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REINSURANCE TAX ISSUES

Moderator: MELVILLE J. YOUNG
Panelists: RONALD ALBERT*
GORDON K. DOWSLEY**
STEPHEN C. ELDRIDGE***
ARTHUR C. SCHNEIDER****
Recorder: MELVILLE J. YOUNG

- A panel discussion on the most current tax issues affecting reinsurance
  - Ceding commissions on indemnity reinsurance
  - Section 845
  - Modified coinsurance
  - Tax issues under assumption reinsurance
  - Alternative minimum tax implications
  - LTD reinsurance tax issues
  - Revised Rule 88-72 -- Intercompany reinsurance
  - Canadian tax developments with regard to investment income
  - United States/Canadian cross border reinsurance

MR. MELVILLE J. YOUNG: Art Schneider is a tax partner in Peat Marwick's Chicago office. He works both in life and property and casualty (P&C). He's associate editor of their insurance newsletter and their quarterly insurance tax publication. His bachelor's degree is from a small university in Indiana that isn't Notre Dame. His master's degree from DePaul University is in accounting and tax. He's a member of the American Institute of Certified Public Accountants and the Illinois CPA Society. He's going to be talking about, amongst other things, ceding commissions, the Colonial American case, Section 845, some modified coinsurance (MODCO) issues, and tax issues involving assumption reinsurance.

Ron Albert is a second vice president and director of tax planning for UNUM, nee Union Mutual. (He says that the company went through a sex change in 1986. I thought the government was trying to take sex out of taxation.) Ron's an accountant, has a master's in tax and has been with UNUM for sixteen years. He recently played a part in an important case that UNUM won in tax court which dealt with reserves for deposit administration (DA) contracts. He's been involved in many reinsurance transactions that UNUM has done over the years and has some fairly interesting experience in reinsurance taxation. And he wanted me to mention that he, like most of the rest of the panel, is a member of the famous tax group, the Northeast Tax Study Group. Ron is going to be talking about the alternative minimum tax and some important planning items, and also LTD reinsurance. Gordon Dowsley is our last speaker. Gordon's been with Crown Life for the last seventeen years in Toronto. He's a vice president and is in charge of financial reinsurance.

* Mr. Albert, not a member of the Society, is Second Vice President and Assistant Tax Director of UNUM in Portland, Maine.

** Mr. Dowsley, not a member of the Society, is Vice President, Financial Reinsurance of Crown Life Insurance Company in Toronto, Ontario, Canada.

*** Mr. Eldridge, not a member of the Society, is a Partner of Ernest and Whinney in New York, New York.

**** Mr. Schneider, not a member of the Society, is a Partner of Peat Marwick Main and Company in Chicago, Illinois.

His current responsibilities include financial reinsurance and international operations, and he's been involved in many large bulk financial reinsurance transactions.

Gordon's going to be talking about Canadian tax developments and possibly some international reinsurance opportunities. I won't get involved too much in Gordon's political background, but I will say that ever since he's been involved in the liberal party in Canada, it's sort of been going downhill. Hopefully, he will make a better contribution to this session than he's made to the liberal party.

MR. ARTHUR C. SCHNEIDER: There's no denying that the 1984 Tax Act took a lot of wind out of the sails of a number of reinsurance tax issues, not only by changing the tax formulas that led so many companies to get involved in reinsurance tax opportunities, but also by providing some disincentives. But there are still a lot of items of interest in the area of reinsurance as it affects the taxation of life insurance companies.

And one of the major ones that is under consideration right now by the Supreme Court is the issue of deduction of ceding commissions that are paid by an assuming reinsurer in an indemnity reinsurance type of transaction. This is an interesting issue because of the ebb and flow that's been involved in the history regarding the issue. The IRS had been taking the position a number of years back that assuming companies had to capitalize and amortize the ceding commissions that were paid in indemnity reinsurance transactions. Although they were doing this on an informal basis, there was no published position of the IRS as such until 1982 when the IRS issued Revenue Ruling 82-69, which formally set forth its position that what it called "up-front" ceding commissions that were paid by a reinsurer in an indemnity reinsurance transaction had to be capitalized and amortized over the life of the contract. In that ruling the IRS distinguished an up-front ceding commission from an annual ceding commission, saying that the annual ceding commission, which was viewed more as a reimbursement of the direct writer's annual expenses after the expenses of putting the business on the books initially, did not have to be capitalized and amortized.

Shortly after that ruling came out, the tax court issued its first opinion on this issue which was in the Beneficial Life case. And in that case, the court held that the ceding commission in indemnity reinsurance is currently deductible by the reinsurer as a return of premium. The court distinguished indemnity reinsurance from assumption reinsurance. In assumption reinsurance it's clear that the ceding commission has to be capitalized and amortized over the life of the business, but the court found indemnity reinsurance to be distinguishable. And, then, after the Beneficial Life case, the tax court also issued a whole string of other opinions in the Modern Security Life case, Individual Life, Colonial American Life and Merit Life, all of which followed the court's position in the Beneficial Life case in rejecting the IRS's position that capitalization and amortization was required. In fact, the court indicated some irritation with the IRS for continuing to bring the issue before it. Some of the opinions that are written had a few put-downs of the IRS for continuing to force the issue and it was hoped, I think, that the IRS would just kind of fold its tent on this issue and go away quietly.

If this issue could be described like a boxing match, I guess you would call what happened next was as if the IRS got up off the canvas and then knocked down its opponent, because all of a sudden the IRS got on a roll on this issue. There was first the Modern American Life case which was an eighth circuit court case, an appeal of one of the IRS losses in the tax court. That case involved modified coinsurance, not regular conventional coinsurance. And there the eighth circuit distinguished the tax court's opinion in the Beneficial Life case. And the way that it did that was by saying that in a MODCO transaction the reinsurer doesn't book any premium income or take any reserves onto its books, and therefore, the court concluded that there couldn't be a return payment of any kind. And, therefore, there could be no deduction of the ceding commission as a returned premium as the tax court had held in the Beneficial Life and other cases.

