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NEW TAX DEVELOPMENTS, AUDIT ISSUES AND ALTERNATE MINIMUM TAX

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- Current developments in the legislative situation and proposed changes
- Continuing unresolved audit issues: 818(c), etc.
- Emerging issues of 1984 and later audits
- Policyholder taxation issues
- Alternate minimum tax (AMT)
  - Adjusted current earnings
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  - Impact on stock companies: shareholder dividends
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  - Super funds

MR. WILLIAM J. SCHREINER: I have been asked to report on new U.S. tax developments for life insurance companies. Frankly, it is very difficult to predict what tax legislation, if any, will be actively considered by Congress this year. It is not certain that we will see a tax bill this year. In fact, the only thing you can be certain about in Washington is that August will be hot and humid.

One thing is clear, however: the budget drives taxes. Since the Administration and Congress have agreed on the need for an increase in revenues of between $5 and 9 billion, conventional wisdom suggests that someone is going to be paying more taxes next year. It remains to be seen what contribution the life insurance industry might make to the pot.

Both the Treasury and the Government Accounting Office (an arm of Congress) are expected to report on the workings of the life insurance company provisions of the 1984 Act in the near future. A large part of these reports is expected to concern Section 809 and the taxation of mutual company matters. It is expected that, following the reports, there will be hearings by the House Subcommittee on Select Revenue Measures.

In addition, the Subcommittee will review the corporate AMT, particularly the transition from the book income to the adjusted current earnings (ACE) preference. Chairman Dan Rostenkowski has already introduced the bill to simplify the AMT, and we expect to see serious consideration of this provision this year. Steve will discuss this issue in much greater detail at the end of this panel.

The ACLI has identified several issues, relative to the applicable federal interest rate (AFR) used to calculate insurer tax reserves, that will be pursued by the ACLI should the legislative opportunity arise. The first issue will be the cap provision and would impose a cap on how far the required AFR could deviate from the prevailing state interest rate. At present there is no limitation on the difference between those two rates.

The second item the ACLI is interested in pursuing is a tolerance factor similar to that in the Standard Valuation Law, which would call for a change in the AFR only when there is a 50 basis point calculation change. Similarly we would seek to have a rounding rule placed in the AFR

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provision that would round to the nearest quarter percent. For example, instead of the AFR of 7.77% last year, you would get 7.75%; this year's 8.16% would be 8.25%. In addition, for certain annuities, we would have the AFR based on a 12-month current average, rather than a 5-year moving average.

With the exception of the cap provision, each of these proposals is similar to corresponding features in the current Standard Valuation Law. We have had preliminary discussions with the Joint Committee on Taxation staff with respect to these points, and they will be pursued if the legislative opportunity arises.

Moving now from legislative issues to regulatory issues, there are several items to report. The first has to do with long-term-care benefits. At the request of the ACLI, the IRS recently issued Revenue Ruling 89-43. The Ruling advises that life insurance companies may treat reserves for long-term-care insurance as deductible life insurance reserves. However, the IRS was not prepared to deal with employer or policyholder issues, so the Ruling is silent on them.

Also relative to Section 807 reserve issues, the ACLI has two proposals currently before the IRS. The first recommends that the IRS adopt the 1985 individual disability tables as replacements for the 1964 Commisioners Disability Table (CDT) or individual disability income insurance. Because the states have not generally adopted such tables, they are unlikely to become prevailing tables unless designated as such by the Service. It can be noted that the 1964 CDT has never been adopted by 26 states.

The ACLI has also asked the IRS to recognize the use of 1980 CSO smoker/nonsmoker tables for computing tax reserves for smoker/nonsmoker policies. These tables were, however, adopted by 26 states in 1986.

This latter effort is particularly significant in the light of the enactment of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). TAMRA ties Section 807 mortality tables to the definition of a life insurance policy under Section 7702. It is one thing to quibble over the basis that should be used to compute an insurance company's taxes, but you raise the level of debate a couple of notches when you bring the Section 7702 definition of life insurance into this discussion. One is a question of dividing the pie, the other is a question of whether the pie gets baked.

The IRS does not currently have on its project list an effort to issue regulations on Section 807 reserves. But now that the stakes have been raised; it is essential that a number of issues like the status of the 1980 CSO smoker/nonsmoker mortality tables be resolved.

Another important issue is the status of 1980 CSO unisex tables. In December 1988, the IRS issued Notice 88-128, which provided a safe harbor for the use of mortality charges for Section 7702 and 7-pay premium test purposes based on unisex mortality tables "to the extent that a state requires contracts issued in that state to use unisex tables." Unfortunately, that leaves hanging situations in which employer-sponsored contracts are issued on a unisex basis to conform to federal law, as interpreted by the Supreme Court Norris decision, and contracts for which insurance companies voluntarily issue unisex contracts. We have urged the IRS to extend the safe harbor to these contracts and supplied the IRS with the results of a survey that indicated that, in 1988, about 95% of the unisex policies issued were of the Norris or voluntary type.

In both the smoker/nonsmoker and unisex areas we have suggested to the IRS that these variations of the 1980 CSO Table are entitled to the same standing as the original 1980 CSO Table. We believe that the IRS regulations must make room for common, nonabusive practices of the marketplace, and we have no reason to believe that this will not be the case.

Relative to TAMRA, the ACLI has also been working to obtain interim advice with respect to certain areas where the law requires implementing regulations for the provisions of the act. TAMRA calls for the IRS to prepare regulations by January 1, 1990, but we believe there is a need for early guidance in certain areas. We have asked for such guidance relative to the 7-pay premium test for the $75 expense allowance rule for contracts with death benefits under $10,000 and with respect to the premium collection expense allowance provided for in the law. We also expect to submit a request for implementing regulations for cost-of-living adjustment policies in a timely manner. These issues, of course, just scratch the surface of the possibilities under TAMRA. We think it is going to be a very busy year working through the implications of TAMRA.

MR. E. P. BAKER: Speaking from a lawyer's perspective, my remarks will be on what I refer to as the final significant tax issues under the 1959 Act, which reflects the revaluation of reserves on universal life and graded premium policies under Internal Revenue Code Section 818(c)(2)(A).

In the early 1980s many life insurance companies began to market universal life, graded premium and modified premium whole life policies. The reserves for such policies generally were estimated or computed using a preliminary term reserving method. Companies which had elected under Section 818(c)(2)(A) to revalue recognized preliminary term reserves for tax purposes claimed significant additional tax deductions, which were generated by the revaluation of the universal life and graded premium reserves. The principal tax issues that have been raised by the IRS with respect to the audits of 1981 through 1983 are whether such revaluation of reserves under Section 818(c)(2)(A) is proper. The tax dollars at risk are significant both to the companies and to the government. Effective resolution of federal income tax audit issues under the 1959 Act always has required a joint effort by accountants, attorneys, and actuaries. In almost every litigated case, actuarial testimony is an essential element. A favorable resolution of these 818(c)(2)(A) issues, however, will be even more dependent on the contributions by in-house actuaries and outside actuarial consultants because the IRS's positions on these issues now emphasize actuarial analysis.

