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IMPACT OF FEDERAL INCOME TAX ON FINANCIAL MANAGEMENT

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Recorder: DAVID C. ZIMMERLI

- o Implications of recent or proposed tax laws
- o Effect on financial performance measures and tax allocation
- o Impact on investment strategy
- o Impact on corporate structure
- o Generally Accepted Accounting Principles issues

MR. VIRGIL D. WAGNER: Since 1982, we have seen changes taking place quite frequently in the Federal Tax Law as it impacts life insurance companies. You have seen many programs at the Society meetings on federal income taxes, and this is another one. However, this one is a bit different in that we are going to slant it more toward the impact on financial management, rather than just discussing changes in the tax law per se.

We are fortunate to have a very impressive panel to lead this discussion. They represent a wide variety of backgrounds and disciplines. Let me introduce them in the order that they will appear. That order was at least partially determined by the subject matter; but when we decided that John Adney should be the

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lead-off speaker, we had Tom, Dick and Harry left and there wasn't any question in what order they had to appear.

John Adney is a managing partner with the law firm of Davis & Harman in Washington, D.C., a name probably fairly well known to most of you. John received his B.A. from Millikin University and his J.D. from Yale University. He was admitted to practice before the U.S. Supreme Court, the Court of Appeals for the Federal Circuit, the U.S. Claims Court and the District of Columbia Court of Appeals. He served as law clerk to the honorable Marion Bennett, U.S. Court of Claims, and in the Trial Division U.S. Court of Claims. He is a member of the American Bar Association, and currently serves as Vice Chairman of the Committee on Insurance Companies Section of Taxation of the American Bar Association. John will center his comments on the recent and proposed changes to the tax law.

Following John, Tom Conroy is also a guest speaker. Tom is a graduate of De Paul University and has an M.B.A. from the University of Chicago; Tom is also a CPA. He joined Security Life in Denver in 1974 and is now its Chief Financial Officer and Executive Vice President. His responsibilities include accounting, valuation, tax and tax planning, investments, systems, financial planning and internal audits. Now if this doesn't get you into the impact of taxes on financial management, I don't know what would. Before joining Security Life, Tom was with Ernst & Whinney (probably it was Ernst & Ernst in those days). Tom is going to comment largely on the GAAP issues of reinsurance and performance measurements.

Following Tom's comments, Dick Miller who is an FSA will be the next speaker. Dick is a graduate of DePauw and the University of Michigan. Dick is now a life company actuarial consultant with Tillinghast/TPF&C in the Dallas office. Previously, Dick had been with Southwestern Life, and its previous owner Tenneco. Dick has been a member of the Board of Directors of the American Academy of Actuaries Board of Directors, and is a long time member of that organization's Committee on Life Insurance Financial Reporting. He was one-time chairman of the ACLI Actuarial Committee and a charter member of the Statutory Technical Advisory Committee to the NAIC, better known as the Greeley Committee. Dick will center his comments around corporate structure, particularly acquisitions and mergers and changes in the law that have impacted those areas.

Finally, Harry Garber will wind up by covering the investment aspects of the subject and supplement some of the previous topics from the mutual company point of view. Harry is a native of Detroit and joined the Equitable immediately upon graduation from Yale where he earned a B.A. degree in 1950. He has been there except for a short leave of absence to serve in the U.S. Navy. In 1984, Harry was elected Vice Chairman of the Equitable board. Currently, he is actively involved in the Federal legislation and tax arenas and overall corporate strategy and direction. He has been responsible, in the past, at Equitable for actuarial EDP systems, corporate planning and development, and financial management. Harry is a director of the Equitable Life Assurance Society of the United States, a director of the Equitable Variable Life Insurance Company and of the Equitable Investment Corporation. He also serves on the boards of Genesco and the American Women's Economic Development Corporation. He is currently a member of the Board of Trustees of Howard University and is on the Board of Governors of the Society of Actuaries.

MR. JOHN T. ADNEY: The subject of federal income taxes as they relate to life insurance companies' financial management, is something we just can't get away from. In particular, we cannot ever seem to quite get away from discussing recent or proposed changes in the tax law. Interestingly, and this may be one of the few exceptions, we come to you in a situation where we don't really have any strong imminent proposed changes in the tax law to report to you; but I think that perhaps this is best seen as the calm in the middle of a storm, and not as any kind of harbinger of a period of great stability in the tax law. Right now we are in a situation where, having more or less survived the Tax Reform Act of 1986, we are trying to figure out what it all means; the implications of some of the areas of that rather sweeping revision are just now beginning to be felt and realized.

The Congress is currently looking at taxes from the standpoint of raising revenues so as to meet certain budget resolution targets. There are reports in the paper and elsewhere, of the Ways and Means Committee looking around for approaches to raising $18 billion in additional revenue without calling it additional revenue, so as to get the White House upset. It looks like excise taxes are not going to make up all of that $18 billion, at least at the moment. So I have to talk about what impact that may have for such items as rates, the ability

of the life insurance industry to get certain items in the 1986 Act corrected as it would have them corrected, and so on.

Let us begin by looking at some of the alterations the 1986 law made in rates. You are all aware of the simplification of the rate structure both for individuals and corporations. For most corporations, most life insurance companies, certainly, we are now talking about a very simple rate structure: it's called 34%. That structure takes effect on July 1, 1987, the middle of this year. Now, life insurance companies, as you know, have been laboring under a somewhat different scheme than the rest of corporate America as a transition off of the 1959 Act. Life insurers have been granted a 20% special deduction, and for those small companies that qualified, a small life insurance company deduction under Section 806 of the Internal Revenue Code. The 20% special deduction was repealed as part of the general lowering of the rates. The members that had sponsored it initially said that it was there to bring the nominal, and hence the effective rate of tax down from 46%, to 36.8% for all corporations at the top rate; but with the rate dropping to 34%, they said that it was no longer needed or justifiable.

However, the repeal of the 20% special life insurance company deduction, ineffective at the beginning of 1987, not in the middle of the year, as was the case with the rate reduction. It was pointed out by the American Council of Life Insurance, among others, that in 1987 this would leave life insurers with a top nominal rate of 40% on a blended basis. So life insurers go from 36.8% in 1986 to 40% in 1987 and then down to 34% thereafter, or for as long thereafter as the rate stays at 34%. The Congress took note of that and said, everybody has to give up something in order to get this tax bill, and this is what life insurance companies will give up. So it is necessary, and has been for some time, for those who are planning from an investment and other standpoints, to take account of this bump in the rate structure; albeit a temporary one, it is certainly there. It is also necessary to see what can be done from a life insurer's standpoint to realize the deductions and not the income this year. This is clearly the year for deductions, and it is certainly a better year for deductions than 1986 was or 1988 will be.

We also see a situation changing on capital gains. We have already been experiencing a change in capital gains whereby the capital gains rate has gone up from

28% to the same rate that's given to the corporation for all other income. And the 34% rate, I think, is recognized by Congress as something that will be the high rate on capital gains for some time to come. The way the law was structured, even if the 34% ordinary income rate changes in the future, it will be somewhat more difficult -- not impossible, certainly -- but more difficult for Congress to change the 34% rate on capital gains. The way the provisions were changed, there will be a 34% rate at the top that will automatically come into being for capital gains if the rates generally are increased on corporations for ordinary income.

Because of the change in the capital gains under the 1986 Act, a number of life insurers pointed out to Congress that, in keeping with some long-term arrangements intended to be funded with capital gains from deep discount bonds, they would be put into a problem pricing their products -- products that have already been priced and sold -- were the rate to go above 28%. The special deduction never applied to reduce the 28% rate, but, certainly, the rate was left at 28%, and this law would increase the rate of tax on those capital gains.