Then the court went on to say that under generally recognized tax principles that would be applicable to other noninsurance-type taxpayers. The cost incurred in acquiring an asset that has a life that extends substantially beyond the end of the current taxable year has to be capitalized and amortized under those principles. It was thought initially that perhaps the eighth circuit's opinion in this case would be limited to modified coinsurance transactions because of the way that it distinguished the Beneficial Life case. But very shortly thereafter in the Prairie States Life case, the eighth circuit court again decided this issue, and it specifically decided to do what it declined to do in the Modern American case and that was to rule that the Beneficial Life case had been incorrectly decided. The Prairie States case involved conventional coinsurance as opposed to modified coinsurance. And, basically, the court just followed the rationale that it had in Modern American Life saying that it was an asset that had a life extending substantially beyond the end of the taxable year, and therefore, amortization of that asset was required.

The IRS then also went on to register two other wins on this issue. In the Colonial American case, the fifth circuit court basically followed the eighth circuit's decisions in the Prairie States and Modern American cases, rationalizing that amortization be required to be "well reasoned" were the words that the fifth circuit used in describing the eighth circuit's analysis of this issue. And the fifth circuit also indicated that it could not read the Internal Revenue Code to distinguish between assumption reinsurance and indemnity reinsurance which was kind of surprising, because I think most tax practitioners would feel that the code does indeed distinguish between those two types of reinsurance.

The IRS also won a district court case in the Oxford Life case. So after that series of wins things were looking pretty good for the IRS. Then the seventh circuit court in the Merit Life case during 1988 completely affirmed the tax court's reasoning that had been used in Beneficial and all the other tax court cases and held that the ceding commission should be currently deductible by the reinsurer. In fact, the seventh circuit very sharply disagreed with the fifth circuit and the eighth circuit and their rationale in deciding for the IRS, and used some rather sharp language, actually, in saying that those decisions had been incorrect and poorly reasoned. So the Merit Life case, by deciding for the taxpayers on this issue, set up the conflict between the circuit courts that was required for the Supreme Court to hear the issue. And the Supreme Court did indeed grant certiorari to hear the Colonial American Life case on appeal from the eighth circuit. Now the oral arguments in the Colonial American case were held on April 18, 1989, and a decision on the case is expected within the next few weeks. Basically, in presenting its oral arguments to the court, the life company argued that, first of all, indemnity reinsurance is insurance and is treated as insurance by the Internal Revenue Code, and that, in fact, indemnity reinsurance is not really treated any differently than directly written business in terms of the deduction of ceding commissions being analogous to commissions that are paid on directly written business. The taxpayers also argued that indemnity reinsurance is indeed distinguishable from assumption reinsurance. And they also argued that NAIC accounting, which requires the deduction of ceding commissions for indemnity reinsurance, should be used for tax purposes as well.

The government on the other hand continued to advance its arguments that the acquisition of an asset, an intangible asset, took place when an indemnity reinsurance transaction was entered into and that, again, general or fundamental tax principles that were applicable to other taxpayers and other noninsurance taxpayers would require that the ceding commission be capitalized and amortized. Again, it seems that the government's focus is incorrect here, at least from my point of view. It's basically saying that a reinsurer in an indemnity reinsurance transaction is acquiring an asset just like it acquires in assumption reinsurance when in fact, the Code treats indemnity reinsurance differently than assumption reinsurance. And indemnity reinsurance is inherently really no different in this regard than the issuance of direct insurance.

From the published reports that took place on the arguments that occurred before the Supreme Court on this issue, it's somewhat difficult to get a feeling for how the court may come out on this issue. It appears from some of the questions that were being asked perhaps Justices O'Connor and Stevens were leaning toward the taxpayers' position on this issue, while perhaps Justice Scalia was leaning toward the government's position. I think it's the feeling of most tax practitioners, myself included, that the good guys should win this one and that the Supreme Court should hold in favor of the industry on this issue. When you look at the government's argument in the context of life insurance accounting tax principles, it really it not a very good argument. And, in addition, the Supreme Court has previously acknowledged in cases like the Consumer's Life case and the Standard Life and Accident case that life insurance accounting is really a world unto itself, and that mechanically applying principles of ordinary accounting that might be applicable to other noninsurance companies would not necessarily get you to the right answer in this case. So within a few weeks we should know and, again, we're hopeful that the Supreme Court will find for the industry on this particular issue.

Moving on, I'll just give a few words about Code Section 845 which was enacted in 1984 to give the IRS very broad powers of reallocating the tax effects in both related party and unrelated party reinsurance transactions. To date no regulations have been issued in this area, and there's not even any regulations projects that are pending within the treasury department. That probably is on purpose, because I think the IRS likes the effect that the vagueness of the Section 845 provisions has in dampening companies' enthusiasm for entering into tax-motivated reinsurance transactions. I think the IRS's attitude seems to be that whenever it prescribes rules, the industry finds a way to get around those rules somehow; and if it doesn't prescribe rules then maybe it will just be better off in terms of accomplishing the objectives of Section 845 in that manner. Section 845 does seem to be having its intended effect in general in terms of reducing the number of tax-motivated reinsurance transactions. Again, I think that's partly due to the changes in the tax law that have occurred, that have taken away some of the things that could be done in that area in the past.

It seems like we're seeing more transactions that either involve assumption reinsurance or conventional coinsurance with no recapture provisions or no experience refund provisions to make things look more like assumption reinsurance and real transfers of risk. Of course, companies are still doing tax-motivated reinsurance transactions when they have to; for example, to avoid triggering a Phase 3 tax because of not having enough premium income for a particular year or to qualify as a life company if a company is having a problem in that area.

