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ALTERNATIVE MINIMUM TAX

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- o Changes occurring in 1990 under current statute
- o Deferred acquisition costs
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MR. DAVID L. OLMSTED: Alternative minimum tax (AMT) is an interesting topic because the rules have changed for 1990 from what they were last year. Affecting actuaries is the requirement to defer acquisition costs, so many of you have been or will be working with your accountants and tax people to accomplish the necessary computations to avoid paying any AMT that your company isn't required to pay.

Our first speaker is Jonathan Chapman, a tax partner with Ernst & Young. He is going to describe the basic changes in the AMT that are taking place for 1990 and say a little bit about legislative proposals. Then Bill Schreiner of the American Council of Life Insurance will discuss the status, the meaning and the effect of the clarification language appearing in the Congressional Committee Reports that preceded the Revenue Reconciliation Act of 1989. Finally, I am going to speak about some of the more practical issues facing a mutual company or perhaps a privately held stock company that has never done any GAAP statements. You will want to keep in mind that each of us is speaking for himself. What we say is our own opinion. It is not necessarily the opinion of our employers, and we are not speaking on behalf of the Society of Actuaries or any other group.

MR. JONATHAN C. CHAPMAN: I would like to begin this session with a brief overview of the calculation of the AMT. I would like to focus on two key adjustments in calculating the AMT. These two key components, one occurring in 1989 and the other in 1990 and subsequent years, are the business untaxed reported profits (BURP) adjustment in 1989 and the adjusted current earnings (ACE) adjustment in 1990 and subsequent years. After we go through a general overview of the AMT calculation, we will then focus on certain changes that were brought about under the 1989 Revenue Reconciliation Act. And then, finally, we will take a look at some proposed legislation by Senator Heinz and by Congressman Downey that would effect the AMT as well as some of the other provisions under the Downey bill.

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Table 1 compares the structural outline of the AMT calculation for 1989 with that for 1990 and subsequent years. I am going to go rather quickly through some of these adjustments by way of explanation, and I will focus on the two key components: the BURP adjustment and the ACE adjustment.

TABLE 1

AMTI Calculation Structural Outline

	Pre-1990	Post-1990
Regular taxable income	$XX,XXX	$XX,XXX
+ Tax preference items	XXX	XXX
+/- Adjustments:		
Depreciation (AMT)	XXX	XXX
Fixed assets (AMT gains/losses)	XXX	XXX
Other (except NOL, BURP or ACE)	XXX	XXX
Tentative AMTI	XX,XXX	XX,XXX
+ BURP adjustment (1)	XXX	N/A
+/- ACE adjustment (2)	N/A	XXX
Tentative AMTI before AMTNOL	XX,XXX	XX,XXX
-- AMTNOL (90% limit)	XXX	XXX
AMTI	$XX,XXX	$XX,XXX

In both years the alternative minimum taxable income (AMTI) upon which AMT is based, begins with regular taxable income. This is the regular taxable income that appears on the form 1120-L. To that number various adjustments and additions are made. The first adjustment that is made is with respect to tax preference items. Tax preference items are specifically referenced in the Internal Revenue Code under Section 57. These include such items as tax exempt interest on private activity bonds (for example Industrial Revenue Bonds [IRB]), accelerated depreciation on certain real estate, certain tax preference items associated with oil and gas investments and so forth. These typically aren't a significant component of the AMTI. After we identify these items and add them to the regular taxable income, we make various adjustments. These adjustments can either increase or decrease regular taxable income in arriving at the AMTI. The most common adjustment is with respect to depreciation.

Under the AMT provisions, a separate depreciation system is provided for AMT purposes. This generally produces a slower rate of depreciation. Because we have a different depreciation system for AMT, we also have a different adjusted tax basis for gains and losses with respect to fixed asset disposals. This is more of an accounting type of exercise than anything else. There is an abundance of software that keeps track of all of these things, and most people are familiar with these adjustments.

There are a number of other adjustments with respect to regular taxable income, including installment sale adjustments, adjustments with respect to certain capitalized costs and so forth, that for the most part are not applicable or applicable only on an insignificant basis to life insurance companies.