The Congress responded with a transitional rule for capital gains, which I believe was unique among the transitional rules. It simply came out and named 15 or so life insurance companies that made themselves known to Congress as those who would have problems if the rate were not kept at 28%. This transitional rule obviously drew some fire after it came out. It was pointed out that some of the companies, that were named in the rule were misnamed, so there really are not 15 companies, there is some number less than that. But, more fundamentally, it was pointed out that it simply was not fair to single out and even name 15 taxpayers out of all taxpayers to be the ones to get this relief.

How stable are all these things? On the capital gains rate question, the American Council of Life Insurance has been working with Capitol Hill to place in the forthcoming technical corrections bill a change which would supersede the 15-company rule by extending some sort of transitional relief to all life insurers. What's in dispute, of course, is what that transitional rate will be. It will probably not be as low as 28% as was the case with the 15 companies, and to be a good transition rate, it would have to be below 34%. At the moment, it appears that the question is being driven by varying revenue estimates of what the cost of the rule would be. All we can tell you at the moment is that it is in

debate and that there is probably going to be something in the technical corrections bill when it is introduced soon. It may well be that political forces will win out over the penny-pinching forces, and that the industry will get some broad-based relief, but that is at the moment unclear.

As for the stability of the corporate rates, the article that was in the *Wall Street Journal* this morning on the subject of the rate increases being among the options considered by Congress is certainly true. I'm not sure how much stock you should take in that, because frankly these kinds of discussions go on all the time, but certainly there will be some pressure to reexamine the rates. I wouldn't doubt that the White House, if it weighed in, would prefer to leave the individual rates alone. That leaves the corporate rates, and unless there is some other way to raise all the $18 billion, the corporate rates are somewhat in jeopardy. You should simply be aware of that; I don't know if there is much more that we can tell you about that at the moment. The 1986 Act, aside from the rate changes, which were certainly among the most sweeping, made a number of changes in the corporate rules that are of general application and that would be of specific interest to life insurance companies and their planning. I will talk briefly about three of these: the repeal of what is known as the General Utilities rule; the introduction of the alternative minimum tax, a very greatly revised and strengthened alternative minimum tax about which I'm sure you have already heard much discussion, and changes in the foreign tax rules.

General Utilities is not any one rule; it is really the name given to a collection of rules which by and large stand for the proposition that a corporation making a liquidating or nonliquidating distribution of property in kind, or a corporation which sells its property as part of a plan of liquidation and then distributes the proceeds, is not going to be taxable at the distributor (corporate) level. In other words, there would not be the usual dual taxation at the corporate and then the shareholder level of such distributions.

The General Utilities rule, all of which comes out of a fairly ancient Supreme Court decision on nonliquidating distributions, had its high water mark when the 1954 Code was written. But in the 1980s, it began to suffer under a lot of criticism connected with the Senate's study of the rules of the general corporate reorganization and acquisition rules of subchapter C of the Code. The nonliquidating distribution rules suffered serious setbacks, and as of the 1984 Act,

nonliquidating distributions by and large gave rise to gain -- not loss but gain -- if there were gains, in the distributing corporation. That left the liquidating distributions in a somewhat awkward position because they had to explain themselves away in the midst of unfavorable rules surrounding them in other matters -- somewhat the same situation the inside buildup on life insurance is in, in an era when other tax-favored treatments have gone the way of the dinosaur. The Congress decided -- for a variety of reasons, I think partly the revenue base, partly a concern with the General Utilities -- that forgiveness of tax was giving rise to inordinate amounts of merger and acquisition activity. Dick Miller may disagree that it's inordinate, but nonetheless the Congress seemed to say so in some of its reports and discussions. Therefore, the Congress repealed that forgiveness of tax at the distributing corporation level.

There are still some exceptions to that. Your typical corporate reorganizations, if you jump through all the right hoops, can get away without having a taxable event, but you will usually have a carry-over basis for the assets involved in those situations. Also, you could have a liquidation of a corporation under Section 332 of the Code, but again that's a carry-over basis situation and that is restricted to corporations that are 80% controlled by the shareholder distributee. So, those are serious restrictions. I will let Dick talk a lot more about that; but I think you can already see some of the implications of all this for mergers and acquisitions and the tax effect on an acquisition price that would result from this. Also, this means that some of the freedom previously enjoyed in structuring the corporate family is not there. There was previously not much penalty to placing assets or business further downstream in one subsidiary right after another. Now, if you plan to liquidate those and move them up, there is a tax cost to doing so and people should be aware of that.

We also have new rules that affect mergers and acquisitions in the area of net operating loss carry forwards, allocation of purchase price in the basis of assets and so on. I think all of these rules are fairly stable. I'm not saying they are without their interpretative problems; the new net operating loss carry forward rules, I think, are trying to rival the pension rules in incomprehensibility. What it all means is, this is going to be the pattern for some time to come and it's going to be much more difficult for people to deal with the tax situation in the case of corporate structure in general and mergers and acquisition in particular.

The minimum tax is with us now and I think it's fair to say we are going to see a corporate alternative minimum tax along the lines we've got now with significant teeth in it until such time as Congress works up the nerve to place the base broadening rules of the minimum tax into the regular tax base itself. Now that we have a concept in the law that some portion of untaxed but reported profits should be subject to a minimum tax, I don't think that's going to go away. The Congress was frequently embarrassed by reports of large profitable corporations not paying tax; this was the response to that.

We have a two-pronged response under the minimum tax structure. The minimum tax structure is basically levying a 20% rate of tax on alternative minimum taxable income defined as an additive amount: general taxable amount plus preferences. That's been the deal for some time. Now preferences have changed and the corporations wind up paying the higher of the two taxes; 20% tax on the expanded base or the 34% tax on the more narrowly defined regular base. This is also subject to a crediting mechanism that will permit timing differences to be taken into account, with credit being given for minimum tax payments whenever regular taxes are paid, if ever. For corporations the significant change in preferences is the addition of the business untaxed reported profits (BURP). This item is supposed to be based on some sort of financial statement income for 1987, 1988, 1989 and then on a notion of earnings and profits technically called adjusted current earnings (ACE) thereafter. The idea is that one-half the excess of business untaxed reported profits over the alternative tax base without that item would be brought into the alternative tax base. When we move to the adjusted current earnings or ACE, 75% of that difference goes into the minimum tax base.

For the 1987-1989 period, financial statements are defined in the law and in recently issued regulations according to a hierarchy of priorities where a company has multiple financial statements. Certainly insurance companies would be in a situation where they may have more than one financial statement. You would think that to provide consistency, the annual statement would be the easy thing to use for life insurance companies; apparently, it was too easy. The Congress chose not to use it. They were still concerned about those corporations that would have GAAP-based reports filed with the SEC or audited financials used elsewhere that would show greater amounts of income than merely statutory income. The Congress did not want to hear arguments that those were

going untaxed and so, where there are SEC-filed financial statements, those presumptively are going to be used. If those do not exist, then financial statements that are audited and used for some significant purpose, based on GAAP rules, are going to be used. Where those do not exist, you may be able to fall back on the annual statement. That is the overall scheme of it. It leaves a somewhat unlevel situation among all insurance companies. I think most mutual companies will find themselves able to use the annual statement where the stock companies will be all over the place. And that is a matter of some concern, but I don't know that that concern is necessarily going to be addressed by Congress. There have been questions raised along those lines; they are pending on the Hill, but I don't know that they are pending with a great deal of interest on the other side.