It does appear that Section 845 is a one-edged sword in terms of its applicability by taxpayers versus the government. In other words, it seems unlikely that companies could argue that a transaction should not be treated as reinsurance or that they would have the authority to determine how to reallocate an item affecting the reinsurance. Although we are aware of at least one of our client companies that has taken the position in its tax return that when it got surplus relief it did not have to report it in income. It's doubtful that would necessarily be allowed by the IRS. Power of reallocation appears to be with the IRS in this particular instance.

Our firm has had few experiences so far with application of Section 845. Many companies, of course, have not finished their examinations by the IRS for post-1983 years, so it's possible that we'll start seeing some more activity in this area. But it doesn't seem like we've seen very much activity in terms of the IRS raising issues at this point on examination of companies for post-1983 years.

There is an item related to surplus relief insurance that I want to mention. States have been tightening their rules on what constitutes surplus relief reinsurance -- in terms of allowing surplus relief for statutory accounting purposes. And it raises a question which one of our clients has in an examination that's currently underway as to what happens if a company enters into a surplus relief transaction, treats the surplus relief as taxable income on its tax return and then somewhere down the road on examination by the state, the state disallows the surplus relief because there was not sufficient risk transfer. It seems like the proper tax answer should be, under the argument that the tax treatment of reinsurance should follow the statutory accounting treatment in terms of recognizing its validity, that the company should be able to go back and file an amended return and remove that surplus relief reinsurance from taxable income. However, this issue is, as I mentioned, an issue in an examination that one of our clients is currently undergoing. And when we tried to do exactly what I said, file amended returns, the IRS has argued that's not the proper accounting and that you should recognize the taxable income as it was reported initially and then, when the state determines that it was not a proper transfer of risk and, therefore, not properly reported as surplus for statutory accounting purposes, the company should get a deduction at that point in time. It seems like rather tortured logic and it's really not a very good argument by the IRS people. They're trying to argue in this particular case that the deduction occurs under accrual accounting concepts and it doesn't really focus on whether or not taxable income was reported in the first place. But with states paying more attention to surplus relief transactions for statutory accounting purposes, it's possible that you may see more of this issue in the future.

Another item probably has narrow applicability, but it's just illustrative of how the IRS likes to hang on to some issues. When the 1982 tax rules were enacted to change on a stop-gap basis the life insurance tax rules for 1982 and 1983, the IRS disallowed the ability of companies to treat modified coinsurance transactions as conventional coinsurance by making what was called a Code Section 820 election. And, at that time, Congress also indicated that pre-1982 modified coinsurance transactions ought to be grandfathered in their effect on tax returns, except in cases of fraud. Well, the IRS didn't really like to give up that easily and it was still pursuing a couple of MODCO issues, mainly the antedating of contracts that sometimes occurred in MODCO transactions. Another issue was the use of investment rates in the MODCO transactions that might have the effect of transferring more investment income from the ceding company to the assuming company than the IRS thought was proper.

In the 1986 Act, the technical corrections that occurred to the 1984 Act, there was specific direction from Congress. Again, Senator Dole indicated in particular that the IRS was not to pursue further pre-1982 MODCO transactions for any issues, including antedating of contracts and the investment rate that was used under the contract. Despite all this, somebody in the IRS still felt that it was necessary to raise the issue. There was recent technical advice from the national office where an appellate agent was asking whether or not he could make an adjustment to the investment rate that was used in the pre-1982 MODCO transaction. Fortunately, the IRS national office reached the only answer that it could, which was, "No." So, hopefully, that will be the last we'll hear of the MODCO grandfathering issue for pre-1982 transactions.

One other area I'd like to mention is technical advice that came out at the end of 1987 from the IRS national office that dealt with a couple of reinsurance issues. Interestingly enough, one of them dealt with the ceding commission in an indemnity reinsurance transaction. In this particular ruling the ceding company was writing single premium immediate annuity business and incurring upfront expenses for commissions and for premium taxes and the like, and then immediately reinsuring a portion of that business to an assuming company in the conventional coinsurance type of arrangement. And the assuming company was paying 12.5% ceding commission to the direct writer. The first issue that the IRS addressed was whether or not this was a ceding commission that had to be capitalized and amortized under the general principles of Revenue Ruling 82-69. And the IRS concluded that in this case it didn't have to be capitalized and amortized. It could be expensed immediately because the payment that was made by the assuming company to the ceding company was really meant to directly reimburse the ceding company for its acquisition expenses. And on that basis the IRS found that this was distinguishable from the up-front ceding commission for which the IRS required capitalization and amortization under Revenue Ruling 82-69. And, perhaps, the key distinction in the IRS's mind here was that the business in this case was being immediately reinsured after it was issued, whereas, apparently, in Rev. Rule 82-69 anyway, there was a block of existing business that was being ceded, and the IRS somehow was able to distinguish reimbursement of acquisition expenses that would occur somewhere down the road. That was an interesting ruling.

In the discussion of another item in this particular technical advice an even more astounding conclusion was reached. It dealt with whether or not the assuming company had to reserve for the business that was ceded on the same basis that the ceding company was doing. Now this was a pre-1984 issue, so the IRS dealing with a case where the statutory reserving method was being used for tax purposes, and amazingly enough the IRS concluded that the assuming company did have to use the same method of reserving as the ceding company. The language in the legislative history that it cited as indicating Congressional intent that this be the answer, I think most people would read to give just the opposite conclusion. The IRS was talking about how Congress intended that a coinsurer be treated in substantially the same manner as a direct writer for purposes of its ability to select reserving methods. And the IRS somehow said that means that the assuming company had to follow the same method that the direct writer did and not that it could have a choice as any direct writer would of what type of reserving methodology it would use.

