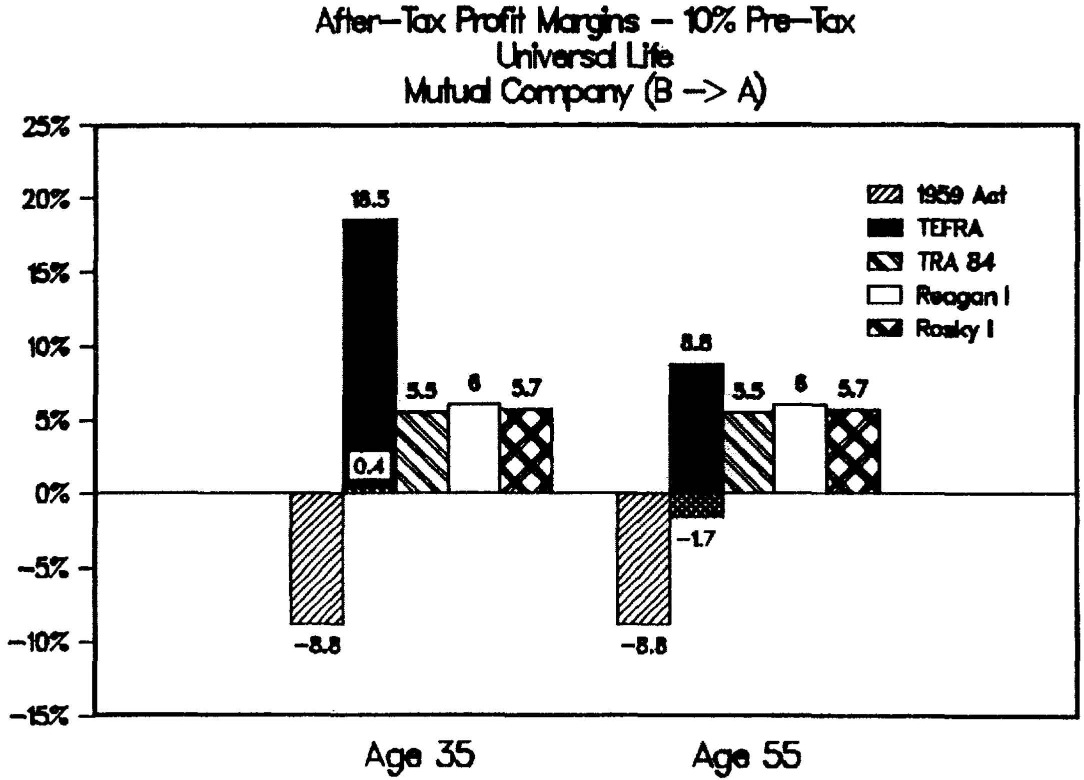
Looking at exactly the same product, priced exactly the same way, by a mutual company, under the same five Acts (Slide 2) was done for consistency and comparative purposes even though mutual companies don't price this way. Under the 1959 Act, the mutuals had a bit of a problem; a 10 percent pretax profit became an almost 9 percent after-tax loss. This is why the mutuals were so adamant and why they couldn't sell universal life. TEFRA solved most of their problems, getting them up, once again, in the range of break-even to almost a 20 percent gain, depending on their perception of those unresolved tax issues. The only difference between the mutual and the stock companies here was the add-on tax. How that's assessed against new business is in the mind of the mutual company actuary. A fairly common approach is to assume that there is a target surplus goal (in this particular case, target surplus was equal to 7 percent of reserves), so we assumed that the mutual company pricing actuary has allocated surplus equal to 7 percent of reserves and assessed that tax against the product and that cost is reflected in these numbers. Once again there are no major changes under the current situation or under the two proposals. For age 55 there are similar results.