Once we make these various additions and subtractions to regular taxable income, we arrive at a number called tentative AMTI. Tentative AMTI is an important number to focus on because it is the key component in the next two adjustments, the BURP adjustment and the ACE adjustment. The BURP adjustment reflects, at least in theory, Congress' attempt to tax economic income. There is a lot of debate and disagreement as to whether it reflects true economic income, but that is the theory. The BURP adjustment is applicable for years 1987, 1988, and 1989. The BURP adjustment is replaced, beginning in 1990, with the ACE adjustment. I would like at this point to focus on these two adjustments in the next two tables and then come back to Table 1 to demonstrate the final calculation of AMTI.

In Table 2, the BURP adjustment begins with the adjusted net book income reflected in a company's applicable financial statement. The applicable financial statement is a key item for life insurance companies as well as other companies. Life insurance companies may have different applicable financial statements, and this has generally been a key component that separated the mutual companies from the stock companies in years prior to 1990. In general, a stock company's applicable financial statement was their GAAP financial statement. For mutual life insurance companies, the applicable financial statement typically was the annual statement. This resulted in most mutual companies not being as exposed to the AMT as stock companies.

TABLE 2

Business Untaxed Reported Profits (BURP)

Adjusted Net Book Income (NBI)
Less Tentative AMTI (TAMTI) before BURP and AMTNOL
BURP
X 50%
BURP adjustment (not less than 0)

Once we determine the applicable financial statement, the adjusted net book income, in general, is the pretax income as reflected in that statement. Once we have identified that number, we compare that to the tentative AMTI that we just looked at and if the adjusted net book income exceeds this number, we have the BURP. Fifty percent of this becomes the BURP adjustment, which we add to tentative AMTI in calculating our AMTI.

Things become a bit more complicated in 1990 when we replace the BURP adjustment with the ACE adjustment (Table 3). The ACE adjustment begins with the tentative AMTI that we just looked at and we make various adjustments to that number. These adjustments may either increase or decrease tentative AMTI. The first adjustment is with respect to depreciation. We have a separate depreciation system under the ACE provisions. Please recognize that what is happening here is that we have a depreciation system and a related adjusted tax basis for fixed assets for purposes of regular tax; we have another depreciation system and adjusted tax basis for AMT in arriving at tentative AMTI; and we have yet a third depreciation system and adjusted tax basis for ACE purposes. Fortunately, as I said earlier, there is an abundance of software that will calculate these things automatically. I can't imagine calculating these things manually.

TABLE 3

Adjusted Current Earnings (ACE)

TAMTI before ACE and AMTNOL
+/- Adjustments:
  ACE depreciation
  ACE fixed asset gains and losses
  Earnings and profits adjustment (income excluded from regular taxable income less related expenses not deducted from regular taxable income)
  DPAC
  Other
ACE
Less TAMTI before ACE and AMTNOL
Excess of ACE over TAMTI
X 75%
ACE adjustment*

* The ACE adjustment may be negative but only to the extent the cumulative ACE adjustments from prior years are positive.

The ACE depreciation method, for the most part, is a straight-line method over an extended period of time. Because we have a separate depreciation system, we also have a different adjusted tax basis, which means we have to separately calculate our gains and losses for ACE purposes.

Those things are rather automatic and involve rather mechanical calculations. Probably a lot of the uncertainty, other than the deferred policy acquisition cost (DPAC) adjustment, concerns earnings and profits. Under the ACE rules, to the extent you have an item of income which is included for earnings and profit purposes, but is not included for regular tax purposes, that item is added back to tentative AMTI in arriving at ACE. An example of this would be tax exempt interest. Recognize that the tax exempt interest was also added back for purposes of the BURP adjustment, because the tax exempt interest was reflected in the applicable financial statement. It is also added back for purposes of the ACE adjustment, but instead of coming indirectly through the BURP adjustment, it is added back directly through the earnings and profits adjustment in arriving at ACE. The only difference is that instead of picking up 50% of this component, as you will see in a moment, we pick up 75%. In addition, certain items are deductible for regular tax purposes, but are not deductible for purposes of earnings and profits. Those items are also added back to tentative AMTI. An example of this would be the dividends-received deduction with certain exceptions which we will look at later.