Very briefly, I will make a couple of comments regarding assumption reinsurance. Something I think that's interesting not only in the assumption reinsurance area, but also in acquisition situations is where a stock purchase is treated for tax purposes as an acquisition of assets by electing either under old law what used to be called Section 334(b) (2) or 338, or now using a Section 338 (2)(10) election. But, in any event, an asset is created that does have to be amortized for tax purposes in the acquisition of business, and the issue arises in the first year as to whether the company can get a full year's deduction or whether it has to take only a portion of the year based on when the acquisition occurred. There's an example in the regulations governing assumption reinsurance which indicates that the company that made a mid-year acquisition of business was able to get a full year's deduction in that first year for the business that it did acquire. And we've used that as an analogy in many purchase transactions for claiming a full year's amortization in the first year. And a number of those are under examination right now. I will say that we've had one case where the IRS did agree that a full year's amortization deduction was allowed, although in that case there wasn't much difference since the acquisition had occurred early in the year.

The other point that is related to assumption reinsurance is that the deduction is not automatically allowable as an amortization of a ceding commission when you have an assumption reinsurance transaction. The IRS regulations in this particular area say that a deduction is allowed to the extent that it would be allowed under Code Section 162, which allows deductions for ordinary and necessary expenses. And the key factor here is that if the company is acquiring what could be analogized as goodwill when it is making an acquisition of business, then it's possible that the IRS could argue that some portion of the payment was made for the good will of the business and is not deductible at all for tax purposes.

And then the third point relating to assumption reinsurance is the effect that it can have on the policyholder's share or company share percentages that are used for prorating tax-exempt interest and dividends-received deductions. Under the old law, daily basis proration used to be required so that you got a matching of the investment income and the required interest on the reserves. There's no similar language specifically in the Code under the new law requiring such a daily basis proration. And if a company did not do such a proration it's possible that it could get a skewing of investment income as compared to required interest on the reserves on the business, and that could affect the amount of deduction that it gets for its tax-exempt interest and its dividends-received deduction, depending on what point in the year the transaction occurs. So those are just a few things to keep in mind in relating to assumption reinsurance.

MR. STEPHEN C. ELDRIDGE: The basic securitization transaction is the selling of a future profit stream in a transaction (which is essentially a nonrecourse loan) which we hope will generate surplus for statutory purposes. In effect, that transaction, for tax purposes, should be a non-event. We would hope that the Internal Revenue Service would treat that transaction as an unsecured loan. The principal tax authority for that is an old oil company case, the Mid-American Pipeline Company (MAPCO) case. In that particular instance an oil company had an expiring net operating loss (NOL), and it sold a future production payment and took the taxable income into account immediately, thereby wiping out its expiring NOL. Then as the income came in over a period of years, the company just did not report that income, claiming that the income had been appropriately reported in the earlier year, (but was wiped out by the expiring NOL). In that case, the Internal Revenue Service argued that the transaction was not income, but instead argued that the transaction was a loan. There are a number of criteria for the treatment that the tax court laid out in that particular case and the Service won the case. It was held to be a loan. Some practitioners are a little bit concerned with the facts. The precise fact pattern in that case doesn't quite match the fact pattern in most of the securitization cases. And I'll agree that the fact pattern doesn't match precisely, but I think that the places that it doesn't match are really irrelevant and immaterial to the central issue. The transaction really and truly is a secured loan, a nonrecourse loan rather, and therefore, should not be taxable income for tax purposes. The reason that it should work ultimately for statutory purposes when New York and the other states come around to understand what the transaction really is, is due to the peculiarities of statutory accounting.

Essentially, these are future profits that are currently not included in statutory surplus because of the conservatism of statutory accounting rules. In a securitization transaction, the company essentially gets cash in hand, and if those statutory profits that are not currently in statutory surplus never emerge, then the loan doesn't have to be repaid. This is why you essentially should get statutory surplus.

FROM THE FLOOR: What was the name of that case?

MR. ELDRIDGE: MAPCO. There's other authority in addition to that. There's actually an old unpublished letter ruling which would suggest that if that were income that would be an advanced premium as well, so it still shouldn't be taxable income.

There are pretax economics to this transaction which are, hopefully, in some cases better than reinsurance. If there's no taxable income on the securitization that's simply an additional measure of value. There should be a pretax benefit.

FROM THE FLOOR: If you're reporting under GAAP, that would be reported as a loan.

MR. ELDRIDGE: Yes, for GAAP purposes it would likely be a loan rather than deferred revenue, which hurts some transactions because some companies can't stand the debt for rating purposes. They don't want any more debt on the GAAP balance sheet.

MR. RONALD ALBERT: What I will attempt to cover relates to both reinsurance tax issues and reinsurance tax planning. It involves the interplay between companies in a regular tax situation and companies subject to the alternative minimum tax (AMT).

All of you have to have an interest in reinsurance and also in tax issues. And if you have an interest in tax issues, you have to have an interest in the AMT. The AMT is here to stay. More and more companies will become subject to the AMT as time goes on, especially in 1990 when adjusted current earnings (ACE) begins. Thus far, not many have been subject to the AMT. That's going to change beginning with 1990. I'll try not to make this a discussion solely on the intricacies of the AMT, but I will have to get into certain specifics.

It's a lot easier and more politically palatable for Washington bureaucrats to broaden the AMT base than to increase regular tax rates. For example, we've seen Mr. Rostenkowski introduce a tax bill recently where he's proposing to expand the so-called ACE adjustment from 75% to 100%. So, already we're seeing an expansion of the AMT base. It's just a bill at this point. We could also see a further expansion of the alternative minimum tax income (AMTI) base in the near future. There are a lot of headaches associated with the AMT. It's very complex and there are no regulations.

The fact that we now have a difference in effective tax rates (the cash tax paid with your tax return) between companies taxed in a regular situation (34%) and companies in the AMT, which is 20% of the AMTI, should lead to creative thinking and result in opportunities. It's almost akin to the old Phase system under the 1959 Act, and interplays between Phase I and Phase II companies. I must caution everyone that for tax planning purposes, you should use marginal tax rates and not effective tax rates. Still, the interplay applies.