The IRS's development of its positions on these issues has been an evolutionary process. Such evolution is continuing with respect to universal life policies, but the position that the IRS has taken on graded premium contracts appears to be fixed and fully developed. The Internal Revenue Service's most recent publicly available analysis on these issues is a technical advice memorandum that became public in mid to late 1988 (private letter ruling (LTR) 8822002). This technical advice memorandum dealt with revaluation of reserves on both graded premium and universal life policies. In addition, this particular technical advice provided what I would describe as a gift to certain members of the industry because it dealt with the issue of inconsistent adjustments, which I will refer to at the end of my remarks.

Graded premium policies are not a new concept. They have been around in some form for a number of years. These are whole life policies that are designed to meet the needs of policyholders who require whole life protection at low premium rates in early policy years. By marketing such policies, life insurers have been able to compete in sales situations that require initial premiums that are attractive to policyholders. These types of policies also have furthered an important social value by making high quality whole life insurance protection available to policyholders who could not otherwise afford it.

The IRS's initial attempts to disallow revaluation of reserves on graded premium policies did not emphasize and often even failed to refer to the reserves that were established for such policies. Rather, the proposed adjustments by the IRS would be justified solely on the grounds that a graded premium policy was not a whole life policy. The Service would allege that graded premium policies in substance were yearly renewable term contracts, which were convertible at the end of the grading period. By concluding that these policies should be treated as annual renewable term, the Service proposed to disallow any revaluation, either at $5 or $19 per thousand. Often these early examination reports would refer to proposed treasury regulations that were in existence as authority for severing these graded premium policies into separate contracts. This, of course, was inappropriate because proposed regulations are not authority until they are finalized, and these particular proposed regulations were in fact never finalized; they were withdrawn. The Internal Revenue Service reports also would take great satisfaction in the fact that such policies lacked cash values in the early years as further support for the proposed adjustment.

This audit approach was intended to address concerns that have been raised by the Senate Finance Committee in its consideration for the legislation that eventually became known as TEFRA. By such legislation, the amount of the revaluation permitted under 818(c)(2)(A) for other than term policies was decreased from $21 to $19 per thousand. Interestingly enough, no changes were adopted in TEFRA that directly or indirectly disallowed revaluation for graded premium or universal life policies.

This initial IRS audit approach can be referred to as a "substance versus form" argument. Taxpayers' responses to such arguments were persuasive, and favorable settlements with the IRS Appeals Offices were achieved. In response to the IRS's substance versus form argument, taxpayers contended that the traditional distinction between term and other than term policies

depended on the duration of the coverage. Such duration was determined by looking at the obligations of the insurance company under the policies that it issued. Taxpayers would point out that graded premium policies provided for a level death benefit guaranteed for the life of the insured under a whole life plan of insurance, that is, the contract would remain in force as long as the premiums were paid. The graded premium contracts provided nonforfeiture values as well as guarantees for the lifetime of the insured. Furthermore, the Standard Valuation Law and the Standard Nonforfeiture Law required that the reserves and cash values under such contracts be determined by reference to the lifetime guarantees.

Thus, taxpayers would say that, in substance as well as form, graded premium contracts were other than term. In addition to the fact that the substance of the contracts reflected all essential elements of whole life under a traditional definitional standard, they were also considered whole life contracts for Annual Statement and state regulatory purposes and could not be split apart on any "facially discernible" basis. That phrase was coined by the tax court in a case called *National Savings* which dealt with modified whole life policies where certain adjustments to the 818(c)(2)(A) revaluation were in fact approved by the court. But the *National Savings* case, which was decided by the tax court, provides clear support to the taxpayer contentions on this issue -- that it is the duration of the benefits guaranteed by the contract that is the controlling factor.

Where the battleground on this issue is substance versus form, the taxpayer's position is generally a good one. Taxpayers should anticipate favorable resolutions. You will note I said generally. All graded premium policies are not the same. Some are more vulnerable to a substance versus form argument by the IRS than others.

Factors that can make a difference in evaluating one's vulnerability include the period of grading, the period before cash values develop, the slope of the grading, a comparison of premiums charged in earlier years to premiums that would be charged for equivalent term coverage, and a comparison of premiums charged when they have become level to premiums that would be charged on traditional policies issued to an insured at that particular attained age. The Senate report and the IRS proposed regulations that were issued in response to the Congressional concerns make a comparison of such factors very important. Taxpayers may have a very serious concern on this issue, where the economic realities of the policies are such that a policyholder would never continue to keep such policies in force after a certain period of time. If the economics of continuation were completely unrealistic after a specific period of time, then the IRS's substance versus form argument could succeed in convincing a court that the policy cannot be considered as an other than term policy despite the terms of the policy. However, where the economics are such that a policyholder would have reason to continue the policy, and the policy guarantees, in fact, are for the life of the insured, the Service's arguments under this approach are not as effective as those that were later developed under what I will refer to as the IRS's actuarial approach.

The level of premiums charged on graded premium policies in the early years can be very important. They can provide clear evidence of prefunding in the early years of the policy. Such evidence will be significant to the taxpayer because prefunding is considered to be a characteristic of a whole life contract. Now the proposed regulations as well as proposed audit adjustments do not refer to prefunding, but rather they place substantial weight on the existence or absence of cash surrender values in the early years. Early cash values as a characteristic of a whole life policy were referred to in the Senate Conference Committee Report. The contention that cash values must exist in early years as a requirement for whole life characterization is interesting, but it does not deserve the importance that the IRS would attach to it. One can argue historically that cash value is not a necessary element of a whole life policy. Cash values were not always required by state regulatory authorities. Policies sold in the last century and in the first part of this century, which clearly were whole life insurance, did not provide cash values. Only in this century did states begin to consider it necessary to provide such benefits for policyholders to reflect the investment element that results from prefunding. Although cash values are required where level premium whole life policies are issued, it is interesting to note that there is no similar cash value requirement for prefunding long-term noncancellable and guaranteed renewable accident and health policies, even though those policies also have an element of prefunding. So, to concentrate so heavily on cash values may not be an appropriate argument. Nevertheless, cash values do demonstrate prefunding, and prefunding does appear to be relevant to the extent that its absence permits the IRS to argue that a policyholder will not continue the policy for life.