Once we have gone through the various earnings and profits adjustments that are added or subtracted, we arrive at one of the key components that is going to be the focus of a lot of attention, and that is the DPAC adjustment. As Bill will discuss, the statute under Section 56(g)(4)(F) provides that all life insurance companies will be required to capitalize and amortize their policy acquisition costs under generally accepted accounting principles. In general this is going to require companies to identify their acquisition costs, capitalize them and amortize them under the various GAAP methodologies. The statute also provides for a fresh start, in that the policy acquisition costs as of December 31, 1989 may also be amortized against tentative AMTI in arriving at ACE. I won't focus much attention on DPAC at this point, as it will be discussed rather thoroughly in a few minutes. There are also some other adjustments in the ACE calculation that, for the most part, are not particularly applicable to life insurance companies, but I won't get into these.

Once we have made all of these adjustments, additions and subtractions to the tentative AMTI, we arrive at the adjusted current earnings. To the extent that the ACE is greater than the tentative AMTI before the ACE and before any AMT net operating loss, 75% of that excess becomes the ACE adjustment. However, unlike the BURP adjustment, the ACE adjustment can be negative, subject to certain limitations. To the extent that the tentative AMTI exceeds the ACE, we have a negative adjustment. Seventy-five percent of that negative adjustment becomes a subtraction from tentative AMTI in arriving at AMTI. That is a very brief and simplified overview of the adjusted current earnings adjustment. I would like to now go back to Table 1 and complete our calculation of AMTI.

Once we have made the BURP adjustment or the ACE adjustment, we arrive at tentative AMTI before any net operating loss (NOL). There is a separate NOL calculation for AMT purposes, but I won't get into that at this point. However, that AMT NOL is subtracted from tentative AMTI. There is a limitation on the NOL subtraction of 90% of the tentative AMTI. Once we have subtracted the AMT NOL, we arrive at the AMTI. We multiple that by 20%. That becomes what is referred to as the tentative minimum tax. To the extent the tentative minimum tax exceeds the regular tax, we have an AMT. Now in general, the AMT is a temporary tax in that the AMT also results in an AMT credit which can be carried forward indefinitely, and can reduce regular tax in future years to the extent that the regular tax in future years exceeds the tentative minimum tax. So, in a sense, it becomes a temporary tax. For a company that finds itself in an AMT for an indefinite period of time on a present value basis, the tax becomes a very real tax -- it effectively approaches becoming a permanent tax the longer the company is subject to it.

I would like to talk about some changes in the Revenue Reconciliation Act of 1989 with respect to the AMT. The first change, I think, is more significant to capital intensive companies. The Act greatly simplified the depreciation rules for the ACE calculation. It removed any reference to book depreciation methods. Under the prior rules, it was necessary to compare on a present value basis, the depreciation based on certain prescribed methods under ACE, with the present value of the depreciation for book purposes. There was considerable confusion and complexity under these rules. The Revenue Reconciliation Act has eliminated any reference to present values or book methods in calculating the ACE depreciation. The second change under the act is that the dividends received deduction has been expanded. If you recall what I said earlier, as part of the ACE calculation, a dividends received deduction is deductible for regular tax purposes but not for earnings and profits purposes. The dividends received deduction therefore, as a general rule, is required to be added back for ACE. The Revenue Reconciliation Act has expanded the exception to this rule in that the dividends received deduction, with respect to any 20% or more owned corporation which results in an 80% dividends received deduction, is deductible for purposes of ACE. Prior to that, it was not deductible for ACE. It also changed the 100% dividends received deduction. Prior to the 1989 act, the 100% dividends received deduction was only allowed in a case where the payer/payee companies could not be members of the same affiliated group because of 1504(b), which meant that one of the companies was a life insurance company and one was not. Now the act has removed that limitation so that, in general, the 100% dividends received deduction is a deductible item for ACE purposes as well as for regular tax purposes. In other words, it is not to be added back. Discharge of indebtedness income, to the extent excluded from regular tax purposes, is also excluded for ACE purposes.

There are also some push down accounting rules under the 1989 act. To the extent there has been an ownership change in a particular company and we have a built in loss for that company, the adjusted tax basis for those assets is recalculated for purposes of ACE. A built in loss occurs if the adjusted tax basis of the assets of the target company was greater than the fair market value of its assets by an amount equal to or greater than the lesser of $10 million or 15% of the fair market value of the company. This is going to be a fairly significant exercise in terms of calculation. Another change is that the installment method is disallowed for certain sales.