Another caution is that being in the AMT under the business untaxed reported profits (BURP) years, which are 1987, 1988 and 1989, is timing and doesn't result in a permanent tax. Being in the AMT in those years reflects a prepayment of regular income tax.

However, under ACE which begins in 1990, there can be permanent differences. So permanent tax rate differences can exist under ACE. However in my opinion, there is a positive effect to the AMT, in that it offers tax planning opportunities. And, certainly, reinsurance can play a big part in it. Thus, it's imperative that the people who are actively involved with reinsurance be familiar with the AMT.

Keep in mind that a taxpayer pays the greater of the regular tax or the AMT. So, in effect, you are prepaying tax if you're in the AMT in the BURP years. Under ACE, there could be a permanent tax difference and that's important. Under BURP, basically you start off with your regular taxable income, add or subtract certain preference and adjustment items, and then include an item called "book income adjustment." That includes certain items like tax-exempt interest. Fifty percent of the book income adjustment is included in your tax base. Under BURP, the book income adjustment is considered a deferral adjustment and may be treated as a credit to future years, when the regular tax exceeds the AMT. Thus, for more items of taxable income, the marginal tax rates for years under BURP is 20% now and 14% deferred. It's timing. Under ACE, you forget about book income. ACE replaces BURP for tax years beginning after December 31, 1989. Again, your starting point is regular taxable income, but you no longer look at book income. You look at earning and profits. Seventy-five percent of the excess of ACE over the tentative alternative minimum tax is included in AMTI.

Earlier I talked about the AMT credit, the credit under BURP. The amount of AMT paid in one year is a carry-forward credit against the regular tax liability. Well, the credit is allowed only for deferral preferences, and not for exclusion preferences. Under ACE, tax-exempt interest income is treated as an exclusion item, and thus, no minimum tax credit is allowed on tax exempts. The tax you pay on tax exempts under ACE is permanent. This can lead to strange situations, like a company with a lot of tax-exempt income being in a permanent 20% tax rate situation, with no 14% deferral.

So with this background, what tax planning opportunities are there? Should a company in the AMT accelerate income assuming it expects to be in a regular tax posture in a later year? Or, what about the treatment of ceding commissions under the AMT? Is it better to fully deduct those ceding commissions currently or amortize them? Let's take a look at some examples.

First of all, I had to make some broad assumptions. I assumed a coinsurance treaty effective December 31, 1989, funds withheld, had no asset transfers other than the fee. The fee (risk charge) is 2.5% of the surplus relief balance at each year-end. The business reinsured will be fully recaptured at the end of five years. I'm just working with the federal income tax rates, I ignored state income tax and GAAP effects and used a 6% discount rate to determine the after-tax benefits and/or costs. Needless to say, I had to simplify these examples; however, they still give a realistic result.

Table 1 is a scenario where the reinsurer is in a regular tax situation and is taxed at 34% for all years. The ceding commission is fully deductible in 1989. Company Y, the ceding company, is in the AMT situation. The business is being recaptured over five years. The net present value benefit to the reinsurer is $840,000. Company Y, the ceding company, which is in the AMT, pays a tax on the surplus relief at 20% currently and 14% deferred until 1993. Now I'm assuming that Company Y will be out of the AMT and into the regular tax situation in 1993. So the marginal tax rate on the surplus relief is, in fact, 34%: 20% now, 14% deferred. The net cost to the ceding company is equal to a net fee paid to Company X plus the tax paid in 1989 on the surplus relief.

Table 2 is basically the same as Table 1 except that the ceding commission paid by the reinsurer is being amortized rather than deducting it immediately. The net present value benefit of $304,000 is significantly smaller as a result of amortizing the ceding commission. The ceding company hasn't changed.

In Table 3, the reinsurer, Company X, is in the AMT, whereas, Company Y, the ceding company, is in a regular tax situation. The net present value benefit to the reinsurer is smaller while in the AMT than when it was in a regular tax situation, due to a smaller benefit of the tax deduction in 1989. Again, that's because of the 20% tax rate currently due and 14% tax rate deferred, versus a 34% tax rate under the regular tax. The net present value cost to the ceding company is a bit higher due to a higher tax paid (34%) on the surplus relief in 1989.

Table 4 shows the reinsurer, Company X, in the AMT and the ceding company in a regular tax. Again, the only difference between Tables 3 and 4 is that the ceding commission is being amortized. Due to the ceding commission being amortized, there is a small net present value benefit to the reinsurer.

Now what does all this mean? Let's make certain observations. For the reinsurer it's obvious that getting an immediate full deduction for the ceding commission is advantageous to amortizing a ceding commission, whether the reinsurer is in a regular tax situation or AMT. If the ceding commission has to be amortized, at least per my examples and using my assumptions, the reinsurer has a slightly greater net benefit while being in the AMT than in the regular tax situation. Now for the ceding company, getting an immediate full deduction or amortizing a ceding commission doesn't matter. However, under my scenarios, the ceding company's net costs were less under the AMT. So, for a reinsurer, is it better to be in a regular tax situation or the AMT? Much depends on the treatment of ceding commissions as well as other factors, such as how long the company expects to be in the AMT. So a message here is that you really have to look at your own company's situation to determine what is best for you. When and if you expect to get out of the AMT and into a regular tax situation is very important. For example, if you're a ceding company, you may be in the AMT prior to receiving surplus relief. After the deal, you could be out of the AMT and receive taxable income at 34% rather than at 20% currently and 14% deferred. You have to take a close look at your own tax situation; do some projections to see if you're going to be in the AMT. Then you have to do net present value calculations. I don't see how you could entertain doing reinsurance without doing this kind of analysis.