As we all know, Section 818(c)(2) provides a mechanical formula for evaluating preliminary term reserves. Life insurance reserves which are recognized preliminary term reserves are increased by $19 or $21 per thousand of insurance in force, and then such amounts are decreased by 1.9 or 2.1% of the reserves under the contracts. Taxpayers point out to the Internal Revenue Service that these statutory terms are clear and unambiguous. They also point out that there is nothing in the statute that refers to the level of premiums or to cash values as a requirement for other than term treatment. The fundamental point that must be made by taxpayers is that the critical determinant in characterizing a policy as term or other than term is the duration of the coverage provided under the policy and not the pattern or the amount of premium payments or the existence or nonexistence of cash values that develop under the contract. Where a policy is a term policy, benefits are payable only if the insured dies within the stated period of coverage. On the other hand, if the policy is other than term, it provides protection for the entire life of the insured and benefits are payable upon the death of the insured whenever that may occur. Professor Dan McGill stated in his classic textbook on insurance, "It is the characteristic of protection of the whole life that gives whole life its name." The expression has no reference to the manner in which the premiums are paid, only to the duration of the protection.

Interestingly enough, the Service itself recognized this distinction in the years prior to the popularity of graded premium policies. In a 1977 letter ruling, the Service pointed out that neither the code nor the regulation has defined term insurance. However, the IRS pointed out that term insurance is generally defined as insurance that provides protection for a specified number of years. The period of coverage, says the IRS, rather than the premium paying period or the name given in the insurance contract is determinative of whether insurance is term insurance or insurance other than term. Interestingly enough, that same letter ruling goes on to point out that the industry's terminology should be looked to in characterizing a policy as term or other than term.

The IRS's audit position on this issue is also inconsistent with a published revenue ruling that was issued in 1965. That ruling dealt with the provisions of Section 809(d)(5) where special deductions are provided with respect to nonparticipating contracts that were issued for 5 years or more. In that ruling it was stated that a one-year renewable contract is one that does not guarantee the rate of premium to be charged, or one which requires an annual application by the insured for renewal. Inasmuch as graded premium contracts do guarantee the premium rate for the lifetime of the insured and do not require any annual application for continuation of coverage, the Service's own definition in a published ruling arguably precludes characterization of such policies as one-year renewable term.

As you can tell, in my view, the Service has significant difficulties where the argument is substance versus form in most instances. The more difficult argument made by the Internal Revenue Service in later audits is what I have referred to as the actuarial approach. This approach is described in the technical advice memorandum, which I cited at the beginning of my remarks. In that technical advice memorandum, the graded premium policy in question was an increasing premium whole life policy, which provided for increasing premiums through the 20th year and did not have cash values develop until the 17th year. The Internal Revenue Service determined that the reserves were not life insurance reserves computed on a recognized preliminary term basis. It reached this conclusion by making its own reserve computations and concluding on the basis of its computations that the taxpayer's preliminary term reserves exceeded what would have been the net level premium reserves for the policy.

The Service computed net level premiums and net level reserves for the policy by looking at the gross premiums in the sample contract. The result was a series of net level premiums computed as a uniform percentage of such gross premiums, which were then compared to the reserves that were computed by the taxpayer. The Service stated in this technical advice memorandum that the following pattern had emerged, and this is the pattern that they are looking for in making this actuarial argument. There are three factors:

1. Taxpayer's first year net premium is larger than the corresponding net level premium for the first policy year;

2. Taxpayer's renewal net premiums are smaller than the net level premiums for the respective year; and

3. Taxpayer's policy reserves are larger than the net level premium reserves for the same duration.

So the IRS looks to the net premiums for the first year and to the net renewal premiums for the succeeding years, and it looks at the amount of the reserves. Obviously the IRS is talking about terminal reserves, and let's not forget that the reserves that are in question on the tax return are the reserves as are reflected on December 31.

The Service takes the position that a preliminary term reserve method replaces net level premiums with a series of net premiums where the net premium for the first year is smaller than the first year net level premium and the balance of the net premiums (the modified renewal net premiums) are larger than the respective renewal net level premiums. Presumably, these statements reflect appropriate actuarial observations in the case of level premium policies reserved on a full preliminary term basis. But to create a legal or actuarial requirement for all situations from such observations, I believe, is a very big step. The IRS further contends that the Congressional purpose for allowing a revaluation of reserves is not present, where reserves computed under the preliminary term method are greater than the reserves that would have resulted had the company used a net level premium basis. I must admit that there's a certain logic to that which may be difficult to deal with.

Thus, the Service's basis for allowing 818(c) revaluation has moved from substance versus form to focusing directly on the reserves that are established for these policies. It is an actuarial argument. If the facts presented in the technical advice by the Internal Revenue Service are in fact accurate, namely that the preliminary term reserves were greater than they would have been had they been computed on a net level premium basis, we have significant litigating risks. Presumably such facts indicate that the premium structure of the policy has to provide either for negative expense allowances or negative terminal reserves, perhaps both.

Notwithstanding the IRS's conclusions, however, it would appear that the taxpayer in question, if you look at the technical advice memorandum, computed its reserve under the Commissioners Reserve Valuation Method (CRVM). Treasury regulations recognize CRVM as a preliminary term method. It is the Standard Valuation Law, not the Internal Revenue Service, that sets forth, as far as I know, the only legal rules that apply to the calculation of CRVM reserves. Furthermore, the factual conclusions that were set forth in that technical advice memorandum may be subject to question and should not be assumed to be correct. If, for example, the taxpayer's reserves at the end of the taxable years under audit for its aggregate liabilities under graded premium policies are, in fact, less than the aggregate reserves that would be held for such liabilities on a net level premium basis, then the taxpayer's litigating hazards are significantly less. Where the IRS has raised actuarial arguments such as those outlined in the technical advice memorandum, it has been our experience that a full development of all the facts will provide an effective rebuttal to the Service's conclusions. Such development of facts will depend primarily on and will require the efforts of the actuary. Some reports have been prepared for the Internal Revenue Service by consulting actuaries. Some of those reports appear to concur that the reserving methods used by taxpayers are in fact preliminary term reserve methods. They even seem to concur that the reserves are preliminary term reserves, but they suggest that the approximate revaluation allowed under 818(c)(2) provides too rich a result and, therefore, should not be allowed.

This cannot be a serious negative factor because both the Internal Revenue Service and the tax court have long ago concluded that this does not provide a basis for the disallowance. So merely the fact that the amounts of the revalued reserves are significant does not in itself preclude such revaluation.

One final actuarial argument on this issue has been offered by the Internal Revenue Service's in-house actuary. He has suggested that the characterization of insurance policies must be determined by reference to the amount of the reserves, and he has constructed a test that must be satisfied by these policies. His informal memorandum suggests that you look at the net premium for the year in question and add that to the amount of the reserves as of the end of the preceding year. If the life benefits promised under the policy cannot be permanently funded by the total of these two sums, the policy must treated as a term policy. If the sum is less than the amount necessary to provide the guaranteed benefits for more than 15 years, the policy will be treated as term for less than 15 years and, therefore, will not be available for revaluation. This is not a difficult argument to rebut because I am unaware of any legal or actuarial basis that supports it.

Carried to its logical conclusion, this argument would disqualify many traditional term and other than term policies that have long been accepted by the Internal Revenue Service as appropriate for revaluation.