Probably one of the more significant items is that the AMT credit has been expanded to include exclusion items. Prior to the 1989 act, the statute provided that the AMT is a temporary tax in that the AMT also results in an AMT credit. The exception to that was that under the prior law, to the extent the AMT was attributable to exclusion items, the AMT became a permanent tax. Now what are exclusion items? I won't go through a list of what they are, but I'll give you an example which was of great concern to a number of companies and to Congress, and that was tax exempt interest. Beginning in 1990, tax exempt interest became an exclusion item, and to the extent you had AMT attributable to tax exempt interest, that became a permanent tax. It wreaked havoc on the effective yield on these investments. Congress was concerned about what was going to happen to the tax exempt market, and concerned that there was going to be significant dumping of tax exempt securities. The AMT credit has now been expanded under the 1989 Act to include all items. So to the extent we have AMT attributable to tax exempt interest, that AMT becomes a temporary tax in the sense that it results in an AMT credit.

That concludes my remarks with respect to the Revenue Reconciliation Act. I want to briefly mention two bills that have been proposed. Senator Heinz has proposed a bill that would repeal Section 56(g)(4)(F) with respect to the DPAC calculation for small life insurance companies. These are life insurance companies that are qualified for the small company deduction, and these small life insurance companies would be exempt from the requirement to capitalize and amortize policy acquisition costs. The effective date of this proposal would be January 1, 1990. So it would provide significant relief to small life insurance companies from the calculation of the DPAC adjustment. The second bill is broader in terms of effect, and we could probably have a separate conference on this bill by itself. This is the Downey Bill. The Downey Bill does a number of things. The good news is that it would repeal Section 56(g)(4)(F) for all companies. So the capitalization and amortization of policy acquisition costs for purposes of the ACE adjustment is repealed under the Downey Bill. For a number of companies, the news goes down hill fast. Still on the upside for certain segments of the industry, Section 809, the equity tax, is repealed for mutual companies. In its place, we have a proxy tax on stock life and mutual life insurance companies. The proxy tax would operate as a surtax. It becomes a permanent tax, and it is based on a company's applicable equity base. For stock companies, this is the applicable equity base attributable to participating business. The tax is on a scale running from .167-.667% and it becomes a tax much like and probably much broader than the Phase III tax in that the tax is not reduced by credits. Also, like the Phase III tax, it is not reduced by net operating losses. Another provision in the Downey Bill is that 50% of the cost of commissions incurred by life insurance companies will be required to be capitalized for regular tax purposes and amortized over a period of seven years. As I mentioned earlier, the deferred acquisition costs provisions under the AMT rules would be eliminated. There are certain relief provisions for small life insurance companies which would permit them to expense up to $10 million of commissions. The commission amount which is referred to in this bill, and subject to the 50% disallowance, is the greater of a company's commissions incurred during the year, or 40% of the first-year premiums received during the year.

Interestingly enough, the repeal of 56(g)(4)(F) under the bill, and, in fact the entire bill, is effective January 1, 1991. So under this bill companies would still be required to set up their DPAC systems and do the capitalization and amortization for 1990.

MR. WILLIAM J. SCHREINER: I've been asked to speak to you on the important subject of the AMT as it applies in 1990; specifically, about the change from a book income adjustment to an ACE adjustment for the AMT. My aim is to clarify the unclear explanation of the amortization of acquisition costs under ACE which is contained in the House and Senate Committee Reports for the Budget Reconciliation Act of 1989.

To set this question in context, we have to go back to 1986. The Tax Reform Act of 1986 brought the AMT into an important position in the taxation of life insurance companies and other commercial entities. The function of the AMT is to provide a minimum tax base which is arrived at basically by adding back income that is not taxed in the regular tax calculation due to statutory tax preferences. Under the 1986 Act, companies would be subject to one AMT formula for taxable years 1987 through 1989 and a second, different formula would apply, starting in 1990. For 1987 through 1989, an important addition to the AMTI base was 50% of book income. In other words, 50% of what a company was telling the world it was earning was included in the AMTI, which was then subjected to a 20% tax rate and compared to the tax calculated under the usual income tax rules. If the result of the AMT calculation was larger, that amount became the company's tax for the year.