Table 5 introduces a new AMT situation. Let's focus on the ceding company which is in the AMT. In 1990, there is a tax rate of 20%. This can result under ACE when a company has a significant amount of exclusion preferences such as tax-exempt interest income. Even though the tax rate is 20%, it doesn't mean that it's a situation which companies should strive for. The ideal situation is to be in a regular tax situation but just on the verge of triggering the AMT.

TABLE 1

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	(10,000)	3,000	2,500	2,000	1,500	1,000
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	(3,400)	1,020	850	680	510	340
Fee Tax Effect	85	60	38	21	9	-
Net Income Effect	3,565	(905)	(776)	(639)	(494)	(340)
Discount Rate	6.00%					
Net Present Value	840					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	14.00%	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	2,000	(600)	(500)	(400)	(160)	(340)
Fee Tax Effect	(50)	(35)	(23)	(13)	76	-
Net Income Effect	(2,200)	460	410	350	60	340
Discount Rate	6.00%					
Net Present Value (Cost)	(806)					

TABLE 2

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Ceding Commission	(10,000)					
Amortization Adjustment	10,000	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	-	1,000	500	-	(500)	(1,000)
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	-	340	170	-	(170)	(340)
Fee Tax Effect	85	60	38	21	9	-
Net Income Effect	165	(225)	(96)	41	187	340
Discount Rate	6.00%					
Net Present Value	304					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	14.00%	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	2,000	(600)	(500)	(400)	(160)	(340)
Fee Tax Effect	(50)	(35)	(23)	(13)	76	-
Net Income Effect	(2,200)	460	410	350	60	340
Discount Rate	6.00%					
Net Present Value (Cost)	(806)					

TABLE 3

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	14.00%	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	(10,000)	3,000	2,500	2,000	1,500	1,000
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	(2,000)	600	500	400	160	340
Fee Tax Effect	50	35	23	13	93	-
Net Income Effect	2,200	(460)	(410)	(350)	(228)	(340)
Discount Rate	6.00%					
Net Present Value	673					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	3,400	(1,020)	(850)	(680)	(510)	(340)
Fee Tax Effect	(85)	(60)	(38)	(21)	(9)	-
Net Income Effect	(3,565)	905	776	639	494	340
Discount Rate	6.00%					
Net Present Value (Cost)	(840)					

TABLE 4

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	14.00%	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Ceding Commission	(10,000)					
Amortization Adjustment	10,000	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	-	1,000	500	-	(500)	(1,000)
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	-	200	100	-	40	(340)
Fee Tax Effect	50	35	23	13	93	-
Net Income Effect	200	(60)	(10)	50	(108)	340
Discount Rate	6.00%					
Net Present Value	345					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	3,400	(1,020)	(850)	(680)	(510)	(340)
Fee Tax Effect	(85)	(60)	(38)	(21)	(9)	-
Net Income Effect	(3,565)	905	776	639	494	340
Discount Rate	6.00%					
Net Present Value (Cost)	(840)					

TABLE 5

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	(10,000)	3,000	2,500	2,000	1,500	1,000
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	(3,400)	1,020	850	680	510	340
Fee Tax Effect	85	60	38	21	9	-
Net Income Effect	3,565	(905)	(776)	(639)	(494)	(340)
Discount Rate	6.00%					
Net Present Value	840					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	-	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	2,000	(600)	(500)	(400)	260	(340)
Fee Tax Effect	(50)	(35)	(23)	(13)	51	-
Net Income Effect	(2,200)	460	410	350	(336)	340
Discount Rate	6.00%					
Net Present Value (Cost)	(1,119)					

This situation can happen to a property and casualty company that has a lot of tax-exempt interest income. The ceding company received surplus relief in 1989, which was taxable income at 20% currently and 14% deferred. As the business started to roll off (recaptured) in 1990, the ceding company only got a benefit of 20% on the deduction. Think about it -- taxable income at 20% now and 14% later, versus a tax deduction at 20% permanently. So, in my opinion, this company should not have gotten surplus relief in 1989, but should have waited until 1990; it should have waited one more year. The net present value cost for the ceding company increased; its costs shot way up. People had better be aware of these exclusion items, and the effects on their companies.

Table 6 is the reinsurer in the AMT and also in the so-called exclusion AMT in 1990. The net present value benefit to the reinsurer is the highest we've seen so far. This example reflects 1989 reinsurance with an immediate full deduction for ceding commissions. The business run-off in 1990 is taxed at only 20% permanently. A situation like this offers great tax planning opportunities. For people in the reinsurance business, they should seek out companies in this situation.

Let's look at Table 7. As you go through and determine what your company's situation will be like over several years and determine marginal tax rates, you can perhaps influence when reinsurance treaties should be recaptured. The reinsurer can certainly increase its net present value benefit through proper timing of the recapture.

There can be a wide range of results depending on what your tax situation is. Very seldom would I recommend to accelerate taxable income or defer tax deductions as a tax planning strategy. However, it can be viable for some companies, especially a company with a lot of exclusion preferences like tax-exempt interest. You must do net present value calculations!

Another thing I want to mention relates to reinsurance. Under ACE, the change in deferred acquisition costs (DAC) is an adjustment in arriving at AMTI for life insurance companies. It's my understanding that some companies in ceding their direct business reduce their DAC associated with those policies ceded. So, for companies in the AMT, you may want to keep that in mind, or inquire whether DAC is reduced. This could have an effect on your AMT.

Will Sec. 845 apply to these interplays between regular tax and the AMT? I believe there could very well be a Sec. 845 risk.

Table 8 could be a situation where mutual companies fall into. Mutual companies typically have not been subject to the AMT under the so-called BURP years. Beginning with 1990, under ACE, they could definitely fall into the AMT. In this example, the reinsurer is in a regular tax situation in 1989, but falls into the AMT in 1990. The last example, Table 9, shows the reinsurer in a regular tax situation in 1990 and in the AMT --- exclusion AMT --- in 1990 and 1991. This situation could apply to a P&C company with a lot of tax exempts.