Beyond that, we are not really sure what is in there. I think this concept was put in with a delayed date because of the recognition for the need to develop it out. It was also the idea of the House of Representatives which traded this off for the 3-year book income approach with the Senate. That was the actuality of the situation, and in the ACE base some of the things were made clear with respect to life insurance companies. Policy acquisition expenses will need to be capitalized and amortized. Tax-exempt interest is certainly in that base and it is not treated as a timing item after 1989 so that we need not apply for the credit. Also, the bluebook said that a mutual life insurance company's dividends would not be deductible in that tax base beyond what is the case in the regular tax base. So I think we are going to see a lot more development there. The industry is working on either an effort to get rid of the need to capitalize and amortize acquisition expenses in that base, or, in the alternative, some rule of thumb that would permit an easy approach to all that. That will have implications when Congress later studies the regular tax base; we'll get to that in a little while.

All of this is by way of saying that there is greater complication. These rules are probably fairly stable, though. At least we are going to see rules along these lines that we are going to have to deal with. There are major implications here for planning, particularly investment planning, and particularly for companies that will find themselves moving in and out, on a regular basis, from the regular tax to the minimum tax and back. Precisely how do you plan ahead for your marginal rate of tax in that situation? I don't know how you do it. You

just have to keep looking ahead and planning and hoping and wondering how Congress is going to change the tax rates next.

As regards the foreign tax rules, all I want to say is that there have been changes and that we need to be aware of those. The tax credits have been tightened up. Subpart F rules have been expanded, and Subpart F rules are requiring immediate repatriation of the income of foreign subsidiaries of U.S. life insurers and casualty insurers. Those may be viewed as somewhat unfortunate in an era when we are trying to improve our trade position, but tax and credit policy do not always move in tandem, even when it's the same Congress trying to move them. I think we will see a revisitation of some of that, but the reason people need to be aware is simply that more and more frequently we find ourselves operating across national lines, and I don't think that Subpart F and the tax credit are areas that we can all that easily ignore in the future.

As respects life insurance companies specifically, the 1986 Act in terms of substantive changes did not do much. Aside from the rate and capital gains changes I mentioned, we have some new loss reserve discounting rules that do have an effect on life insurance companies; you should be aware of those. They will apply to life insurance companies in the case of unpaid losses on noncancellable disability policies and other A&H policies, and they will apply across the board the reserves and other nonpremium reserves for cancellable accident and health policies. The scheme, generally, is to divide the world into three parts: credit insurance, (credit disability insurance uses the standard discounting approaches of other property casualty lines; apply a rate to the annual statement number and go away) disability insurance, and everything else. The treatment of everything else is very easy. You apply some sort of a convention based either on six months or the company's experience, depending on whom you talk to, but the rule is to use the property casualty discount rate with that delay in claims payments assumed, and discount the amounts and be done with it. For disability, the solution reached by Congress is to use the rules for life insurance reserves for noncancellable accident and health (A&H) insurance with the company's use of its own mortality and morbidity experience. That's the general scheme. It is probably more of a nuisance for most life insurance companies than anything else, but when it comes to the end of this year and you're evaluating the fresh start you might get off of this and you might want to look very carefully at it and not just brush it aside.

The last thing I want to go over are a few developments still under the 1984 Act and where we might be going with those. We now have rulings telling us what the mortality tables and interest rates are, in most cases, of life insurance reserves. We have regulations prescribing diversification and standards for variable contracts -- those regulations are scheduled for a hearing at the IRS on the first of July. We have an absence of regulations in the reinsurance area, not surprisingly, as those rules, Section 845 rules which Tom will be talking about, are operating on a somewhat interim basis. We have an absence of regulations under Section 809, a very significant set of rules. We do, however, have some ruling history on what the differential earnings rate is: we had the tentative rate, the final rate and the correction to the final rate and the further correction to the final rate. So we are gaining some experience there.

Apropos of that, you should be aware there will be a hearing this fall before the Ways and Means Committee on taxes incurred by life insurance companies under the 1984 At as a whole and by stock and mutual segments. This hearing has been called to hear from the industry and to receive reports from the Treasury in the General Accounting office. The Treasury is about to embark on a survey of life insurance companies. They apparently have had some trouble finding tax returns; but like the dog chasing the car, they wouldn't know what to do with it if they caught it, and they would not quite know how to analyze consolidated returns even if they found them. So, like Caesar at the time of the birth of Christ, they are about to go out and survey the world that everyone might be taxed. In this case, the world is the life insurance industry and probably most companies represented in this room will be receiving survey questionnaires from the Treasury in the next couple of weeks asking for data on taxes incurred, certain annual statement data, life/nonlife consolidated return data where applicable, and so on; all of this feeding into a hearing in the fall. We are looking towards, I think, despite that hearing, a fairly quiet period, and yet we are building up toward a total reexamination of the regular tax base for life insurance companies in 1989.

MR. THOMAS F. CONROY: The areas I will attempt to cover today are the GAAP accounting issues of the recent change in the tax law and also, perhaps, the upcoming changes in the GAAP tax accounting rules. I will also address the reinsurance issues (for this I will be looking more at the 1984 Act than the 1986 Act and the current state regulatory climate) and very briefly a nebulous area

called "financial performance measures" which really gets to managing capital and surplus, earnings (heaven forbid!) and long and medium-term financial forecasting and financial planning.

In the GAAP arena, I will identify some of the changes in the tax act I feel are relevant for GAAP consideration under the current accounting rules and present my ideas on how the current accounting rules are to be used in reporting under the updated Act. I will concentrate on the areas of uncertainty and the problems that must be addressed.

Second, under GAAP issues, I will look at the differentials in accounting treatment which will take place if the changes in accounting for income taxes are adopted as stated in the exposure draft. Finally, I will make a few comments on taxes with respect to the proposed changes in accounting rules for long duration insurance contracts.

On the reinsurance side, I will discuss the impacts on financial management and planning of the reinsurance provisions of the Deficit Reform Act of 1984, and the impacts on GAAP reporting and management of the changes that may take place in the reinsurance ceded marketplace because of the state regulatory pressure brought on by New York Regulation 102 and similar actions in other states.

Finally, with regard to financial performance measures, I'll talk about the profitability of the old book of business and what the Tax Act meant to it, the impacts of the unknown future tax rates that apply to mutual companies, and the impact on surplus needs, forecasting requirements, and the rest.

As far as the GAAP issues are concerned, before we get into the current accounting versus future accounting, it might be helpful to mention the history of the deferred tax accounting and why the current differences of opinion exist. The fundamental problem is caused by a subject near and dear to the hearts of all "old" accountants, something that goes back to the dawn of accounting, a tradition grafted directly to the hearts of all accountants . . . double-entry bookkeeping. This may sound facetious but, believe me, this is at the heart of the problem. Fundamentally, the problem centers on this question: What are accountants trying to report on? Are they reporting on the economic values created during the period on which the report is issued? Is the focus of the

financial statements on performance in the company? Or, rather, is what is being reported on the financial position and strength of the company, the solvency position of the company and the ability of the company to honor its contracts and pay its liabilities?

Now, reasonable people, and that includes most actuaries, would answer you are trying to report on both and most accountants would agree conceptually. But the structure of accounting, which requires two financial statements only, an income statement and a balance sheet, and further, the constriction of double-entry bookkeeping where the debits must equal the credits and, therefore, the activities in the balance sheet and income statements must be, by definition, complementary, causes the problem. This doesn't always occur but it does occur when you are attempting to report the impact of long-term transactions or a connected series of transactions, a multi-period transaction, in period-by-period financial statements. It occurs because circumstances surrounding and impacting that transaction may change during the period of time over which it is being reported or the current earnings impact and current financial position impact are not complementary. Which way do you lean? Generally speaking, the accountants write the rules to give preference to the financial statement which is currently considered the more important one and, therefore, the impacts of the accounting rules in the statement of lesser importance sometimes produce bizarre results. This is true both with respect to deferred taxes, which we will address, and perhaps also to life insurance reserves, which we won't.