The question most often asked during any extended discussion of 818(c) has nothing to do with all this analysis as to the arguments made by taxpayers and the arguments made by the Internal Revenue Service. The question is, where has everybody settled on the issue? The answer is that the settlements have been varied. Some have been as low as $5 per thousand and some have been significantly higher where the policies provide early cash values and a moderate grading. Numbers ranging from $9-12 have been common resolutions of this issue. Resolutions where the emphasis has been on whether the policy should be broken apart generally turn out better for the taxpayer than those where the IRS's emphasis has been on reserves. Appeals officers find this reserve argument difficult to handle and difficult to understand, and I am very sympathetic to that. Where the reserves have satisfied the IRS's criteria and the increases in premiums have been for a relatively short period of time, say 5-10 years, and where cash values have appeared within the 3rd or 4th year, the issue has been settled for amounts far in excess of the $9-12 amounts I have referred to. Of course it should be because under those circumstances the IRS has no basis for the disallowance.

Turning now to universal life, the Internal Revenue Service also seeks to disallow the 818(c)(2) revaluation on both fixed and flexible premium adjustable whole life policies that are commonly referred to as universal life policies. Such policies were issued by companies in response to a new age of consumerism and could be made available to consumers only when advances in computer technology were such that they could be issued in an understandable manner. They are, in fact, an evolutionary successor to the traditional policy. The IRS has issued three technical advice memorandums which disallow the revaluation on these policies. The first and third of these memorandums dealt with a flexible premium policy and the second dealt with a fixed premium policy. It is not surprising that in each instance the Service concluded that no revaluation was allowed, and it did so on a basis that no universal life policy could satisfy.

As in the case of graded premium policies, the IRS rationales, in various examination reports, for the disallowance on this issue also have differed. The initial examination reports concluded that reserves on universal life policies were not to be revalued because the policies were not whole life insurance. The Internal Revenue Service contended there that the universal life contract was a combination of term insurance with either a deposit fund or an annuity contract. Such arguments were made even though Congress has enacted Section 101(F) as part of TEFRA to make it clear that such policies were in fact life insurance where the policies satisfied certain guidelines. Internal Revenue Service personnel argued that such a characterization was simply for the limited purpose of allowing a beneficiary to exclude the death benefits from income. More recently, the IRS has pointed to Financial Accounting Standard (FAS) 97 as support for its position that a universal life policy constitutes in truth a combination of term insurance and a deposit fund.

In response to these arguments, taxpayers pointed out that universal life policies represent a natural evolution of traditional whole life policies. They provide policyholders with flexibility, within certain limits, in selecting the specified amount of insurance as well as the premiums to be paid and the time of payment of such premiums. In addition to the flexibility, universal life policies also disclose to the policyholder the amount of the interest additions and the mortality charges. Universal life policies are interest sensitive. Both the interest rates credited and the mortality charges can be changed by the company to reflect current conditions. Such changes, however, cannot result in interest rates less than those guaranteed nor in mortality charges greater than those set forth in the policy. Nevertheless, it is these indeterminate features that the IRS relies on in each of the three technical advice memorandums to disallow the revaluation.

All of the mentioned features of universal life policies have their ancestry in the basic provisions of traditional whole life insurance. Obviously policyholders have discretion in selecting the type of policy that best suits their needs, both as to the amount of death benefit and as to the frequency and amount of premiums to be paid for the policy. Different policies permit different premium payment modes even though death and maturity benefits may be identical. Cash outlays by a policyholder also may vary where a policyholder takes advantage of policy loan provisions. Where the traditional policy is a participating policy, additional flexibility is provided through policyholder dividends. Thus, the mere fact that universal life policies provide and extend the flexibility that is inherent in the traditional policy and also disclose the interest credited and

mortality charges to the consumer should not allow the IRS to split apart the policy for tax purposes or to treat it as anything other than traditional whole life insurance.

A similar argument that concerns some actuaries was suggested by early examination reports that stated that universal life contracts, in substance, were a series of single premium contracts for which preliminary term reserves cannot be held. Taxpayers rebutted this argument by developing facts that demonstrated future premiums were contemplated at the time of issuance and that such premiums in fact were being paid. This often was done by referring to situations where periodic payments were scheduled to be paid, either by employer withholding or through a bank automatic payment plan. Furthermore, it was clear that the reserves for universal life policies were not computed as if they were a series of single premium contracts. They could not be so computed under state insurance department requirements.

Perhaps in recognition of the difficulties that these types of arguments presented, the Internal Revenue Service temporarily seemed to abandon them and concluded that the best approach for disallowance in the universal life situation was to contend that the reserves on such policies were not life insurance reserves and, if they were, they could not be computed on a recognized preliminary term basis. A reasonable summation of the current position taken by the technical advice memorandums is that the reserves cannot be computed using a recognized preliminary term method because of the indeterminate features of the policy relating to future interest and mortality charges. Because these features were not determinable upon the issuance of the policy, one cannot compute the reserve prospectively, as neither the present value of future benefits, which could be changed, nor the present value of future premiums could be ascertained. Needless to say, similar assumptions are required as to benefits and premiums in computing reserves for traditional policies, and such assumptions also may not prove to be correct in the long run.

For contracts issued prior to the promulgation of the Model Regulation, insurance companies could calculate preliminary term reserves under the Standard Valuation Law by following the general requirement that reserves for policies with varying premiums or varying insurance amounts should be calculated using a method consistent with CRVM prescribed for reserves for policies that had level premiums and level death benefits. So clearly there is contemplation that you could have a computation of these types of reserves with respect to the universal life policies. Where taxpayers used the NAIC Model Regulation on Universal Life Insurance, which was issued in December of 1983, in computing the reserves or where they sought to satisfy the Standard Valuation Law by using the standards that I have referred to in determining reserves with modified net premiums, such reserves should be accepted as recognized preliminary term reserves. This is especially so because they are accepted and have been accepted as such by the state insurance departments and by industry experts.

Another argument suggested as supporting the disallowance of revalued reserves on universal life policies was that the total reserves are not preliminary term reserves because the expense allowance is not computed by reference to a preliminary term net premium. My understanding is that this is not true when the Model Regulation CRVM reserves are computed. Moreover it is my further understanding that the expense allowance in other recognized preliminary term reserve methods, such as the select and ultimate method, which was recognized as a preliminary term method by the Service and its regulations, is not determined by reference to a preliminary term net premium. Thus, again an argument that is predicated on actuarial considerations does not appear to have significant substance.

Finally, the IRS has suggested that the total reserves are the equivalent of retrospectively computed reserves for a single premium policy with no expense allowance taken into account. This argument also seems to fail inasmuch as such reserves were computed to satisfy the requirements of the Standard Valuation Law, which impose a minimum reserve standard based on a prospective reserve calculation. If the cash surrender values in excess of the basic reserves have not been separately reflected in Section 8G of the Annual Statement, the Internal Revenue Service has stated in a published ruling that reporting an item in an inappropriate place in the Annual Statement does not change the tax result. Therefore, the problem that many companies faced, that is, including the entire reserve as 8A rather than splitting it apart between 8A and 8G reflecting the cash surrender values in excess of the reserve that would have been computed, should not be a basis for disallowing it.