Those models were for big companies; Slide 3 shows a small stock life insurance company. Throughout this discussion, our definition of small is what would qualify for full deductions under all proposals, that is, $1,000,000 of revenue and $100,000,000 of assets. Under the old laws, there was no difference from the big company case. Under the current law, there is an 8.5 percent after-tax profit margin. Remember, that

SLIDE 1

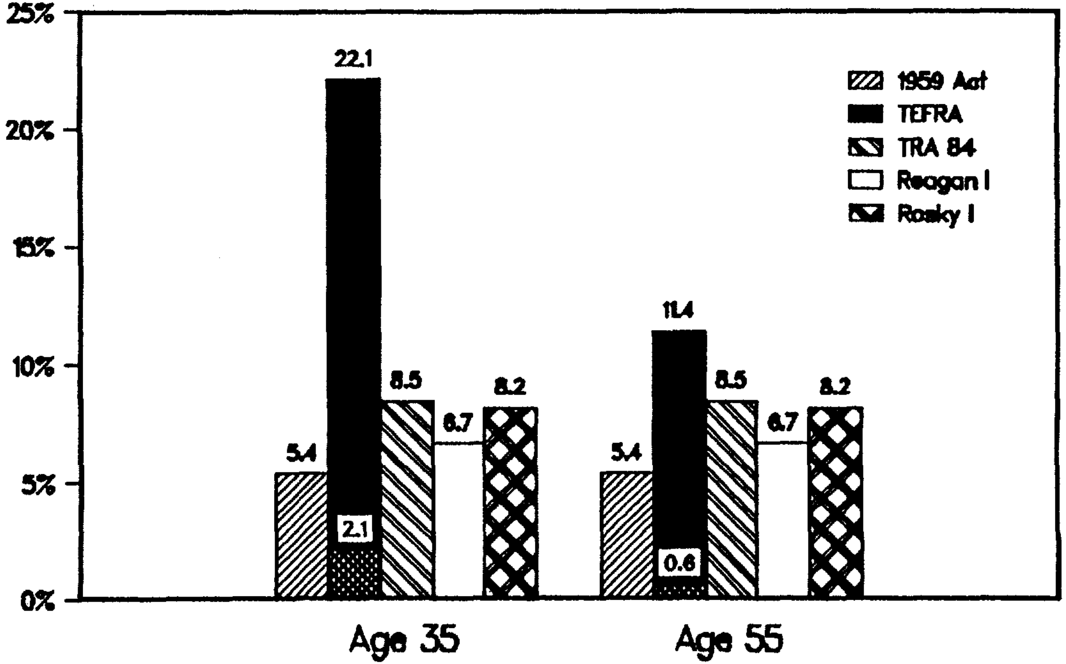
After-Tax Profit Margins – 10% Pre-Tax
Universal Life
Stock Company (A)




After–Tax Profit Margins – 10% Pre–Tax
Universal Life
Mutual Company (B –> A)
25%
20%
15%
10%
5%
0%
–5%
–10%
–15%
18.5
0.4
5.5
6
5.7
–8.8
8.8
–1.7
5.5
6
5.7
–8.8
1959 Act
TEFRA
TRA 84
Reagan I
Rosky I
Age 35
Age 55

SLIDE 3

After-Tax Profit Margins - 10% Pre-Tax
Universal Life
Small Stock Company (A)



number was about 6 percent for the large stock companies, so small companies make a lot more. Whereas for the big companies, the two proposals didn't make much difference when compared to the current law, for a small company, there is a big difference in what its after-tax profitability would be. There were similar results for age 55.

Slide 4 shows the so-called excess-interest whole life, interest-sensitive whole life, or fixed-premium whole life. This is only for age 35 under the 1959 Act. As in the previous example, this was priced at a pretax profit of 10 percent and resulted in an after-tax profit of 14 percent; thus, this product actually had negative taxes. With the old Act, you could have very large tax savings on products like this. There are some circumstances where you could actually wind up with tax losses greater than the premium; thus, you could actually afford to give the business away. Under the prior tax law, TEFRA, profits probably averaged over 10 percent, and it still looks good under the current law. In the future, these products will have profits of the same sort as we saw for universal life. Thus, these new proposals are quite damaging to this product.