In 1990 a new system called ACE, replaces the book income adjustment. Under the ACE system, 75% of adjusted current earnings, rather than 50% of book income, is included in the AMTI to determine whether taxes are paid under the regular tax system or under the AMT system.

Let us now consider what the change to ACE under the AMT means for life insurance companies. What follows is a tale of four sentences, and when we are done analyzing them, I believe the application of ACE to life insurance companies in 1990 will be clear. The first sentence is from the tax code, Section 56(g)(4)(F). Under the heading of adjustments it says that "in determining adjusted current earnings, the following adjustments shall apply: . . . (F) ACQUISITION EXPENSES OF LIFE INSURANCE COMPANIES. -- Acquisition expenses of life insurance companies shall be capitalized and amortized in accordance with the treatment generally required under generally accepted accounting principles as if this subparagraph applied to all taxable years." Part of the meaning of this sentence is straightforward. The first part of the sentence says that acquisition expenses shall be capitalized and amortized. This clearly means that instead of charging all acquisition costs to income when they are incurred, as the regular tax calculation permits, acquisition expenses must be capitalized and amortized.

The last part of the sentence is also relatively clear when it says amortization should be done "as if this subparagraph applied to all taxable years." This means that you don't have to start from scratch at the beginning of 1990. Rather, for the purposes of this tax calculation, a life insurance company starts 1990 with a theoretical inventory of capitalized and, as yet, unamortized deferred acquisition costs on hand from contracts issued in prior years even though, for tax purposes, no such inventory has existed in the past. Therefore, for tax purposes, such an inventory must be constructed.

Turning back now to the beginning of our sentence, it says that acquisition costs are to be capitalized and amortized in accordance with GAAP. This means that the 1990 acquisition expense charge will be determined from the constructed inventory of unamortized pre-1990 acquisition costs plus 1990s current acquisition costs by using generally accepted accounting principles. The next question is, What is GAAP accounting as applied to life insurance companies? Does it mean those companies that have a GAAP financial statement merely pluck out of that statement their GAAP acquisition cost charges of the current year and drop them into the federal tax calculation for AMT? And what about those companies, both mutual companies and stock companies, which do not prepare GAAP statements? How are they to proceed in this endeavor?

The lack of certainty about what this sentence in the law meant gave rise to considerable concern for both types of companies. Those which had never done GAAP accounting were not certain as to how to go about the calculation. The concern, however, was probably greatest among companies that were already preparing GAAP financial statements. Their concern was not administrative; it was financial. This was so because some accounting firms were suggesting that such companies should use their actual GAAP amortization charges in the ACE adjustment. These companies saw that if they were to just pluck the amortization figures out of their GAAP statement, their AMTI would rise significantly (assuming they were selling more new business each year), and moreover, it would rise beyond what fairly could be considered economic income.

This would be so because, under such an approach, GAAP acquisition cost amortization would be paired with a Commissioners Reserve Valuation Method (CRVM) to determine each year's increase in contract reserves in the calculation of AMTI.

As you know, the Commissioners Reserve Valuation Method is based on a preliminary term reserve concept which sets up little or no reserve in the first year of the contract. This reserve basis was specifically designed to reduce surplus strain on life insurance companies in the early years of a contract in a statutory accounting environment which required the immediate recognition of all acquisition costs. Clearly, amortizing acquisition expenses, together with establishing reserves based on the Commissioners Reserve Valuation Method, would distort the recognized income of the company and would have the effect of pushing that income into the early years of the contract.

In recognition of the inappropriateness of a tax basis which combines amortized acquisition charges and CRVM reserves, the American Council of Life Insurance went to both the Treasury Department and the Congress' Joint Committee on Taxation in 1989 to discuss the need for a clarification of the intent of this sentence in the Internal Revenue Code. The ACLI obtained agreement from the Treasury and the staff of the Joint Committee on Taxation of the Congress on a clarification and, as a result, three identical sentences appeared in the House report and the Senate report with respect to the Budget Reconciliation Act of 1989.

Of course, the main reason I am here speaking is that some people are not sure that those three sentences actually clarified the issue. My objective is to go through these sentences with you so that you will understand exactly what this clarification means and what it was intended to accomplish.