The IRS argument also erroneously assumes that the single premium policy has a smaller amount of insurance in force than the actual face amount of the policy. So it doesn't stand up factually either.

Settlements with the IRS Appeals office on this issue also have varied. At least one Appeals Officer has refused to settle this issue for more than $5 per thousand, and this refusal has led to the initiation of litigation in the United States Tax Court by one company. On the other hand, the taxpayer that was the subject to letter ruling 8822002 received a full concession, $21 per thousand, of the universal life issue in the years 1981 and 1982. Presumably there was a trade-off of issues in that instance for reasons that are not evident on the record.

On the average, settlements of the universal life issue have been slightly more generous than those on graded premium policies. In my opinion, this is a proper reflection that the litigating hazards to taxpayers on this issue are generally less than those on the graded premium issue. This opinion is based in part on my very strong belief that in fact universal life policies are an evolution of the traditional policy and that there is no valid policy reason for disallowing revaluation of such reserves. My feeling is that this is a strong issue for the taxpayer and that settlements should reflect that.

Very briefly I would like to touch on one last item that is important with respect to the 818(c) revalued reserves, not only on these issues but also on other issues. The final topic I will discuss is the IRS's current practice of making inconsistent adjustments. By inconsistent adjustments I am referring to the disallowance of a reserve in its entirety at the end of a taxable year without making a similar adjustment to disallow that same reserve as of the beginning of the year. The tax statute allows a deduction for the increase in such items, and it is difficult to understand how an adjustment, which goes far beyond the disallowance of the increase in such items, can be justified. Never have I seen an examination report where the justification appears. It just seems to be done automatically and consistently.

The funny thing is that the IRS will make the adjustment on both ends when it is computing phase one, because it wants to get the best of both worlds. But such an adjustment appears to be inconsistent with the existence of a statute of limitations, which is intended to allow a final resolution of issues once the statute of limitations is passed. The economic consequence of making these inconsistent adjustments is to include in income in the year under audit all the adjustments that otherwise would have been made over a period of years. This is not only inconsistent with the statute of limitations, but it produces a distortion of income that, in itself, is inconsistent with the Service's general policy on accounting methods. You are not supposed to have distortions of income.

Now try to think of a justification for this type of an adjustment. The only thing I can come up with is that there must be some kind of argument that the IRS wants to make under the tax benefit doctrine, which says that if you have a tax benefit in the past you are going to have to pay for it in the future. But again technically this argument doesn't seem to hold water because the Supreme Court has dealt with the prerequisites of the tax benefit and there must be either a recovery, which there is none, or an inconsistent event, which also is not satisfied. So I think it is very difficult for the Service to make these types of inconsistent adjustments, and the technical advice that I have referred to has provided taxpayers a gift in that regard.

In that case the taxpayer had settled 1981 and 1982 and, as I indicated earlier, had received a full concession of the issue on universal life in 1982. The Internal Revenue Service's agents proposed to disallow the entire reserve at year-end 1983, and of course, the impact of that would be to do away with the benefit of the 1981 and 1982 settlement. Recognizing this, the National Office said that, where the settlement has been pursuant to mutual concessions by the taxpayer and the IRS, the IRS will give that recognition by making the adjustments not only at the end of the taxable year, but also as of the beginning of the taxable year. This is a great victory for the taxpayer, and while it is currently limited to the context of prior appeal settlements, I think it is something not to lose track of because it affords a number of interesting opportunities for settlements as well as good legal arguments. For example, the interesting settlements that can occur in fact did occur with respect to the graded premium policy in question in that technical advice. In that case, the graded premium policies were no longer being issued so that instead of the reserves going up, the reserves were going down. This means by agreeing to the adjustment as long as it is made on both ends, the taxpayer saved the money that otherwise would have been included in income pursuant

to the general requirements. So, there the IRS has actually given the taxpayer a favorable resolution to which it otherwise might not have been entitled. So good guys don't always finish last.

MR. STEPHEN C. ELDRIDGE: Now Ted said this is one of the last issues under the 1959 Tax Act. Actually the subject will never die because, as you know, for Phase III purposes, the limitations on the amount that can be held in the Policyholder Surplus Account are based on reserves, and for this purpose, reserves are calculated as they are under the 1959 Act. So, 818(c) will never die.

We are going to discuss the AMT next. First, let's review what the 1986 Tax Act did with respect to alternative minimum tax. It gave us the book untaxed reported profits (BURP) system for 1987, 1988 and 1989. Then the ACE system is probably going to come into effect in 1990. Last we will touch on Congressman Rostenkowski's proposals. Notice that I said that it looks now like we are going to go to the ACE system in 1990. All this time we aren't really sure. It has been wavering back and forth these last two years. There were some in Congress who wanted to move ACE from 1990 back to 1988 and 1989, and there were some others who wanted to keep using BURP forever. Clearly, ACE hasn't been pushed back and is scheduled to come into effect January 1, 1990, and if Rostenkowski has his way, that is what is going to happen.

In the next three years, the BURP calculation starts off with taxable income, as the ACE will, too, but there will be important differences. Under this BURP system, we will first make adjustments and add back preferences, which include such things as certain tax-exempt interest on special purpose bonds. For example, the special Blue Cross/Blue Shield deduction is not allowed for this purpose, and depreciation is calculated differently for AMT purposes then it is for regular purposes. So again, we start with taxable income, make a number of adjustments, and come up with a figure that I call tentative Alternative Minimum Taxable Income (AMTI). Now to tentative AMTI for 1987, 1988 and 1989 years, we add the BURP adjustment. The whole AMT is known as the General provision. The background is that General Electric and General Dynamics issued financial statements to their public shareholders in which they said that their GAAP pretax earnings were $17 trillion and their GAAP financial statements had even shown a few trillion dollars of tax expense. But if you look at their corporate tax returns for that year, you will find that those companies paid zip. The whole purpose of the AMT is to make companies pay something each year. The initial focus was on companies' financial statements. The BURP adjustment, in effect, gets at those companies that are reporting to shareholders large amounts of pretax income, but yet on their current tax returns are paying no tax.

AMT has gotten the Internal Revenue Service into the accounting business. It wrote a series of regulations defining what financial statement income is. Let's first of all take a look at the overview of the system.