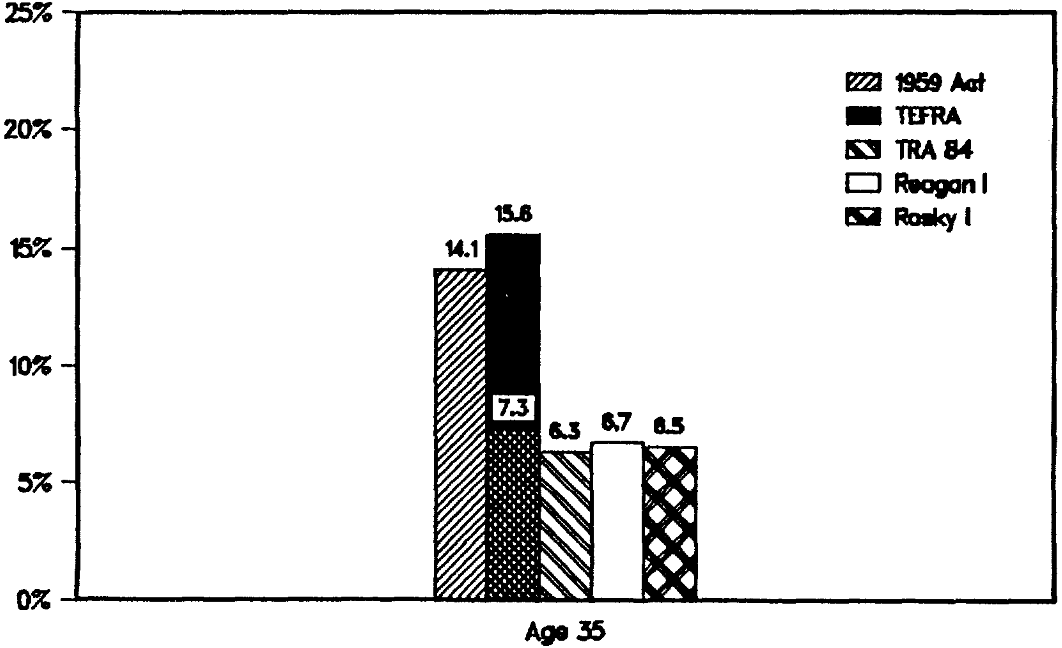
It's interesting to compare universal life to excess-interest whole life (Slide 5). Under each of the five Acts, we have comparisons of the profitability of universal life versus this product. Under the 1959 Act, excess-interest whole life was dramatically more profitable than universal life. Under TEFRA, you had a wide variation, but, again, probably an advantage. Under all the new proposals, we've now got the "level playing field," and it doesn't make any difference which product you're selling. There is no tax advantage of one versus the other.

Term insurance is shown in Slide 6. For most companies, annual renewable term means graded-premium whole life. For the five tax acts shown across the bottom, there is no profit. This product has been priced at break-even or at a zero-profit margin. This is the way that a lot of companies have been pricing this product. In some cases this was not purposeful, and in many of those cases, a number of companies wished they could have had profitability equal to zero. The only purpose of this slide is to demonstrate, if you priced under the prior tax act (assuming you got the 818(c) deduction), the dramatic effect that method could have on your after-tax profit margins. This could increase profit from pretax break-even, all the way up to an after-tax profit margin (if everything went right) of 34 percent. Under the current law and all the proposals, none of these tax advantages remain.