In any event, it should be remembered that when the deferred tax accounting rules were written, the ones that are currently in effect, Accounting Principles Board (APB) Opinion 11 and the attendant statements and interpretations, the principal focus of the accounting profession was on the reporting of income and reporting the economic effect over the period of the report. Therefore, the rules were defined to focus principally on income for the period. The impacts on the balance sheet were given secondary consideration.

As most of you are aware, that focus has been changing. The accounting profession is returning first to focusing on solvency, and the balance sheet has moved back into the number one focus. I think that you can see that change in emphasis if you have had time to study any of the recent actions taken by the FASB or the exposure drafts which we are concerned with, both that of

accounting for federal income taxes as well as accounting for long-term life insurance contracts.

Let me now list a few of the items which we need to be concerned with coming out of the 1986 Tax Act. I am sure my list is not all-inclusive, and you may think of many more, but these are the only ones I am going to talk about.

1. Income tax rate changes.

2. Change in capital gains taxation, and deep discount investments.

3 "Nongrandfathers" on the policy side and impact on GAAP policy assumptions.

4. Uncertainties with respect to tax consolidations.

5. Alternative minimum tax.

6. Repeal of the 20% exclusion.

7. Discounting of nonlife reserves.

These seem to be the major changes and some of these items in reality have very little, if any, GAAP impact. Let's look first at the current accounting rules.

As I mentioned, current accounting rules were written with their focus to the income statement. I always find that I can eliminate a lot of the complexity if I relate to the original rationale of APB Opinion 11. Since Accounting Research Board Statement No. 48 was the most recent pronouncement at the time I entered the profession, I am one of the few around who may still remember the deliberations on APB 11. In any event, the principle focus of Opinion 11 was the income statement. Its objective was to produce a total tax expense which would represent federal income taxes incurred if the GAAP before tax income was tax return income before adjustment for permanent differences. I find that if I keep this in the back of my mind, there then seems to be some logic in what we accountants currently do in calculating deferred income taxes. This explains why discounting is not appropriate under the rules and it explains why

adjustments are not generally made to the deferred tax liability when tax law changes occur which impact previously established amounts. I am sure you can point out exceptions to this rule but I think what you will find is when those exceptions were adopted, the accountants let their balance sheet considerations dominate.

Let's now examine the items I listed. With respect to the rate change, in this category you can also include the change in the capital gains taxation as well as the changes with respect to discount bonds. Not being one of the appointed 15, this change is at least of academic consideration to Security Life. You can probably also toss into this "basket" the impact of the elimination of the 20% exclusion because, while not technically a rate adjustment, the mechanics function in the same way. With respect to all of these, no adjustments to deferred taxes occur on the effective dates of the rate changes themselves. Remember, we want tax expense in the 1987 financial statement to be taxes as if the 1987 GAAP income was taxable income before permanent differences. This also means that for 1987, transactions occurring in the GAAP income statement in 1987 will be tax-effected at the 1987 effective tax rates, the blended rates, even though, for all practical purposes, the taxation that takes place takes place post-1987 or pre-1987.

This theory also applies to the discounting of loss reserves although this is complicated by the "fresh-start" adjustment. I'm on shaky ground here because I have little experience with loss reserves, not writing any health insurance, but my belief is that no timing difference existed, GAAP versus tax prior to the change in tax law. Most companies on the property and casualty side are putting up gross reserves for both GAAP and tax purposes. Therefore, the fresh start produces a timing difference which is attributable to pre-1987 transactions. I believe that fundamentally, under APB 11, this should result in no adjustment for deferred taxes for the fresh start adjustment but you can make an argument, and we did with respect to the 818(c) fresh start, that the change in the tax law is a current transaction and we need to reflect that in the current period's income statement. In any event, the area is unclear. Since the fresh start produces a deferred tax asset, as we'll be getting a future tax deduction with no book expense, we will need to explore this further should the rules on accounting for federal income taxes not change.

A bigger problem, I believe, is the changes to the Tax Law which left some uncertainty as to how they were to be done. I use the term *changes in the Tax Act* in its broadest sense. In this category, I include the uncertainties with respect to consolidation, the alternative minimum tax, and the indirect impact of the potential need to change GAAP product assumptions because of the environmental changes brought on by the Income Tax Act. Let's look first at GAAP reserve assumptions.

Plans of insurance that were designed and sold to be loaned, the minimum deposit plans, the zero cash outlays, and other such devices were not, in reality, grandfathered no matter how you look at it. The change in the Tax Act changes significantly the economic impact of these plans of insurance on our policyholders and, at least theoretically, should produce a change in behavior of these policyholders which may require a reexamination of the GAAP assumptions, principally the persistency assumption. Many people would argue that the lock-in principle applies and the assumption can't be changed, but a close reading of the audit guide leads me to conclude that a change in persistency assumptions is not only warranted but is mandated by the audit guide should fundamental deviations from expected be taking place. The question in my mind is when do you recognize it? Do you do it now, before you have had sufficient time to gather and analyze the evidence of what is taking place, or do you wait until you have undeniable evidence and quantifiable data? In this circumstance, I would argue that the change needs to be made as soon as feasible as what you are attempting to report in your current financial statements is the impact of the change in the tax law on the insurance company.

This is not a tax accounting issue. It is an overall financial reporting issue and it's one that we are still facing at Security Life. We did not make changes in our assumptions in 1986 although you can argue that I should have done that. My problem is that I haven't been able to gather enough data to determine what those changes should be. In our case, at least, there were changes that should impact the persistency both positively and negatively and we have not yet been able to sort out whether they counter-balance or whether there is imbalance in either direction. If we do need to change, however, we must face the question of whether we do a retroactive change, consider the change to be a current period event and flow the whole thing through for the current statement, or go back and restate the financial statements for the full period being reported.

The current rules would lead me to believe that the change should be reported in the current period's income statement. In this, however, we may find that the FASB has saved us from having to decide if they adopt the changes presently being considered with respect to the accounting for life insurance in general. That's a positive, maybe the only positive, that you can find in the current universal life FASB proposal.

The alternative minimum tax also has GAAP implications because the alternative minimum tax is basically caused by timing differences between book and tax income, including many of the tax preferences that are listed, but it also does include some tax preferences which, from an accounting standpoint, are permanent. The question to be addressed is can you completely ignore the alternative minimum tax under the current rules? I personally don't think you can ignore it although under most circumstances, I suspect that after making all of the calculations, it will not impact GAAP deferred taxes. The only areas of concern, I believe, are those entries in the alternative minimum tax calculation that are considered permanent differences for GAAP purposes. All others, when GAAPed, should flush out the calculations. Currently this basically includes the tax-exempt and dividend received deduction and some of the specialized industry exclusions such as percentage depletion. Post-1989 could include deferred acquisition costs because post-1989 the tax rules for calculating deferred acquisition costs and reserves will deviate from the book rules. Under certain sets of circumstances, permanent differences can be created. Whether the creation of permanent differences will be sufficient to offset the tax rate differential between the alternative minimum tax and the regular tax rate as well as the 75% adjustment factor is unclear, but it could. In any event, companies that are looking at an alternative minimum tax, particularly for extended periods of time, may need to provide for a tax expense in the GAAP statements for the alternative minimum tax. Those who anticipate moving back and forth or can demonstrate, through the use of alternative minimum tax carryforward, that the long-term basis of the company from a tax paying standpoint is the regular tax, should be in a position not to have to provide in the GAAP financial statements for the alternative minimum tax because of the credit carryforward. This may not be true under the exposure draft.