On Table 1, on the right is the regular tax system. We have a TI (Taxable Income) of $1,000, a tax rate of 34% and a regular tax of $340. In the left-hand column, we start off again with taxable income -- I am assuming away any adjustments and preferences. ANBI is Adjusted Net Book Income as defined by the regulations, and you notice in this example Adjusted Net Book Income, Book Income, and Financial Statement Income is $4,000; Taxable Income is $1,000. You subtract and the difference is $3,000. Fifty percent of the excess of book income over taxable income gets added into the AMT base. So I have my $1,000 taxable income, add $1,500 for the .5 of the excess of book over taxable income, and we come up with AMTI (Alternative Minimum Taxable Income) of $2,500. This we multiply by the AMT rate of 20%, and we have an AMT tax of $500. In this example, the taxpayer will pay the tax of $500 because that is the greater of the two. The concept of paying the greater of the two will continue under the ACE system in 1990.

In calculating the book income you can tell that there are going to be several problems and complications because you are going to have to do a number of interesting things. For example, when you do this calculation, you are going to have to create a financial statement that may not have been separately stated. You start with a tax return, so you look to the company's tax return.

If you have a company filing a separate return, you look to that company's financial statement. If you are filing a consolidated tax return, you may very easily have to create a consolidated financial statement for that group of companies that are included in the filing of a consolidated return. So these financial statements may not exist automatically in that form.

TABLE 1

BURP Example

		AMT	REG
TI		$1,000	$1,000
ANBI	$4,000		
TI	(1,000)		
DIFF	3,000		
Rate	50%	1,500	
AMTI		2,500	
Tax Rate		20%	34%
Tax		$ 500	$ 340

You have problems with companies that have a different book and tax year, and there are adjustments provided for this. There are other problems with BURP. In 1986, the first year before the AMT system came into effect, if a company had an item of book income, book deduction for example, but couldn't deduct it on the company's 1986 tax return and deducted that item on its tax return in 1987, actually that company had really prepaid its tax because it couldn't deduct it when it was deducted for book purposes in 1986. Yet that company would possibly incur an AMT in 1987 because in that year it had a tax deduction but had no corresponding deduction for book income. We are going to see problems again as we go into ACE because ACE is a totally different system. Going back to the BURP system, you have to figure out which financial statement you have to use. Even if you have your financial statements, if you had certain disclosures in the footnotes and those disclosures didn't meet certain criteria, you could destroy the viability of using that financial statement, or the IRS could restate adjusted net book income.

If you change your method of accounting after 1986, in determining adjusted net book income, you would have to pick up the cumulative effect of the change, except to the extent that it was effective in pre-1987 years. So life is kind of complicated, and again it all revolves around your financial statements. There is a series of listings of priority of which financial statements are to be used. An SEC financial statement is the first priority. If you have an SEC financial statement, that must be used. The second priority is a certified audited financial statement, which means certified and audited by an outside accounting firm, not one you use solely for internal purposes. Now third is statutory financial statements for the insurance industry, then comes Other, and last, you use earnings and profits. You can tell that companies are using different bases. Small stock companies that don't have GAAP financial statements and mutual companies that don't have audited GAAP financial statements will have one starting point for "adjusted net book income," and stock companies that use GAAP financial statements or SEC reports will be starting from a different point. The stock companies complained on that issue, and Congress made a change in the 1987 Act so that, for 1988 and 1989 years, when and only when the Treasury ever comes out with regulations for the 1988 and 1989 years, those small stocks that don't have GAAP and the mutual companies that didn't use GAAP in those years will have to calculate their adjusted net book income using GAAP-like principles.

When this first happened, I was advising clients in small stocks and mutuals to do their thinking as if these regulations would be issued and their tax posture for 1989 would in fact be on a basis comparable to using GAAP financial statements for purposes of calculating the book-tax preference. Well, I was wrong. In fact the Service has never come out with those regulations, and it doesn't look like it ever will. The further along we get in time with those regulations not coming out, the more legal grounds we have for not ever having to make the calculations. The Service, in order to make those regulations effective for 1988 and 1989, have to come out with them on a timely basis, and it does not look like it is going to happen. Hopefully those regulations will not get written, but those small stock and mutual companies were rather concerned for those years.

The Act also said that the equity tax, Section 809, on mutual companies shall be taken into account, where the deduction for policyholder dividends is limited to the deduction for tax purposes. It is not perfectly clear how that is supposed to work out. But that is another change in effect for 1988 and 1989.

The next topic is the minimum tax. When Ronald Reagan told people what he was trying to do with tax reform, he said, "I am trying to simplify your taxes." So as we go through this, I want you to understand that we started off with a single tax system with a single tax rate and now we have two side-by-side tax systems: the regular tax system and the alternative minimum tax. They are coexistent and independent of each other. I just want you to appreciate tax simplification as we go along.

On the regular side of Table 2, I have taxable income of $1,000 and a net operating loss (NOL) of the same $1,000. This company can have $8 trillion worth of NOLs. The point is that its regular taxable income for the current year is going to be $0. Moving over to the column on your right, let's assume that its alternative minimum taxable income is the same $1,000. Let's assume, too, that it has another $8 trillion worth of AMT NOLs and by the way, the tax loss carryforward for AMT is also different than the tax loss carryforward for regular tax purposes. We have two different figures, and that is part of tax simplification. For AMT purposes this company could also have trillions of dollars of AMT NOLs. You note that I have limited it to $900. There is a 90% limitation. No matter how much you have in NOL carryforwards, you can only use 90% of the pre-NOL figure as the AMT NOL. The purpose there is that you will always be paying some tax.

NOL is another new rule. Again remember Congress wants a taxpayer to pay some tax, no matter what.

TABLE 2

NOL Example

	REG	AMT
TI	$1,000	$1,000
NOL	(1,000)	(900)
TI	-	100
Tax Rate		20%
Tax		$ 20

At this moment, we have three potential tax rates: we have a regular taxpayer at 34%; we have AMT-Regular taxpayer paying taxes of 20%; and we have an AMT-NOL taxpayer paying tax at 2% on items that affect taxable income 100%. Under the BURP System, 50% of the tax-exempt interest falls into the difference between book and taxable income. Therefore half of tax-exempt income gets taxed at a 20% rate. So for the companies' share for life companies on the part of tax-exempt income that is not prorated, the effective tax rate is 10% if you are an AMT-Regular taxpayer and 1% if you are an AMT-NOL taxpayer. How is that for simplification?

Let's move on then to ACE. The ACE system works in many ways like the BURP system, but what really happens under ACE is that we no longer look at book income. Financial statements, in 1990, are out the window. We still have the same sort of adjustments and preferences. Depreciation is calculated a little bit differently, but we basically have adjustments and preferences, and again you come up with the same concept of tentative AMTI, that is, you start off with taxable income after adjustments and preferences, and you have a tentative AMTI before the ACE adjustment. We will calculate ACE and will add 75% of the excess of ACE over tentative AMTI. If you have no adjustments and preferences, the simple way to look at it is that you add 75% of the excess of the adjusted current earnings over taxable income. We are starting again at taxable income, and the reference is no longer to book income.