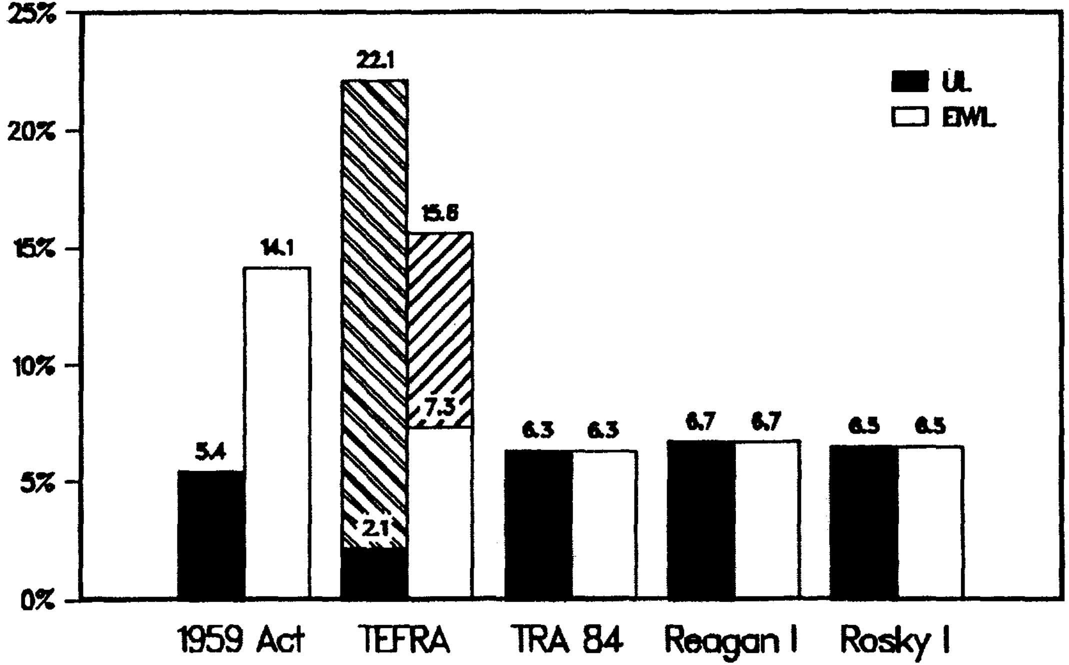
Slide 7 shows the major product sold by the mutual companies. Historically, this has been participating whole life. We see something similar to the situation with the universal life product, which was the problem that the mutual companies had with the old tax act. They priced a product at 10 percent pretax profit and still lost money after taxes because of some of the approximations under that law. TEFRA, in essence, bailed them out. Under TEFRA they did quite well, and under DEFRA and the current proposals, they continue to do fairly well.

In all of these illustrations, I have avoided the tax reserve question. All of these graphs assume that the tax reserves are equal to the

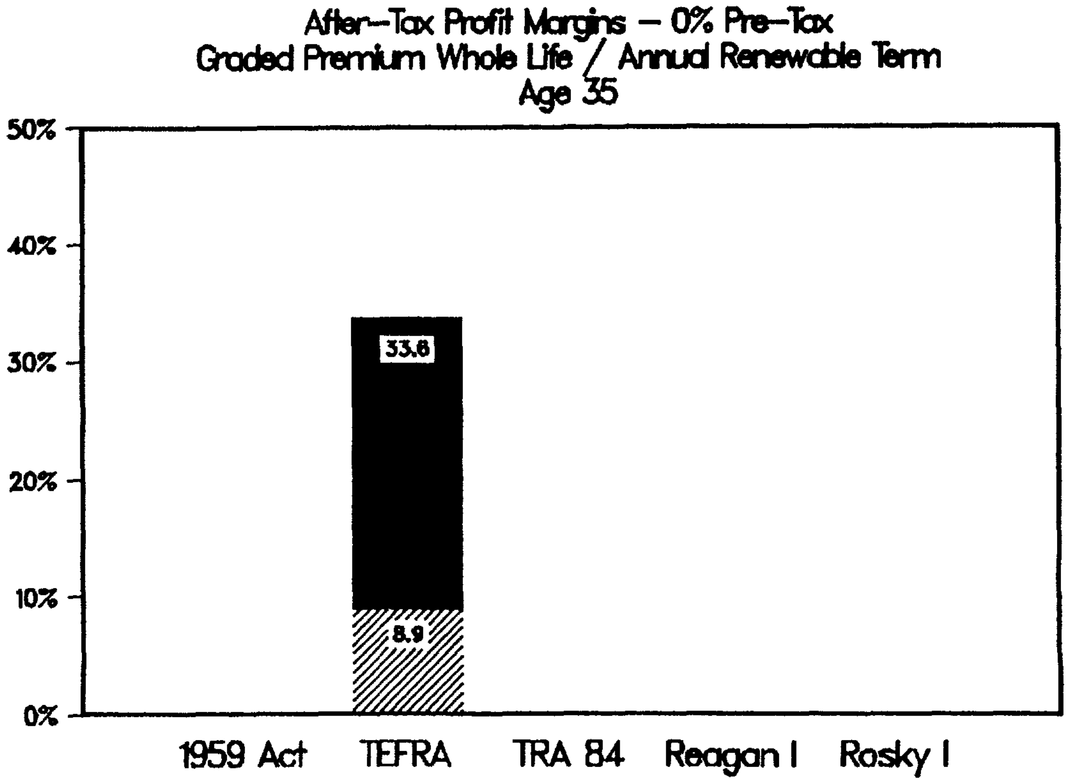
After–Tax Profit Margins – 10% Pre–Tax
Excess Interest Whole Life
Stock Company (A)