There is also uncertainty in the consolidation area. This has to be done principally with the alternative minimum tax calculations. This could have some

impact on deferred taxes, particularly if you are producing GAAP financial statements for entities at a level below the tax consolidation level. I believe the areas of consideration in the consolidation arena will be unique to each consolidated group and I don't have the time nor the expertise to identify and address all the considerations. All I can do is admonish you to review closely your own tax consolidation picture and, keeping in mind the intent of the current accounting rules, evaluate whether peculiarities in the taxation of your consolidated group should impact the GAAP tax expense of the entities reported on.

To address the problems inherent in a change to the accounting prescribed in the exposure draft on federal income taxes, we must discuss the fundamental change which is a shift to a balance sheet orientation. Rather than focusing on tax expense, the exposure draft focuses on the tax asset or liability in the balance sheet and whether it represents an appropriate quantification of the future benefits to be gained, or the future liabilities to be paid for federal income taxes.

As many of you know, the accounting profession has been reevaluating the rules on deferred income taxes for the last several years. It has considered several alternatives, including doing away with deferred income tax accounting as a concept. The exposure draft rejects this radical approach and adopts as its objectives the same objectives that are fundamental to APB 11 and what it refers to as an "accrual accounting" approach. That is, it continues the concept of accounting for all of the tax effects, past, present, and future, for every financial transaction that took place during the period. The focus, however, is first to the balance sheet rather than first to the income statement. Focusing on the balance sheet first shifts the emphasis of the rules toward measuring the tax liability or tax asset rather than measuring the tax expenses for the period. While this may seem trivial, the impacts are significant because of the limitations of double-entry bookkeeping. So, when the intent is to present an appropriate liability or asset from a financial position standpoint, sometimes the impact on the income statement can be bizarre. I have seen examples in the accounting literature where the GAAP tax expense for the period, under the new rules, can exceed the income before taxes because of the relative timing of the temporary differences. While some of you may think the extreme cases that the opponents cite are rare occurrences, I can assure you that they are not.

The rules in the exposure draft currently are the rules Security Life follows to a large extent in its reporting to its parent, a Dutch insurance company. Deferred tax accounting in Holland has been on the liability method for many years. The difference, however, is that in Holland we are allowed to discount in the calculation. Under the proposed FASB rules we will not be. If anything, this should increase rather than decrease the unusual income statement effects that can occur.

In any event, the balance sheet reporting under the new rules will probably be okay. The amounts reflected in the balance sheet, at least on the liability side, should be a conservative but relatively accurate amount of the exposure to the company. Given the fact that the new rules preclude the recognition of any deferred tax debits, except in the case where it can be demonstrated that the debits can be utilized within the carryforward or carryback period against deferred tax credits or previously paid taxes, the balance sheet approach under the proposal must be deemed extremely conservative. Even under the current procedures, deferred tax debits can be recognized as long as it can be reasonably demonstrated that future taxable income will occur which will make the realization of the value of the debit appropriate. Under the new proposal, even when this is demonstrated, the debit may not be recognized.

On the income statement side, however, we may have some very funny effects. First, discounting is still ignored. Therefore, the time value of money is not recognized. Second, scenarios can be constructed where the conservatism built into the balance sheet, e.g., the inability to offset deferred tax debits and credits unless they mature within periods bounded by the carryforward rules, could create situations where, for temporary differences, we would only be recognizing the impact of the deferred tax credits and not the debits. In extreme cases, the total tax expense provided in the income statement could well exceed the income before taxes for the period.

Given this, let's take a look at the exposure draft's effect on the factors to be evaluated arising from the 1986 Act. First, with respect to rate changes, (and this is application not just to rate changes but to the capital gains effect which, from our standpoint, are rate changes), we would recalculate the liability for deferred taxes at the end of the year using the new rates and we would flow the difference between the deferred tax account at the end of the year and the

deferred tax balance sheet account at the beginning of the year through the income statement. In this manner, the current period or, if chosen, the earliest period reported on in the set of financial statements presented, would show the full effect of the rate change in the income statement. With respect to changes in GAAP reserving assumptions, any change in deferred taxes would follow the reporting of the change in reserves. Hence, if the reserves were restated, deferred taxes would be restated as the computation of deferred taxes is dependent upon the balance sheet valuation of the assets versus the tax return valuation.

With respect to the alternative minimum tax (AMT), I believe there would be no argument as to whether or not it should be considered for GAAP purposes. Given the rules for not anticipating taxable income to make a reasonable determination, I don't see where the alternative minimum tax could be ignored. This is not to say that a provision needs to be made as it might well be that the AMT tax credit carryforward could be absorbed in the reversing of temporary differences in the carryforward period but, whatever the case, it could not be treated solely as a temporary difference on the assumption that, over the long term, the company would be paying tax under the corporate provisions rather than the alternative minimum tax provisions.

With respect to consolidations, the same comments apply. In addition, there may be some additional reporting requirements in the footnotes with regard to the intercompany agreements on allocation of taxes between the companies although, for the most part, I believe this reporting is generally done now.

With respect to accident and health reserves, I also believe that there would be no argument. The fresh start should be recognized in the deferred tax calculations and, to the extent of the ability to recognize deferred tax debits, it would be recorded.

The calculation method has also changed under the exposure draft. Under the old method, the income statement items were tax effected and major calculations were based upon the income statement numbers. The new rules tax-effect the balance sheet accounts on the difference between book and tax basis. Also under the draft, some of the deferred tax calculations with respect to business combinations changed. Dick Miller will address these. Finally, you will find

that you have to categorize your temporary differences as to when they reverse, identifying year by year the amounts involved. This is so that you can make the determination as to whether the items can be offset by looking at whether they come forward or backward in the carryforward or carryback period. This can be tricky as we have found in dealing with our European basis financial statements. Finally, the way the draft is written indicates that stock life insurance companies would have to provide deferred taxes on policyholder surplus. The draft indicates that the indefinite reversal exception that came from APB 23 and applied to bad debt reserves and savings and loan associations, some other incidental items and Phase III taxes for insurance companies, would be repealed. My understanding, however, is that the FASB is backing down on this provision, although I have seen nothing officially to confirm that.

With respect to the draft on long duration contracts, taxation should follow the changes in reserves and, obviously, talking about the taxes is like the tail wagging the dog. There will only be symmetry, however, if both exposure drafts are adopted. If we move to the new long duration rules and continue with the existing deferred tax rules, then the question will be "Do you make a deferred tax liability adjustment with the restatement of reserves?" Again, we may have some questions raised. If that does occur, however, I would anticipate that there would be a technical bulletin which would allow you to adjust deferred tax assets and liabilities.

Let's move on to reinsurance issues. There are some GAAP accounting issues but I think these are dwarfed by the financial planning issues. Changes in the reinsurance rules have had a dramatic effect on the ability to use reinsurance as a financial planning tool. The tax law changes that are important are not in the 1986 Act but in the 1984 Act, Sec. 845, which applies to both life and property and casualty (P&C) companies. This gives the Internal Revenue Service wide latitude in reallocating the economics of a reinsurance deal in the tax return. The biggest problem here is the uncertainty as we haven't seen any significant audit impacts yet. The uncertainty means that a lot of people who would have used financial planning reinsurance are not doing it. As a result, from a GAAP standpoint, we will probably see a reduction in the number of agreements that are accounted for as financing arrangements.

Also influencing this is the change in state regulatory considerations. New York Reg. 102 which restricts the surplus credits you can take on reinsurance agreements that are not deemed appropriate has been issued and the New York department's interpretation, as far as we know, has been very rigid. In addition, California is following these rules administratively and Texas has now adopted its version. Several other states are also considering adopting a version of New York Regulation 102. All this will do is place more uncertainty on the use of financial planning reinsurance. The effect is to limit the ability to borrow surplus from other insurers at low cost. The only thing that will fly in certain circumstances is straight coinsurance. Because of the risks that are transferred, the cost obviously will go up. With interest-sensitive products, the investment considerations of coinsurance must be addressed.