I will talk briefly about property-casualty companies because many of you have affiliated property-casualty companies. Section 846 deals with discounting of loss reserves. As you know property-casualty companies now have to discount reserves. Under the BURP system, the discounting took place for tax purposes, but not for GAAP or Stat, and so a property-casualty company under the BURP system in effect had a head start. It had additional taxable income with no book income so that Section 846 discounting for property-casualty companies protected a fair amount of other preferences that property-casualty companies had. Under the new ACE system, we are starting off with taxable income, and we are adding only things that never get taxed, such as tax-exempt interest. What that really means is that property-casualty companies no

longer have that protective corridor between alternative minimum taxable income and regular taxable income. They are now more subject to AMT than ever before. The last word on property/ casualty companies is about Section 847, which is Special Estimated Tax Payments, which can be used by life insurance companies as well with respect to their A&H business. It is really a GAAP provision that allows you to make an "election" which makes your auditor go away happy because it assures that you can recover your excess taxes paid because of discounting. There has been a lot of debate and discussion. The point that I want to make here is that utilizing Section 847 Special Estimated Taxes does not create or increase an AMT. It is a very helpful clarification that we have had on that issue.

There are a couple of interesting things about ACE that we have to deal with. One is taxation of inside buildup. For purposes of calculating adjusted current earnings, we take into account those things that will never hit the tax return, such as tax-exempt interest, the dividends received deduction and the special items for the insurance industry, such as the inside buildup on life and annuity products. For this purpose, the inside buildup on corporate held life insurance is currently subject to AMT on an annual basis. This will not have much of an impact on a life insurance company itself, but on its sales. Corporate held life insurance is a tool that is used for a lot of purposes, not just buyouts. Companies have been looking at life insurance to fund long-term reserves such as medical malpractice. The utilization of corporate held life insurance will diminish in this regard. For example, in cross buyouts, you will now have to have life insurance policies owned by the shareholders rather than by the corporation.

The same rule applies to annuities, but that is a little bit late because, on corporate held annuities, the inside buildup has already been subject to tax. Since it is already in the regular tax base, then you shouldn't make a duplicate adjustment in the AMT base. To the extent you have grand-fathered corporate-held annuities, which is the more likely case, where there is no taxation of the inside buildup, then you will have an adjustment under the ACE system. There was a problem on structured settlement annuities, which was clarified by TAMRA, so there is no longer any AMT adjustment with respect to structure settlement annuities.

The other exciting thing in ACE is the deferred acquisition cost (DAC). Even though we hope we never will get to DAC under the 1988 and 1989 system, we will have to deal with DAC under ACE. Clearly your acquisition costs are not expensed for purposes of calculating ACE, but they are capitalized and amortized. There is some duplication due to the fact that provision for deferring acquisition costs is inherently contained in the preliminary term tax reserving methodologies.

Attempts will be made to work out a system whereby the double whammy, the duplication of the adjustment, is eliminated. Bill Schreiner was kind enough to tell me there was a meeting in Washington of the ACLI Committee on the subject of this duplication issue. A subcommittee of the committee is working on this problem, it will be developing a series of papers to present to the larger committee. I hope, for the organization's benefit, that stock/mutual issues can be kept in the background, and we can work from the point of view of industry issues. I hope the group can come together with a paper that makes sense to avoid duplication and to avoid taxes on the insurance industry as a whole. If that is the approach, then we will get somewhere. If this isn't the approach, we will be back to getting nowhere because of too much infighting.

There is a lot of debate on how to do this, not only on the extent of duplication but also on just how to amortize DAC. One of the issues is whether to look to the GAAP methodology for amortizing deferring acquisition costs, i.e., under the new FAS 97, which amortizes DAC as profits emerge. So do you use the GAAP approach, or do you take a separate approach, perhaps how profits emerge on a tax basis? I like the second one because that is another level of complexity. We hope to get some enlightment and some relief from the double tax.

Next I will talk about the credit provided for under BURP and under ACE. Essentially, you recalculate the tax that you would have paid only with permanent differences. To the extent you pay AMT under BURP or ACE due to timing differences, you should be able to get the credit back. Now, with respect to tax-exempt interest, although it sounds like a permanent item, think for a moment. The only place that tax-exempt interest gets into the BURP calculation in 1987, 1988 and 1989 is through the book tax preference. It is in book income but not in taxable income. By quirk, the book-tax preference is treated as a timing difference in itself. So by quirk, any AMT that you pay for 1987, 1988 and 1989 that is due to tax-exempt interest is recoverable in any

future year in which the regular tax exceeds the AMT. That carryforward may be carried forward forever. So, if in some future year you have an excess, you will get your money back. Starting January 1, 1990, that changes dramatically. Any AMT that you pay starting in 1990, which is due to the tax-exempt interest, is never recoverable.

Interestingly, if you pay an AMT because of the NOL limitation, that is treated as a timing difference under both systems. So if you pay AMT because of an NOL, you can get that back either from 1987, 1988 or 1989 years, or if you incur an AMT in 1990 and thereafter because you are utilizing an NOL, that is also recoverable. But the important deductions that you lose out on are tax-exempt interest and the dividends-received deduction.

I just wanted to spend a minute on Rostenkowski's proposals. Chairman Rostenkowski of the House Ways and Means Committee has said, "I want to simplify your taxes." He is going to make a new system that is going to simplify taxes and at the same time get no new revenues out of this. It is supposed to be revenue neutral. He does not want to raise any money; he just wants to make things simple. One of the things the system is going to do is eliminate this excess of 75% over AMTI before the ACE adjustment. He is going to build everything into the system itself. In effect, the AMT base will be your taxable income, you will add adjustments and preferences again, and you just add in these other items. You won't do the 75% calculation.

Depreciation is going to be made a little bit more simple. In the ACE system, you won't have to refer back to book depreciation. Rostenkowski is going to eliminate all references to book depreciation. He is going to simplify depreciation and frankly make it a little bit more liberal. Now if this is supposed to be revenue neutral and he is giving something to taxpayers in the way of depreciation adjustments, what is this going to cost the taxpayer? Naturally this is going to mean effectively that the 75% add-on rate goes to 100%. Instead of adding 75% of all of these items, you will now be adding in 100% of all these items.

I will finish with something that is more relevant on the property-casualty side, but there is some relevance on the life side. The number one topic in the property-casualty industry is investments and investment strategies and the cost of holding tax-exempts. There are not many life companies that have tax-exempts, but some do and some have large portfolios. The tax-exempt market has been experiencing a slowdown on purchases from the insurance industry, particularly a slowdown with the property-casualty companies, which were the big buyers. I think you are going to start to see more property-casualty companies dumping their old portfolios and even some life companies dumping their old portfolios. From a CPA's point of view, the market for tax-exempts should be soft for a long time. It is a question of liquidity, getting out at the right time.