After-Tax Profit Margins — 10% Pre-Tax
Universal Life vs Excess Interest Whole Life
Stock Company (A)
Age 35

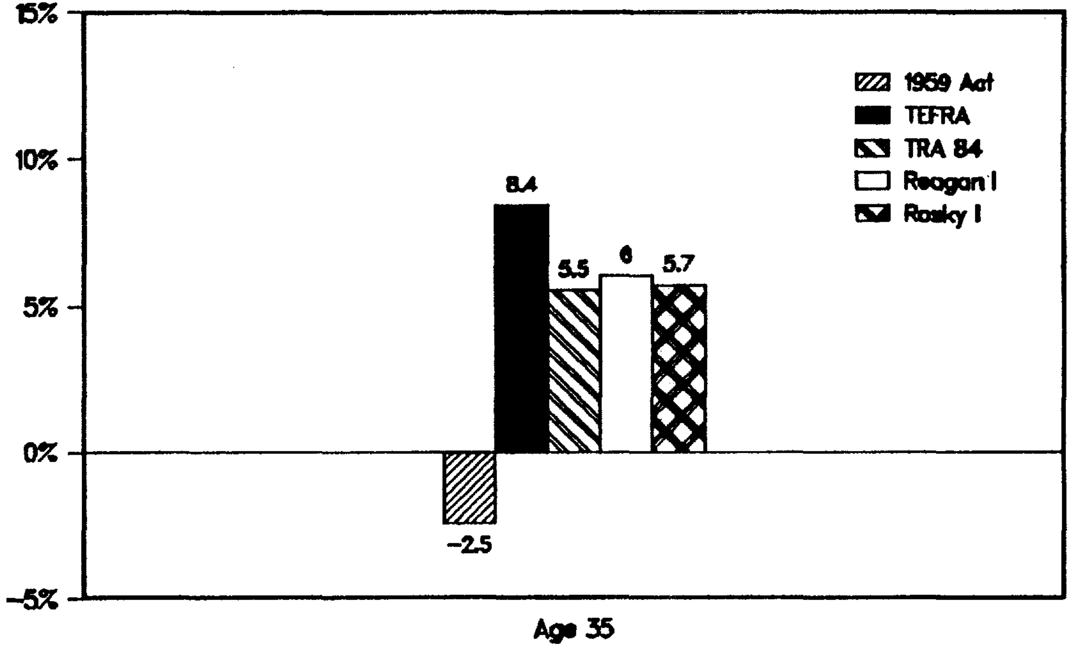


SLIDE 6


After-Tax Profit Margins – 0% Pre-Tax
Graded Premium Whole Life / Annual Renewable Term
Age 35
50%
40%
30%
20%
10%
0%
33.6
8.9
1959 Act
TEFRA
TRA 84
Reagan I
Rosky I

SLIDE 7

After-Tax Profit Margins - 10% Pre-Tax
Par Whole Life
Mutual Company (B -> A)



statutory reserves. If tax reserves are less than statutory reserves, there is quite a heated debate as to how that situation is reflected in pricing, and, mechanically, how you come up with an answer. There is a significant tax cost involved and if your tax reserves are less than statutory reserves, the after-tax profit margins will drop dramatically.