As is typical with regulation, this program, which is designed to protect the consumer, will in the long run hurt them as it will serve to restrict competition. Given the status of current products, the statutory surplus strains that are generated are such that most companies cannot support a rapid growth no matter how big they are. While capacity does exist in the industry to absorb it all, the inability to spread the capacity around through reinsurance will restrict those that have the products and the marketing force to rapidly grow from obtaining the surplus at the lowest price; hence, the cost to the consumer will go up.

With respect to financial performance measures -- and in some ways I'm not even sure what we mean by this -- I think the devices themselves will not be impacted significantly by the change in the tax law. On performance itself, however, the tax law is going to change the profitability of the existing book of business for many carriers. This is particularly true of any plans of insurance that were sold on a minimum deposit basis or in any way relied on the economics of taxation in the sales process.

On the positive side, it may improve the performance of some products that were not sold this way as, obviously, many of the ads say, "Life insurance is one of the last of the effective tax shelters." In any event, however, the tax law is changing or has changed the profitability of the existing books of business either positively or negatively and that needs to be included in your evaluation and forecast of financial performance.

The tax law will also complicate the pricing process. With the advent of the alternative minimum tax in its current form, this will need to be considered. For some companies, the tax cost of its products may be different than its competitors or, in any event, what it used to experience. On the mutual company horizon, the uncertainty with respect to the add-on tax, as far as rates and levels, is also of concern in product pricing. This obviously will complicate the product pricing and may lead to even more "nonguarantees" in the pricing area. Finally, the change will cause companies to find themselves in different circumstances, change the competitors' pricing and perhaps some of the competitive balance company-by-company in the industry.

I won't address the managing of surplus needs but I believe this is a serious concern for all financial people with insurers. All I can say is that you need to pay specific attention to the management of surplus needs as that is becoming more and more critical, not just from a financial statement standpoint or a financial management standpoint, but also from a marketing standpoint.

In conclusion, then, I believe the change in the tax law has had a significant effect on both the financial performance of the company as well as the ability to manage your financial performance and forecast your financial needs.

MR. RICHARD S. MILLER: My topic is the impact of tax reform on mergers and acquisitions. As John indicated, the centerpiece of what I'm going to talk about is the effect of the General Utilities repeal. Through the use of the general utilities doctrine and rule, it was possible to structure a purchase and acquisition of a company so that the acquiring company could in effect depreciate the book of business in force over its future lifetime to offset the emerging taxable income that might otherwise come out of that book, if it could show that the value of that book was an appropriate depreciable asset. That had a great favorable effect on the pricing of mergers in the early 1980s, and generated, apparently, many billions in deductions for our companies. The repeal basically says that you can still go ahead and do that, but in the final tax return of the companies being taken over and theoretically liquidated -- or actually liquidated, in some instances -- the value of this business in force will be compared to its tax basis, which probably is zero, and that income will be pushed through the final return of the liquidating company. In some instances on existing acquisitions, if the repeal had had an effect as the Treasury wanted it to, the

resulting tax would have completely wiped out the statutory surplus of the acquired company and you would have had an immediate insolvency.

The IRS attempted to institute the new treatment with a bulletin issued on April 7, 1986, which in essence said they would grandfather anything happening, but anything that happened after that would be subject to this type of income recognition. Whether they would actually have been successful in implementing that is an open question, because they won the war by getting the General Utilities rule repealed in the Congress. However, one can still use tax planning and the ability still exists to deduct, in effect, or amortize against a tax return, a purchase price for a block of business. It may even exist at the company level in the situations which might have previously been deemed one of these Section 338 reorganizations. The peculiar situations are those where the company to be acquired perhaps has a significant loss carry forward which might turn surly under the acquired or the consolidated rules, or where the general parent corporation of the selling company has loss carry forwards which it wants to apply. You might have a situation where the selling company is in the small company rules at a very favorable tax rate, relative to the tax rate of the acquiring company. In all these instances, it may be economically well worthwhile for the selling corporation to incur this tax in its final tax return, particularly if it doesn't generate any cash tax, in order to allow the acquiring company to emerge from the transaction with what is a more valuable block of business to it. I have seen a couple of examples of admittedly relatively small companies being purchased where they are still going through the liquidation and taking advantage of the combined loss carry forward and small company rules.

As far as the older Section 338 and Section 334 mergers are concerned, they are now maturing into actual audits. The IRS is taking every shot it can at the values being placed on the block of business, through the process of almost automatically throwing out consideration of any 18(c) net level adjustment in determining the liabilities of the liquidated company; through the process of adopting an investor's required return rate well in excess of 20% -- I have seen one at 23 and one at 25; through the process of inflating expense rates over and above the expense considerations inherent in the valuations that were done. The consultants to the IRS have managed to arrive at numbers which are as much as 60% less or 40% of the original numbers. The curious thing is that if you apply all of these discounts to the depreciable asset side of the house and

completely forget the fact that the asset side of the company was also significantly reduced in most of these, you produce a situation where a company that has gone through a 338 revaluation, with the appropriate value placed on its business, may appear from the IRS's standpoint to be more profitable after acquisition and to be subject to more taxes after acquisition than before. In one case that I'm quite familiar with, the asset side of the house was depreciated about 25%, and that 25%, of course, flows back as additional taxable income in future years. They aren't contesting that at all.

In any case, at a recent Peat Marwick seminar, the opinion was expressed that this mass attack on the previous 334, 338 valuations is one that almost certainly will go to court. There are too many dollars involved. It's a fact situation, and there were some opinions expressed that a more reasoned or a more reasonable approach to discount rates and the value of the business, and a comparison with what the marketplace actually did place on the business, would produce something closer to what was originally claimed.

As far as current situations are concerned on the purchase GAAP field with respect to acquisitions and mergers, the tax aspects of deferred taxes have become considerably muddied by the FASB exposure draft. That exposure draft would return a deferred tax item to the immediate balance sheet of the purchased company. That deferred tax would be the expected future tax effect of the emerging difference between the book reserves and the tax reserves. In the past, that difference probably has been buried by the company in its reserve factors. As such it was almost certainly discounted and it was almost certainly offset by the beneficial effect of the 334, 338 type deductions that were expected to be taken. And thus, those were also discounted. So we have a past situation where purchase GAAP treats the future emerging deferred tax differences on a discounted basis; and the current exposure draft would say that you can't do that, that you may not discount those future differences. So the implication is that the current exposure draft would require us to break out of the liability side of the house whatever we put in there for deferred taxes and then "undiscount" it and set it up as a separate item. And that could be a very unsettling experience if you add that in with the Phase III overhang treatment which might be present for other members of the consolidated group (usually not present in the 334, 338 situation). The FASB proposal can do a great deal of mischief to

the existing balance sheet's reportable income for past merger and acquisition situations.

On a more current basis, the presence of Section 845 is having some strange effects on mergers and acquisitions as well. Mergers and acquisitions in the life business can be accomplished in several ways; one of them is by reinsurance. A block of business can be coinsured, commonly referred to as indemnity reinsurance. Past rules would normally indicate that on indemnity reinsurance the complete amount of any ceding commission paid could be currently deducted. And if you are talking about a block of in-force business, the ceding commission economically looks very much like a purchase price. So you get a lump sum deduction in the year of purchase under indemnity coinsurance. Under assumption reinsurance, it's pretty well established that you get to take your ceding commission -- your purchase price -- as a deduction, but you have to take it over the expected future lifetime. But past treatment by the IRS has pretty well accepted some fairly reasonable future lifetimes -- fairly short future lifetimes, in fact -- for blocks of business. I have seen at least one instance where 20% in the first year and the remaining 80% pro rata over five years was accepted, which is probably very rapid depreciation relative to the emergence of the profits of the book.