The first sentence in the clarification is easy. It says, "In determining adjusted current earnings, acquisition expenses of life insurance companies are required to be capitalized and amortized in accordance with the treatment required under generally accepted accounting principles, as if such treatment were required for all prior taxable years." This sentence is nothing more than a recasting of the sentence that appears in the Internal Revenue Code concerning the required capitalization and amortization of acquisition expenses under ACE.

Let us now move to the third sentence in our tale which is the second sentence in the House and Senate reports: "To the extent that life insurance reserves are relevant in determining the amortization schedule under generally accepted accounting principles, tax reserves (instead of reserves determined under generally accepted accounting principles) are to be used." What does this sentence mean? It means that if life insurance reserves have anything to do with determining the amortization schedule, then tax reserves should be used in determining the amortization schedule. This clearly says that you toss out actual GAAP amortization charges and recalculate the amortization charge on the basis of tax reserves. I would be willing to wager that if the clarification in the Committee Reports stopped at this point, very few people would have any difficulty in understanding what should be done in calculating AMT under ACE.

Of course, in this business things are never easy, and we do have an extra complication arising from the fact that there are two different amortization schemes applicable to life insurance products under GAAP. Financial Accounting Standard No. 60 applies to what might be termed traditional life insurance products and Financial Accounting Standard No. 97 applies to universal life contracts. Fortunately, FAS 60 and 97 use the same basis to determine what acquisition expenses should be capitalized and amortized. Under both standards "acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts." Reasonable people may differ in the application of this standard to a specific expense, but that need not concern us.

Let us consider first how amortization should be determined for FAS 60 contracts if tax reserves are to replace GAAP reserves in the AMT ACE calculation. FAS 60 says acquisition expenses should be deferred and charged against income in proportion to premium revenues recognized. The 1972 Audit Guide, on which FAS 60 is based, says a level recognition of premium revenue over the lives of individual contracts was considered an appropriate method of recognizing revenues in proportion to performance. As I am sure you all know, apart from provision for adverse deviation, this means that for FAS 60 contracts, profits emerge as a level percentage of premium. This is the fundamental principle of income recognition under FAS 60.

Transferring this to the ACE context, we see that FAS 60 products require an adjustment in the regular GAAP acquisition cost charges in order to produce profit as a level percentage of premium in an environment where nonlevel premium reserves, such as CRVM, are utilized if the requirement that profits emerge as a level percentage of premium is to be met. In fact, it is a dollar-for-dollar adjustment, at least up to the point at which one runs out of unamortized acquisition costs. Since premiums are the same in each case (that is, under public reporting GAAP and ACE), for every dollar that CRVM reserves are less than GAAP reserves, a dollar must be added to the comparable GAAP amortization charge, if the level percentage of premium principle is to be followed. Thus, under AMT ACE, apart from margins for adverse deviations for FAS 60 products, the amortization schedule of acquisition expenses when taken together with the provision for reserves, should produce AMTI that is the same level percentage of premium as would be obtained under GAAP.

This result was illustrated to the Joint Committee and to the Treasury Department last year when the ACLI asked for clarification of the procedure to defer and amortize acquisition expenses under FAS 60 products. Both the Joint Committee and the Treasury Department were fully aware of the implications of this clarification for FAS 60 products when they agreed to put it in the Committee Reports. In seeking this clarification, the ACLI indicated that in a GAAP statement, level premium reserves are used and the FAS 60 amortization schedule for acquisition expenses is linked to that reserve method.

In particular, the ACLI argued that there is no indication in the 1986 legislative history that, in moving from book income to adjusted current earnings under AMT beginning in 1990, Congress intended to significantly change the impact of the amortization requirement for acquisition expenses other than by raising the inclusion factor from 50-75%. In other words, Congress did not intend the movement in 1990 from book income to ACE to give rise to a tax windfall because of the mismatching of reserve bases and amortization bases. Both the Treasury and the Joint Committee found this argument to be compelling. Thus, our third sentence specifically indicates that tax reserves, rather than GAAP reserves, should be used in determining the amortization schedule for ACE purposes.

Let us now turn to FAS 97 products where different amortization rules apply. Under FAS 97, "capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts." This is a very different rule than that which applies to FAS 60 products, where the reserve basis and the amortization scheme, in effect, can be combined to make sure that a level percentage of premium profit stream results. Instead, FAS 97 contracts have a specific acquisition cost amortization scheme dictated -- one that it is based on the present value of estimated gross profit amounts expected to be realized over the life of the contract.