Again consider the situation of the small companies versus that of the large companies (Slide 8). Under the current tax law, a small company makes substantially more profit for exactly the same product, priced the same way than would either a large stock or a large mutual. This illustration compares the profitability that a small company is getting as compared to a large stock or mutual. Under the Reagan I approach, they're all on an equal footing. Under Rosky I, the small companies still have an advantage, but the advantage is decreased.

Slide 9 shows basically the same thing, but with marginal tax rates (this is the complement of the inverse of the profitability). The large companies are in the 37 to 45 percent range, while the small companies have a much lower effective tax rate. Reagan I has the same effective tax rates as under Rosky I.

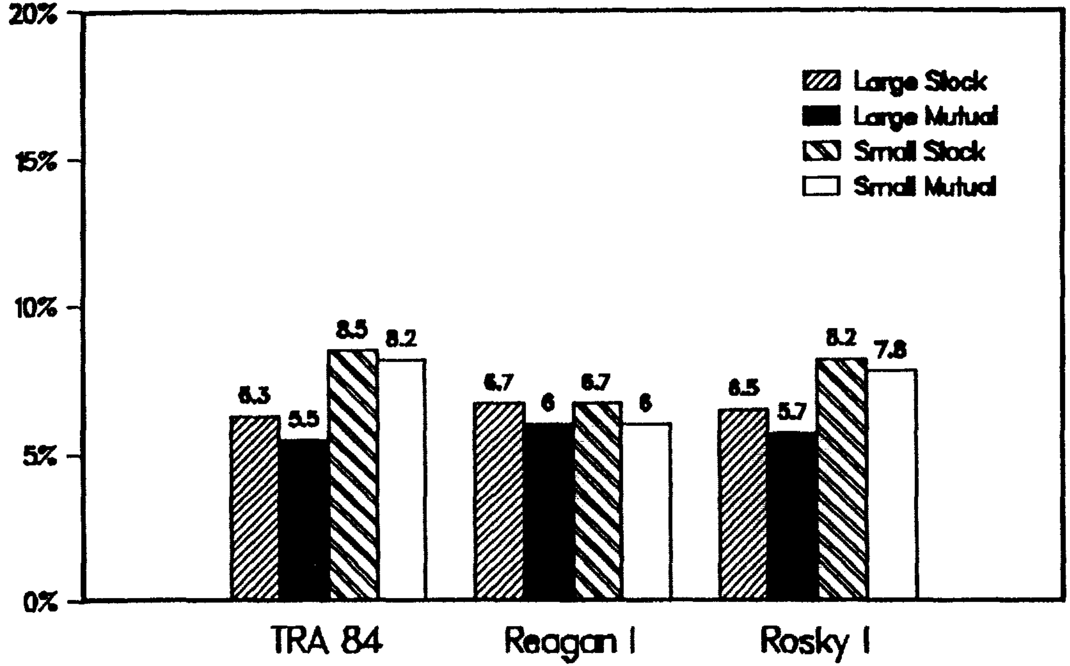
What can we generalize from all this? What sort of summary or conclusion can we reach from the pricing actuary's point of view? If you look at the 1959 Act and TEFRA, you'll see that they are both extremely complex acts. There were a number of unresolved issues, so that you didn't know exactly how much money you were making. You noticed a big difference in after-tax profitability for different products. You noticed a big variation in taxability for different issue ages. Under the current tax law, TRA-84, the playing field has indeed been made level so that the results are roughly the same for different products and roughly the same for different issue ages. Both of the current proposals, Reagan I and Rosky I, continue that same level playing field. The add-on tax or the surplus tax remains a hot issue both under the current proposals and under the current law.

As far as the Small Company Deduction, you can deduce from the slides what the issues are. Although both proposals severely cut back on the tax break for smaller companies, one proposal levels the field between small companies and large companies, the other proposal maintains that differential. In general, as far as pricing goes, you can see that companies are slightly better off under the proposals as far as profitability, but there is no substantial difference from the current situation.

In conclusion, you'll notice that we're talking about the fourth tax law during the 1980s, and we are not even half way through the decade yet. This is after 20 years with the same tax law. For pricing in the 1980s, or for any sort of pricing, you obviously should plan for changes. You can't make the assumption that it's going to stay the same forever.