Briefly, I will make some comments on LTD reinsurance. The only thing that I'll mention is that there is a special rule in the Internal Revenue Code. It's Section 846(f6) which deals with disability income such as LTD and it relates to the discounting of LTD claim reserves for tax purposes. I think one of the key points of interest in that rule is that a company can use a mortality or morbidity table based on its own experience, so in discounting or in arriving at tax reserves, say for LTD claim reserves, there's no mandated table by the IRS. You can use a table reflecting your own experience. And the IRS offers some opportunities again for the very creative.

MR. GORDON K. DOWSLEY: Before 1969 the only corporate income tax paid by life insurance companies in Canada was, for simplicity sake, a 15% holding tax on dividends paid to shareholders. As a result of the tax reform movement in the sixties, an income tax act was introduced for life insurance companies in 1969. This tax reform movement also led to a desire to tax the inside buildup in life insurance policies. So an investment income tax was introduced at the same time to be applied on the corporation equal to 15% of the investment income being credited to the policyholders. Suddenly dashing new figures appeared in life companies. These were the tax planners. In truth, it could be an overstatement to say that, like consulting actuaries, they were frequently surrounded by groupies, but on a professional basis they had two things going for them. First, the taxes were so new that they were filled with oversights and errors. And, second, the calculation of the taxable investment income was very complicated, because the calculation of

TABLE 6

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	-	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	(10,000)	3,000	2,500	2,000	1,500	1,000
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	(2,000)	600	500	400	(260)	340
Fee Tax Effect	50	35	23	13	68	-
Net Income Effect	2,200	(460)	(410)	(350)	217	(340)
Discount Rate	6.00%					
Net Present Value	1,025					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	3,400	(1,020)	(850)	(680)	(510)	(340)
Fee Tax Effect	(85)	(60)	(38)	(21)	(9)	-
Net Income Effect	(3,565)	905	776	639	494	340
Discount Rate	6.00%					
Net Present Value (Cost)	(840)					

TABLE 7

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	20.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	14.00%	-	-	14.00%	-	-
Credit Exhaustion Year	1993					
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	7,000			
Taxable Income Effect	(10,000)	3,000	7,000	-	-	-
Fee Rate	2.50%					
Fee - Income	250	175	-	-	-	-
Transaction Tax Effect	(2,000)	600	1,400	-	(1,400)	-
Fee Tax Effect	50	35	-	-	35	-
Net Income Effect	2,200	(460)	(1,400)	-	1,365	-
Discount Rate	6.00%					
Net Present Value	1,601					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Taxable Income Effect	10,000	(3,000)	(7,000)	-	-	-
Fee Rate	2.50%					
Fee	(250)	(175)	-	-	-	-
Transaction Tax Effect	3,400	(1,020)	(2,380)	-	-	-
Fee Tax Effect	(85)	(60)	-	-	-	-
Net Income Effect	(3,565)	905	2,380	-	-	-
Discount Rate	6.00%					
Net Present Value (Cost)	(594)					

TABLE 8

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	34.00%	20.00%	20.00%	20.00%	34.00%	34.00%
Credit Exhaustion Yr.	-	14.00%	14.00%	14.00%	-	-
Credit Exhaustion Year	1993					
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	(10,000)	3,000	2,500	2,000	1,500	1,000
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	(3,400)	600	500	400	1,560	340
Fee Tax Effect	85	35	23	13	58	-
Net Income Effect	3,565	(460)	(410)	(350)	(1,593)	(340)
Discount Rate	6.00%					
Net Present Value	957					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	3,400	(1,020)	(850)	(680)	(510)	(340)
Fee Tax Effect	(85)	(60)	(38)	(21)	(9)	-
Net Income Effect	(3,565)	905	776	639	494	340
Discount Rate	6.00%					
Net Present Value (Cost)	(840)					

TABLE 9

Indemnity Reinsurance Transaction

	1989	1990	1991	1992	1993	1994
Company X - Reinsurer						
Tax Rates on Current Inc.						
Current Year	34.00%	20.00%	20.00%	20.00%	20.00%	34.00%
Credit Exhaustion Yr.	-	-	-	14.00%	14.00%	-
Credit Exhaustion Year	1994					
Ceding Commission	(10,000)					
Amortization Adjustment	-	-	-	-	-	-
Business Runoff	-	3,000	2,500	2,000	1,500	1,000
Taxable Income Effect	(10,000)	3,000	2,500	2,000	1,500	1,000
Fee Rate	2.50%					
Fee - Income	250	175	113	63	25	-
Transaction Tax Effect	(3,400)	600	500	400	300	830
Fee Tax Effect	85	35	23	13	5	12
Net Income Effect	3,565	(460)	(410)	(350)	(280)	(842)
Discount Rate	6.00%					
Net Present Value	1,621					

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	1989	1990	1991	1992	1993	1994
COMPANY Y - Ceding Co.						
Tax Rates on Current Inc.						
Current Year	34.00%	34.00%	34.00%	34.00%	34.00%	34.00%
Taxable Income Effect	10,000	(3,000)	(2,500)	(2,000)	(1,500)	(1,000)
Fee Rate	2.50%					
Fee	(250)	(175)	(113)	(63)	(25)	-
Transaction Tax Effect	3,400	(1,020)	(850)	(680)	(510)	(340)
Fee Tax Effect	(85)	(60)	(38)	(21)	(9)	-
Net Income Effect	(3,565)	905	776	639	494	340
Discount Rate	6.00%					
Net Present Value (Cost)	(840)					

this tax tied into the calculation of the corporate income tax and vice versa. Wherever there are complexities there are loopholes. The large one here was affectionately known as the flip-flop. Eventually, the investment income tax was withdrawn because of its failure to generate revenues. In 1977 the government conceded and wiped the slate clean by starting all over again with a new law and no tax loss carry-forwards. The civil servants, however, were still and are still determined to get at that inside buildup. For this reason the taxation of death benefits was proposed in one budget but killed by the politicians after much outcry. On the next wave the civil servants came back again with a bold proposal to tax the inside buildup directly in the hands of the policyholders. This was killed by the politicians again after much public outcry with the main argument being that the taxpayer did not actually receive any money and therefore, such a tax violated Adam Smith's principle of convenience. If you don't have the cash you can't pay the tax, which in this case would mean the policies would be lapsed and many private sector social benefits would be reduced. The tax men are persistent, if nothing else, in their continuing quest to tax investment income. The investment income tax was reintroduced with some modifications in 1987. This effort to bring horizontal equity to the system by getting at the inside buildup has been the framework for understanding Canadian tax developments for twenty years.