Anyway, the existence of Section 845, at least theoretically, gives the IRS the right to treat any reinsurance acquisition of a block of business however they want to treat it. And that's a threat and creates uncertainty in the pricing of existing acquisitions.

Another item that needs to be considered relative to mergers and acquisitions is the existence of in-force reinsurance in the company to be acquired, particularly surplus relief for financial reinsurance. At a minimum, in the appraisal of the company, you need to schedule out the reversal of that reinsurance and its effects on the tax return as it emerges in future years. You may well have a situation where loss carry forwards or expected tax deductions mean that there won't be any cash taxes paid in those future years. So you've got a further deferral out to the point when these reversals will cause actual cash tax deferrals. That kind of scheduling is then further complicated by the question of whether this is a financing or a risk transfer. Basically, I guess the approach I implied there was that the surplus relief was a financing transaction. And

usually the accounting attitude is taken both for tax and for GAAP. But if it's a risk transfer, and you need to make the argument, particularly in front of the regulators, the conflict of arguments here leads to some significant complications in trying to do the appraisal process to determine the appropriate purchase price.

As a final matter relative to the in-force financial reinsurance, with the advent of the Reg. 102 California position and the Texas new regulation and the other states that are coming on board, there is a double jeopardy type of situation present. While almost all of these regulations provide some kind of grandfather for existing contracts, if they are disclosed to the department, I suspect that the existence of marginal contracts -- contracts that hadn't been disclosed, revealed in the hearings for transfer of ownership, would give the appropriate department an additional opportunity to insist upon somewhat different funding of the required statutory position by the acquiring company. In one instance we got to look at recently, there was a serious question as to whether the existing reinsurance contracts would survive approval by the department or whether the outside acquiring company would have to provide considerable amounts of cash to shore up the surplus of one of the subsidiaries.

MR. HARRY D. GARBER: I'll try and move fairly quickly through the material to allow some time for questions. What I wanted to cover was both the effect of tax laws on investment decisions like company investment decisions and then also some special effects on mutual companies.

Most of us who are in the insurance side of the business tend to think of taxes on insurance products and to evaluate them in asset share calculations, pricing formulas, and so on. And when we do this we're thinking of an investment as a typical bond or stock that is bought at par and is sold or eventually matures at par, which has a fixed income that is fully taxable. So really all the income is taxable; there are no capital gains and everything is relatively straightforward.

As you know, as you get into the investment world, investments come in all kinds of shapes, sizes, and configurations, and a good many of them have very different tax treatments than the straightforward bond or mortgage. And this is something that we need to take into account in shaping both investment strategies and in making decisions on specific investment deals. But in doing so, let's

remember that tax affects only the after tax yield on investments and that this may not be determinative when you want to consider other things such as risk and asset-liability matching. So taxes have an important but limited role here.

There are really two types of tax effects. One is the difference in rates applicable to different forms of income. John talked earlier about capital gains as a different form of income that used to have a different rate. Some time in the future, it may again have a different rate, but in 1988, it will not have a different rate, and the current tax law says that for years after that it wouldn't have a different rate. Tax-exempt interest has a different rate. Dividends received by corporations have a different rate. So those are some rate differences that apply.

Second, there are timing considerations in that income for tax purposes comes at a different time than it does for book purposes. These timing differences can have an effect, because if in fact you can defer paying taxes into some future year on a particular type of investment as compared with a bond or mortgage, that deferral has a value which you can evaluate and take into account in making the investment. The problem with this is that this describes a very simple, nice world here and there are a lot of complexities to it that have made it much more difficult.

First, a lot of the differences were eliminated in the 1984/86 tax changes and I'll come back and talk about some of those. The minimum tax has an effect. There are some proration rules on life companies that apply to tax exempt interest and dividends received which have an effect. The company's tax position has an effect, and then, of course, there's the whole question of what's going to happen in the future on taxes. As you are looking at investments, you are looking at the values of deals being made today, but which will mature many years from now, and tax changes over that time will have an effect.

It is helpful here if you can give your investment professionals some rules to go by. And one of the things we have done -- I wouldn't say terribly successfully -- is to try to give them some idea of converting the yield that they see on a particular investment into a pretax equivalent yield for an investment that has tax favored features, and converting that through present value mechanisms into

an increase in yield. It's a complicated process and it doesn't always work, but it may be helpful in some circumstances.

Let me speak about a few specific investments just to give you some examples of what I meant by rate differences and timing differences. Real estate, for example, is the prime place where all these kinds of differences occur. With a piece of real estate, you depreciate the property over time on the assumption that its value will go down as the years go by. Real estate depreciation, in an economic sense, is essentially the same as repayment of principal on a bond or mortgage. The difference is that for tax purposes, you can deduct real estate depreciation. This is all on the assumption that the value is going down. Accordingly, if the value of a piece of property increases with time instead of decreasing, as most have in recent years, you get a depreciation deduction, but at the point at which you sell, you will have income which is the amount of your deductions plus appreciation in value. However, that's at a much later point in time and so the deferral here of tax could have a value to you.

For book purposes, you would normally in GAAP be using 40 or 50 years to depreciate a piece of property; on your statutory books, you'd use a similar long period or you might use a constant yield basis. For tax purposes, depreciation of anything purchased in the 1981-1986 period was in the 15-19 year range. So clearly, the depreciation was going twice as fast for tax purposes as it was for book purposes and this would have a value to you. In 1986, 1987 and later, that is now up to 31-1/2 years, so the value has been diminished somewhat. Now, at the point at which you dispose of the property, you have a capital gain equal to the sale price minus the depreciated value; so you have deferred the taxable income, and you can put a value on your ability to do that.

If you bought bonds at a discount back before 1985, you were able to not amortize that discount for tax purposes, but treat it instead as a capital gain at the point at which the bond matured. So if you buy a bond at 90, you would take the annual interest payments into account as income but that difference between 90 and 100 would come in as a capital gain at the point of maturity of the bond. The tax law changes have put a damper on that one. In 1984, there was a decision that they wouldn't allow this kind of treatment for any bonds after that date, and then of course, last year, they eliminated the difference between capital gains tax rates and ordinary tax rates. So at the moment you have some

bonds floating around which still have this treatment associated with them but newly issued bonds would not.

For corporate dividends, you were able to exclude 85% of the dividends from income; for tax-exempt interest, the interest is not taxable, but for life companies, since 1959, we've had proration rules which, in fact, are saying that you can't both not include the income and take the deduction as you credit it to your customers. These rules vary significantly from company to company. In the Equitable's case, we probably only have a benefit of about 10-15%. Other companies may be in the 40-60% range. That's where you have to look very much at individual circumstances. What happens here, of course, is that if you have taxpayers who are in a position where they are able to take account of this fully, then the yield that is set on tax exempts will take into account their position and not the position of less favored buyers; and we will find that those aren't good investments in many cases because the rate has been set by taxpayers who are in a much more favored state.

There are other investments -- leasing and owning of equipment is an area -- convertible debentures, real estate partnerships -- a whole series of areas which have to be evaluated by looking at their own effects. Here, the tax effects and how they affect our companies as opposed to how they affect some other kinds of investors can give us preferred positions in particular circumstances, but they have to be looked at on a one-by-one basis.

Some other effects that are important, though are: first, the tax rate itself. Small companies clearly have a much more favored rate, and there are companies who are not paying taxes currently -- or would not pay them in prospective years. It is important to know where you are, because if you are not paying any tax today, then deferring income to some future year has really very little value to you. So it is important to understand whether this deferral of income for tax purposes has a value and take it into account in your calculations.