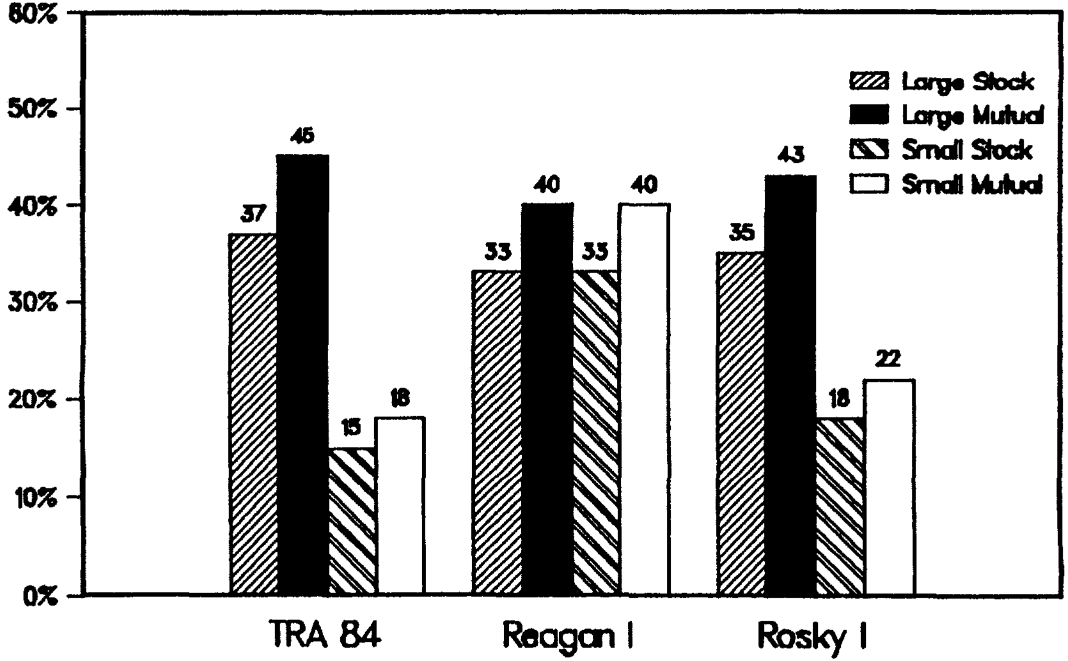
MR. FICKES: In regard to tax strategies designed more for life insurance companies, (1) we have strategies that apply to both stocks and mutuals, and (2) we have strategies that apply particularly to mutual companies. Of course, with mutual companies, the federal government

After-Tax Profit Margins — 10% Pre-Tax
Large Company vs Small Company
Stock Company & Mutual Company
Universal Life — Age 35



SLIDE 9

Effective Tax Rate



should have known that if you tax anything besides profits which you have to report, your tax base is bound to get smaller.

The stock and mutual company strategies include (1) statutory reserves, (2) nondeductible reserves, which can be reinsured away, (3) consolidated returns, and (4) the Small Company Deduction.

The mutual company strategies include (1) disqualification as a life company (you do not have the Mutual Company Surplus Tax), (2) surplus relief, (3) selling surplus draining products, and (4) establishing Canadian branches for warehousing surplus. Branches of Canadian mutuals also got caught up under the TRA-84. They are mutual companies and subject to a mutual company's taxes, but a carryover of the 1959 Act was the imputed surplus through the Secretary's Ratio. Basically the Secretary's Ratio is multiplied by a Canadian mutual's reserves on U.S. business. Those reserves are an amount of imputed surplus that they have in the United States. They will be taxed, of course, on their imputed surplus. The obvious way around this is to reinsure your reserves away; or you can just clean up the Mandatory Securities Valuation Reserve (MSVR) and other nondeductible reserves and try to maintain them at a minimum.