What then does this clarification mean with respect to FAS 97 contracts? I believe the answer is straightforward. Amortization should be based on the present value of the estimated gross profit amounts expected to be realized. Those gross profit amounts are the amounts that will emerge in federal income tax calculations when CRVM reserves are utilized. Instead of looking at the profit stream that emerges under GAAP accounting, one looks at the profit stream that emerges under tax accounting and bases the amortization on the present value of the estimated gross taxable income on these contracts.

The careful reader may point out that this sentence requires that life insurance reserves be relevant in determining the amortization schedule. Under FAS 97, are life insurance reserves relevant? Some may note that for universal life contracts, FAS 97 doesn't utilize reserves in determining the stream of profit. It doesn't consider premiums to be revenue and, therefore, there is no requirement for offsetting reserves. The accounting scheme is similar to that which a bank utilizes with respect to its deposit accounts. So you might ask, what do reserves have to do with determining profits for these contracts?

I think the answer is that federal tax accounting does involve reserves for all products, including universal life products, and taxes are determined on the basis of taxable income which counts premiums as revenue and reserves as an offset. Thus, if in tax accounting you blindly use tax reserves based on CRVM in the calculation of the amortization of acquisition costs, front-ending of taxable income will result. And it was this front-ending of taxable income that the Treasury and the Joint Committee agreed was not intended by the switch from book income to ACE under the AMT. Therefore, for the AMT ACE adjustment, amortization of the acquisition costs should be based on the estimated present value of gross tax profits.

Let's move now to our fourth sentence. It says, "this clarification is considered necessary in order to treat acquisition expenses consistently under the book income preference and the ACE provision, and should not be considered as establishing a connection between the tax reserve method for a life insurance contract and the income tax treatment of acquisition costs relating to such contracts." With the background that I mentioned earlier about the winning argument to the Treasury and the Joint Committee that ACE is not intended to treat acquisition expenses more harshly in 1990 and beyond than had been the case under the book income approach prior to 1990, the meaning of the portion of the sentence through the comma should be clear. In fact, if this fourth sentence had stopped after the phrase "and the ACE provision" (in other words, if we put a period there rather than the comma), I think few would have any difficulty in understanding what was intended through this clarification and how it should be applied.

Unfortunately, there are 31 more words in this sentence. And those 31 words seem to contradict everything that goes before them. They indicate that the tax-reserve method and the income tax treatment of acquisition costs are not connected. However, these words are not intended to contradict or to take away from the preceding sentence-and-a-half. They simply represent an important point that the Treasury wanted to make in this context. What the Treasury accomplished with these 31 words was to preserve its options with respect to any future changes that might be made in the determination of reserve deductions for federal income tax purposes for life insurance companies. While they had no difficulty with the recognition of tax reserves in the AMT ACE context for amortization of acquisition cost purposes, they were not prepared to make a statement that would appear for all time and forever to link tax reserves and acquisition costs. As I am sure you know, there are people in the government who do not believe that even CRVM reserves are an appropriate regular deduction for life insurance companies. In fact, to some, any deduction for policy reserves is suspect, although others would be willing to recognize policy cash value increases as appropriate deductions. It is in the context of this issue that the Treasury was reserving its right at some future date to come up with some different approach with respect to life insurance reserves without having its hands tied on the acquisition cost side when that took place by a precedent under AMT ACE. For example, were amortization of acquisition costs to be required for FAS 60 products, a new reserve approach could be completely undone by a dollar-for-dollar acquisition cost amortization adjustment.

There is one final matter that I would like to touch on. The three sentence clarification we have been reviewing appears in both the House and Senate Committee Reports, but it does not appear in the Conference Agreement regarding the final bill. That omission does not affect its value as legislative history and guidance. It does not appear in the Conference Report simply because it did not affect the statutory language of the Budget Reconciliation Act of 1989, and because there was complete agreement on the language by the two Committees.