Now what are some of the current concerns that Revenue Canada has? There are three I would like to mention here. From time to time it talks about offshore reinsurance and raises the question of whether or not the country is losing tax. In Canada there is currently no excise tax on reinsurance premiums paid to foreign reinsurers. Should we adopt a system similar to the United States? This is of far more concern in the P&C area than it is in the life area. In the P&C business there is $1 billion a year leaving the country in the form of reinsurance premiums. But this amount, of course, is offset to a large extent by claims flowing back into the country.

The second point is the concern about Section 845 in the Internal Revenue Code of the United States. This infamous section, which in theory would allow authorities to roll back any transaction, regardless of the reason behind it, is seen by some zealous crusaders as a way to prevent abuses which really do not occur. Two years ago the finance and economic affairs committee of the House of Commons recommended, "That the use of financial arrangements including reinsurance contracts between financial intermediaries be blocked by a specific anti-avoidance rule similar to Section 845 of the U.S. Internal Revenue Code." In a rather frank admission, the committee did point out that reinsurance had never been a problem, because other deficiencies in the law provided ample opportunity for life companies to pay a minimum tax.

The financial reinsurance market in Canada has never existed as it has in the United States, and hence, the so-called abuses of MODCO and 818C have never occurred here, nor has there been any significant revenue loss because of reinsurance. Furthermore, we already have in the Canadian tax law a general anti-avoidance rule (GAAR) section deals already, something like Section 845.

One can find this provision in Section 245 of the Income Tax Act; i.e., you have to read 600 fewer sections than in the Internal Revenue Code to get the same answer. Section 245 says that "no deduction in respect to the transaction will be allowed that would unduly or artificially reduce income tax." Why the authorities feel anything more might be needed is unclear to us.

The third item of concern that I would like to mention concerns the Canadian investment fund (CIF). Life insurance companies are the only taxpayers in Canada to be taxed on their Canadian business only, as opposed to the worldwide business. Hence, a mechanism is needed to allocate a portion of worldwide investment income to the Canadian tax return. This mechanism is known as the CIF. Basically, it's Canadian reserves over total reserves times total invested assets. This gives the total size of the asset pool to be considered. And the makeup of the pool follows a series of complex rules. The income on the pool goes into the Canadian tax return as Canadian investment income. Now the total invested assets is a very important figure to life insurance companies. The larger that number, the larger the taxable income. Currently, one of the audit issues is which, if any, amounts due from reinsurers should be considered part of total invested assets. On many reinsurance treaties these items are being viewed as balancing items and companies would not consider these balances as invested assets. Revenue Canada is currently formulating a position.

Well, I talked briefly on the history. I've mentioned three current items of concern and I'd now like to project into the future with the new budget that was introduced recently in Canada. This year's budget has been of great interest in the country, since for the first time in history the entire budget was leaked to the press before it was delivered to Parliament. It's been great theater in Parliament where it was long believed the Parliamentary tradition would require a finance minister to resign over any leak, let alone a leak of such magnitude. However, history seems to have been made when the resignation was not offered and the great Parliamentary tradition has disappeared.

So what is new for insurance companies? There are two new taxes, the capital tax and the sales tax. Under the capital tax the budget proposes a new tax of .175% on the capital employed in Canada in excess of $10 million and this is applicable to both corporation and branches. This is known as the large corporation's tax or the LCT. It is not deductible in the income tax calculation, but it is a credit against corporate surtax and income tax. This means in effect that this tax on capital employed becomes a corporate minimum tax.

The second tax was the goods and services tax or the GST. Now in Canada we have long had provincial sales taxes at the retail level as well as a federal sales tax at the wholesale level. This federal sales tax is being changed to a tax similar to a value-added tax on goods and services. It will be 90% effective in 1991. The base will be much broader and the tax applies at all levels of sales including retail with offsets for taxes paid by suppliers at earlier stages. This tax has been in the conceptual and planning stage for sometime. Would all goods and services be subject to this tax? Along the way food was exempted, but what other necessities to human health and happiness are there, such as services provided by insurance companies and other financial institutions? This is an aspect of the federal margin tax. However, finance found that it was unable to calculate what the tax base would be. This inability to comprehend the formulae that the life companies themselves cannot comprehend was expressed as "technical problems remain." Finance was also afraid that business would move offshore since other countries have not adopted a similar tax. Such a concern should become more and more prevalent in Canada as we wrestle with the implications of free trade with our southern neighbors and falling trade barriers with the rest of the world. There is a real possibility that the new federal sales tax will apply to other services offered by insurance companies, not only life insurers, but also the P&C companies. Just what these services might be we are not quite sure.

I have talked about what the situation is today and particularly what is developing for the future. I would like to remind you of the wisdom of the old Kentucky judge who had a great fondness for corn liquor, so much so that he always kept a glass under his desk during his hearing. One day after a long session when he was feeling particularly mellow, he went out and threw the saddle on the horse. He was preparing to leave when the young attorney pointed out to him that the saddle was on backwards. He looked at him and he said, "Son, how could you have any idea which direction I'm planning to go?"