John and Tom both talked about the alternative minimum tax. This used to be something that did not apply to us at Equitable -- it now could very well apply and if it does, one of the first things that happens is that the alternative minimum tax base now changes the depreciation on real estate from 31 1/2 to 40 years. If you have installment sales where you have been able to defer income

on real estate, those have to be brought back into the year of sale and certain tax-exempt interest has to be brought back in -- so a lot of the benefits you have gotten get put into the minimum tax base. That may not make any difference if you don't pay minimum tax at all, but if you do, then that is another complication in looking at the value of these deferral transactions.

Finally, the whole tax structure is obviously very unsettled at this point. I think I feel somewhat more confident than John does that the rate structure is likely to stay the way it is, but it is certainly not one you want to bet a lot of money on. So to the extent you are assuming that tax rates are going to be at a certain level in future years and therefore there is a value in deferring income, you are taking the risk that by the time that income comes in, it will be taxable at a much higher rate than it is today.

Finally, on the balance sheet considerations, statutory balance sheets do not have a deferred tax element. To the extent that your company has a lot of deferred income for tax purposes, in particular a lot of real estate and so forth, you may have a very significant liability here which you have never calculated before. It is worth calculating -- it will scare you in some cases, but it is worth looking at.

Let me spend a few minutes now on mutual company considerations. As has been described before, mutual companies have an additional tax element which is determined by taking what is called a differential earnings rate and multiplying it by the equity base of the companies. The differential earnings rate is determined by comparing the mutual industry as a whole with a representative group of stock companies. The equity base is an individual company matter which looks at the statutory surplus, plus the mandatory securities valuation reserve (MSVR), plus the nonadmitted financial assets, plus the difference between statutory reserves and tax reserves, plus half of the dividend apportionment and a few other items. Essentially, it turns out to be a number somewhere between 1.5 and 2 times statutory surplus. So whereas each company computes its own equity base, the differential earnings rate is an overall number for the whole industry. What's happened here is a social burden has been placed on mutual companies generally, so that these dollars have nothing to do particularly with individual company circumstances. The differential earnings rates have been

very unstable so you have an item which is unclear as to when it will stabilize, or if it will stabilize at all. And the question is what do you do with it?

Actually there are three questions: first, what do you do with it on your statutory blank? I think the best thing there is to allocate it by line, and probably an allocation that follows the allocation of the tax equity base would be the best approach. Second, if you have subsidiary companies, do you charge it to your subsidiaries, or do you just ignore it in dealing with subsidiaries -- this gets into your tax sharing arrangements with subsidiaries. I think it is probably best just to ignore it, but that is again an individual company consideration. Finally, what do you do with it in pricing products? There are two approaches here, and I haven't been able to do enough checking among my compatriots in other mutual companies to know which is the preferred approach. One clearly is, if you are going to allocate it, to charge the allocated amount, or some estimate of what the allocated amount will be, in your pricing. The second is to set a certain return that you expect to get from these products before the add-on tax, and set the return rate high enough so that you can pay any reasonable level of add-on tax and then add to surplus as you see fit. I think you can use either choice; that is an individual company consideration. The minimum tax, of course, comes in for mutuals here; I think that's been pretty well covered.

I would add one particular mutual element as we get out to 1990 and beyond, where the so-called earnings and profits test comes in. There is an adjustment in there, which was defined in no more than one line, for acquisition costs. There are a couple of problems with that, and one is that the mutuals have not ever had to compute acquisition costs and amortize them for accounting purposes. The second covers both mutual and stock companies: clearly if you get an acquisition cost adjustment, but earnings and profits are still based on tax reserves (which tend to be CRVM reserves), you in fact have a double adjustment in there, and you are going to have even more taxable income than GAAP income. So clearly that is an area where the industry will have to work with the Congress to try to clean up the law. The history of this was, as John mentioned, that the Senate liked the book income approach, the House liked the earned premium (EP) approach, and what's happened now is that the Senate is now controlled by the Democrats rather than the Republicans, and the Senate Democrats like the EP approach better than the book income approach too. So I

think that they will get together on bringing that one in earlier, although it does not look like it will be either 1987 or 1988.

MR. PETER S. PALMER: I want to ask Tom Conroy a question on the subject of deferred taxes. We have all become a lot more interested recently in the rating agencies' treatment of life companies. It seems that of two otherwise identical life insurance companies, one of which maintains deferred taxes on its statutory books, and one of which does not, the one which does not is going to be treated more favorably by a rating agency because it has a higher surplus number, even though there is no difference in the facts of the company. I was wondering, in the study you have done of deferred taxes, if you expect this situation to change as people learn more about the life industry.

MR. CONROY: Peter, I do. I think you may be selling the analysts at the rating agencies short. Our experience with Standard & Poor's was that first of all, they focused on the statutory side, not the GAAP side. Second, they had a pretty thorough understanding of the balance sheet versus income effects or what real assets and real liabilities are and what the residuals of calculations are that just wind up in your statement. So I don't share the same concerns that you do with respect to rating agencies. I think they pretty much focus on the statutory statement. I think particularly from the mutual company's standpoint, Harry's observation about quantifying those deferred tax liabilities on a reasonable basis with respect to the timing differences, particularly in real estate, is going to be of interest. We don't have much of that, so they did not raise those questions with us, but my guess is they have raised those questions in their detailed review with the companies that have significant deferred tax problems. Does that answer your question?

MR. PALMER: Yes, thank you.

MR. ADNEY: I have first a follow-up comment to Harry's point about the work that needs to be done by the industry with the Congress as respects the policy acquisition expense capitalization requirement in the adjusted current earnings base. There is work underway in industry groups, and I think all of that is focusing on an ACLI effort, to point out the argument that there is a duplication in requiring the companies to use a preliminary term method in determining tax reserves, and to capitalize and amortize the acquisition expenses. I will be

interested to hear the government's reactions to that -- I think their reactions in part will depend on whether they really stand by the reserve rules that were enacted in 1984. I would not doubt that some will come in and argue that those still allow overblown deductions, and on that basis we'll try to resist efforts to change what Congress has already put in, but efforts will be made to avoid that duplication. Part of the work is really the need to quantify what the degree of the duplication is, point that out to the government, hope that that argument will bite, and then for whatever is left, come up with some sort of a proxy, to place the capitalization/amortization on something of a uniform base.

I also have a question, and I will direct this to Tom, but anyone else who wants to respond can do so. I have heard discussion regarding what you have said about the desire -- in some instances express need -- on the part of people in certain companies to try to persuade FASB to recognize some kind of a prepaid tax asset in those areas where tax has been paid on the discounting of reserves, where that discounting is not otherwise recognized in the GAAP treatment. Is this anything that we should look at seriously in your judgment -- does it have any chance of succeeding?

MR. CONROY: Whether it has a chance of succeeding, I don't really know. I know that the FASB -- and I'm in Denver and they are in Connecticut, so I'm a long way from them -- has, at least informally under consideration, changes in their stance on discounting. And I think the reason it's not in the income tax draft is simply because they want to address it in a much broader base. That will be an issue that will be under examination. I can also state that the new chairman, Dennis Beresford, who I worked with when I was with Ernst & Whinney, is quite a reasonable guy, and I think that it certainly would not hurt to have some interchange with the FASB. I think there will be a move towards discounting, particularly with this basic shift in emphasis from the income statement to the balance sheet, which we see going on throughout the accounting rules.

The prepaid tax asset question gets to be another problem, because they also are focusing on the balance sheet -- financial solvency -- and taking a very conservative approach to what can be recognized as an asset. And the new rules about having to demonstrate that the deferred tax debits can be offset against currently existing deferred tax credits without anticipating, even in a

reasonable nature, any future income, raise questions in my mind in that area. So it is a double-edged sword.