Table 3 compares the impact of tax-exempt interest after proration under the three systems. Life companies suffer a very significant proration on tax-exempts, property-casualty companies suffer 15%. But after proration under the BURP system, 100% of the after-proration tax-exempt income gets into the system, 50% gets taxed at AMTI, and with a tax rate of 20%, you pay a tax of $10. If you look carefully enough, I say $10 to $0. In effect, any AMT that you pay under the BURP system because of tax-exempt interest is really a prepayment. The net cost depends on how quickly you get that money back. So you are paying $10, but if you get it back the next year, your effective cost is very little. If you get it 10 years later, it is a lot more. If you get it back in 30 years, forget about it. So it is a prepayment, and the real cost of paying an AMT because of tax-exempt interest under the BURP system is a matter of timing.

TABLE 3

	BURP	ACE	New Proposal
TEI*	$100	$100	$100
Rate	50%	75%	100%
	50	75	100
Tax Rate	20%	20%	20%
Tax	$ 10	$ 15	$ 20

*After Proration

Now when I move over to ACE, we have the same $100, the rate is now 75%, so $75 comes into the tax base at a rate of 20%, and we have a tax of $15. Notice that there is no 15-something next to it. Again, that is because under the ACE system, it is never recoverable. That fact alone was rather dramatic. Companies are finally understanding what is really happening. Companies have begun significantly, not to dump everything, but to simply turn new cash flows into fully taxable income.

Another thing I have been saying is that the AMT can only get worse. Under Rostenkowski's proposal 100% rather than 75% of the difference gets into the tax base, and the tax goes to $20 on tax-exempt interest. Either that is going to happen, or the rate of 20% is going to increase; but this is simply going to get worse, and ultimately the AMT will replace the regular tax base.

This fact really shakes up investment people tremendously, and I urge you to look at it and discuss this with your own investment people. It has a significant impact. Maybe you don't have a large portfolio you will dump. If you want to dump, dump now before the crowd comes in.

MR. WILLIAM P. CHIROLAS: Steve, you mention that, under the BURP system, the AMTI credit is carried forward. What is used first, NOL or the AMTI credit carryforward?

MR. ELDRIDGE: You apply your NOLs first. You first calculate what your AMT is. You use all your NOL carryforwards. At the end of the day or the next year, you compare your regular tax to your AMT, however calculated, and then if your regular tax exceeds your AMT, then you could apply to reduce your regular tax down to the AMT by that carryforward.

MR. CHIROLAS: My question regards the idea that this CRVM method somehow offsets the GAAP concept; therefore, we should get some sort of a break on DAC-GAAP calculation routines.

Under FAS 60, CRVM reserves are used under tax, yet GAAP benefit reserves, which are developing our alternate GAAP book income, are developed using a lapse factor and developed differently than a net level reserve under tax. So the question is, isn't that somewhat of an offset to the concept that we need a break for the DAC amortization rules that GAAP imposes?

MR. FRIEDSTAT: No, I don't think so. If you are talking from a mutual company position where the basis of your reserves is going to be tax, I don't thing that there is.

MR. CHIROLAS: I am talking about a stock company. You are comparing a stock company versus a mutual in this case, and the stock company will be producing income based upon a GAAP benefit reserve calculation, which will include a lapse factor. You are suggesting that the mutual companies receive some sort of a lessor DAC.

MR. SCHREINER: Why do you think there is some suggestion as to what the mutual companies would receive?

MR. CHIROLAS: The suggestion is that there is a lapse discount factor normally in a benefit reserve calculation under FAS 60.

MR. SCHREINER: Let's consider a traditional policy and compare the situation you would have if you had a net level premium reserve versus a modified Commissioners reserve. There is obviously a difference in the reported earnings if you are going to amortize those expenses or if you are going to charge them upfront. The objective in the process ought to be to not keep the reported tax earnings at the front. If you have a system that keeps income at the front, that is a very bad system for the insurance company and a very good one for the IRS, and that is something that insurance companies wish to avoid.

MR. CHIROLAS: I totally agree. I am in favor of less tax myself, but the question comes up that, if you have the CRVM method, therefore, we must modify the DAC amortization rules. The CRVM method has a traditional mortality and interest-only discounts. It is not the same thing as GAAP benefit reserve, which the stocks are looking at.

MR. BAKER: As an attorney I have neither a mathematical nor accounting background, but it seems to me that, if we are talking about a differential in the GAAP reserves and the reserves that we have for tax purposes and if the GAAP reserves are larger than the tax reserves, the logic is

that, in fact, the expenses are being taken into account in a different manner, and therefore, some adjustment is appropriate. It might be a different adjustment than it would be if you were looking at the reserves in an annual statement. What you have to do is take a look at those separately computed reserves. If in fact there is a differential, presumably you have some basis for making an argument for alternative tax purpose that you don't just take the number off your GAAP statement for DAC.

MR. MARK M. HOPFINGER: I have two questions; one is for Bill Schreiner. With the recent submission to the Treasury on clarification of Section 807 for options under 1980 CSO, do you have any interpretation of select and ultimate mortality rates? It is my impression that ultimate mortality generally gives lower reserves. Is that the mortality table that should be used for calculation of 7702A net premium even if the rating basis is select?

MR. SCHREINER: Yes.

MR. HOPFINGER: My second question is for Mr. Baker. When you go through the IRS document on comparing reserves and net premiums, do you see any hope in using the argument that says, when the first year net premium is less than net level premium and the renewal net premium is greater than net level premium, then is that a characteristic of a preliminary term reserve? Do you see any basis in that argument being used successfully for universal life? For example, could it be used for front-end loaded universal life?

MR. BAKER: Well, again, I will try to address the question with the hope that I'm doing it in proper response. It seems to me that arguments can be made with respect to the front-end load universal life. Basically, what you do have left constitutes taking an expense allowance, and in fact, you are computing your reserves on a preliminary term basis even if you have just taken the whole amount. I think those arguments are a little less compelling then separately computing your reserve and taking that excess amount as an 8G reserve. If I am understanding the question, yes, I think you can make that argument separately as an alternative argument.

MR. ABRAHAM WEISHAUS: I have a comment and a question, both directed to Mr. Eldridge. The comment is about tax-exempt investments. So far the market this year has been pretty strong for them despite your comments. Just as a guess, perhaps tax-exempts have been pushed for senior citizens who have to pay the Medicare tax, a new market. Maybe that is why these investments have been so strong.

MR. ELDRIDGE: People tell me that it is hoped that the individual market will buoy the tax-exempt market. Still when you get a whole industry that may be dumping, and the property/casualty industry is a big holder, it can't help the market.

MR. WEISHAUS: The market has been strong so far, so apparently dumping has not occurred yet.

MR. ELDRIDGE: Yes. It will be interesting to see what will happen next year.

MR. WEISHAUS: My question is, in discussing timing difference and what counts as a timing difference under ACE, you have mentioned tax-exempt investments, but you forgot to mention what the DAC is considered, a timing difference or permanent difference?

MR. ELDRIDGE: DAC is a timing difference, but ACE will prescribe the AMT treatment for DAC as a GAAP-type approach.