Since many strategies involve reinsurance, Section 845(b) is involved. Section 845(b) emerges when (1) you are committing tax avoidance, and (2) it is significant. The company could be committing tax avoidance by income shifting, going from a large company to a small company. Whether or not it is significant depends on whether the risk that you undertook in doing the reinsurance equals the amount of tax benefits you're getting back out of the reinsurance.

How to comply with 845(b)? I have several recommendations. The first thing you want to do is to build commercial purposes into all your reinsurance treaties. The second thing is always make your treaty as long as possible to make it look like it is permanent. The third thing is to put an optimum point where it becomes mutually beneficial for both parties to get out of the treaty without actually specifying in writing where that optimum point occurs. The last thing is to develop a portfolio of reinsurance. If you continually do several reinsurance arrangements, even if some have no tax implications, you can build yourself a portfolio to help you comply with 845(b).

The House proposal will affect the stock company strategies. It looks like statutory reserves will survive, so going back to a statutory reserve basis will work. Nondeductible reserves should also still work.

Consolidated returns are a little questionable now that both life companies and nonlife companies presumably will be at a 35 percent tax rate. It's not as beneficial to turn on and off being a life company and consolidate one year and then not consolidate the next year. I think the Small Company Deduction and tax planning have their greatest significance right now with agent-owned captives. When the new tax law first came out, we saw the interest shift from going off-shore for an agent-owned captive to coming back on-shore, where, at worst, you could only have a 14.7 percent tax rate. We now find out that 14.7

percent may not last very long. The only bad news, on the other side, is that going off-shore is going to get more difficult under the proposals.

The House proposal will also affect mutual company strategies. If everybody goes to a 35 percent tax rate and our industry loses its special deduction, disqualification as a life company may be desirable. However, on the horizon, is a mutual company tax for property and casualty companies. Therefore, three or four years down the road you could look rather foolish if you disqualified as a life company and ended up with mutual company tax anyway.

Surplus relief is still a viable option, as is selling more surplus draining products. Both for Canadian branches and branches of Canadian mutuals the same basically applies. You should still try to clean up your surplus base.

There is a lot that has to do with where you are based in regard to what kind of strategies you want. Companies in New York pay more than just a high cost of living. The chances are much greater that very well-qualified auditors will be working in that IRS division. If you go to Bismark, North Dakota, the person doing your life company taxes probably does hardware store taxes, too, and there I would try to be a little bit more aggressive in tax planning.

To plan any kind of strategies, you need to go way out into the future and look at what is going to happen before you set your goals. I thought I'd look at some possible headlines we might see in the newspapers or The National Underwriter in the year 2000. One possibility is:

Congress Revamps Life Insurance Company Taxation

14th Time in 20 Years

So any tax strategy you set that does not recognize the possibility that the tax law may change is a dangerous strategy. Another possible headline in the year 2000 is:

Proposal Before Congress to Tax Inside Buildup

This is something I don't think the Congress can ever afford to actually pass. They've been using it for so long as a bargaining chip and probably will get more revenues out threatening to pass it then they ever could by actually passing it. In 1984, we heard that the purpose of the new tax law was to level the playing field between stocks and mutuals. I think in the year 2000, this is what we are going to hear when they talk about tax reform:

Level the Playing Field Among the Financial Services Sector

In any type of tax planning, we have to take a broad view, not only of our industry taxation, but what's happening elsewhere.

The proposals for personal income look like we are going to three rate brackets. The top rate will be 35 percent, interest deductions are going to become quite limited, working married couples will not get the working couple deduction (meaning couples have to suffer twice), and business meals will be only 75 percent deductible.

It looks like the corporate tax rate is now going to be 35 percent, or thereabout. The investment tax credit and depreciation are both going to be curtailed substantially.

It's rather interesting that banks are finally going to have to start paying tax. Banks are going to lose what amounts to our industry's old policyholder share of tax exempts.

Life insurance and property and casualty companies are quickly coming into the same tax basis. We have qualified reserve accounting which basically is a way to tax investment income in casualty companies. We probably are also going to see a mutual property and casualty company surplus tax. In regard to structured settlements, the IRS is trying to get a tax on investment income, not to the recipient, but on the investment income building within the company.