Let us review and summarize last year's attempted clarification. The first sentence is nothing more than a recounting of the applicable statute. The second sentence tells us what we need to know in determining the amortization schedules for AMT under ACE. Tax reserves are to be used in that determination. For FAS 60 products, there is a dollar-for-dollar increase in amortization charges for every dollar that the increase in tax reserves is less than the increase in GAAP reserves. For FAS 97 products, there is a proportional increase in acquisition cost amortization; the increase is proportional to the increase in the present value of future tax profits for a given year resulting from the use of CRVM reserves. (In some years, of course, those increases will be negative.) Finally, the last sentence tells us why this clarification is necessary and what it was intended to accomplish; in addition, it warns us that it may not be used as a precedent should there be a change in the determination of regular tax reserves for life insurance companies in the future.

MR. OLMSTED: The law indicates that "Acquisition expenses of life insurance companies shall be capitalized and amortized in accordance with the treatment generally required under generally accepted accounting principles as if this subparagraph applied to all taxable years." This means that in calculating AMTI, we will not get to deduct our acquisition costs in the year we pay them. Because the ACE adjustment is computed at 75% we will in effect deduct 25% of our acquisition costs in the year they are incurred, while the other 75% will be deferred and will not be deducted until they reappear as amortization. If a company never finds itself in an AMT situation, this deferral may never actually affect its taxes, although it will still have to compute the ACE adjustment in order to discover that it is not in an AMT situation. For a company that does find itself in an AMT situation, however, taxes will be directly affected by the interplay of the amounts that are deferred, and the amounts that are amortized.

The last phrase indicates that the computation is to be made, "as if this subparagraph applied to all taxable years." In a sense, this is the good news. We are going to begin 1990 (for ACE purposes) with a December 31, 1989 deferred acquisition cost balance which we've never had as a specific tax item before. This beginning balance will be deducted in future years as it is amortized. Thus, all other things being equal, a larger beginning balance is better. Unfortunately, many of the decisions which will have to be made as to methods and assumptions will affect not only the amount of the beginning balance, but also the amount deferred in the current year and the rate at which both of these items are amortized. In many cases, this will make it hard to determine even the direction of the tax effect of some decisions, without either careful analysis, or actually trying it both ways. One thing to keep in mind, however, is that permanence has not been the keynote of our tax law in recent years. You may want to pay much more attention to the effects of decisions on current AMT computations, than to projected results out in the future, and this might help simplify your analysis.

The computation is also to be made "in accordance with the treatment generally required under generally accepted accounting principles." We need to find out what GAAP is. This question is most answerable for stock companies. Even if your stock company has never had a reason to compute GAAP earnings, many others have.

What about mutuals? There are sessions on "Mutual Company GAAP" at this meeting. Have they been literally discussing generally accepted accounting principles for mutual companies? Probably not. They have and will be discussing internal management reporting, reporting to rating agencies, and whether or not there is a need to develop a recommended GAAP model for all mutual companies. The actual current situation is that the Financial Accounting Standards Board, which defines GAAP, has not spoken on mutual life insurance company reporting. In a sense, there is no mutual company GAAP. Both FAS 60 and FAS 97 exclude mutual life insurance companies. Lacking any pronouncements to define GAAP for mutual companies, many accountants believe that statutory accounting is currently accounting according to generally accepted accounting principles for mutual life insurance companies.

Probably Congress didn't intend for mutuals to defer and amortize acquisition expense in accordance with statutory accounting. When the law speaks of the treatment generally required under GAAP, it appears to mean that mutual companies are to apply the principles of stock life GAAP to their acquisition costs. To some extent, this is as straightforward as GAAP ever is. The acquisition costs of mutual life companies are similar to the acquisition costs of stock life insurers. Universal life policies written by most mutual insurers are similar to those written by stock insurers. The rub comes when we get to traditional participating business. While stocks do write participating business, it is argued that mutual company participating business is different from stock company participating business.

Traditional business under FAS 60 is accounted for under GAAP so as to level a portion of the profits as a percentage of premium under the assumptions used. The primary question in applying GAAP principles to mutual company participating business is whether to level profits before or after dividends. This decision does not directly affect the computation and amortization of deferred acquisition costs, but it is important to the issue of what we are trying to accomplish when we attempt to avoid the double deferral caused by using CRVM reserves for tax purposes. We will come back to the question of amortization and reserves, but first we will tackle acquisition costs.

If we are to defer our acquisition costs, we'll have to figure out which costs they are. FAS 60 indicates that acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. FAS 97 made no changes in this rule. Determining which costs both vary with and are primarily related to the production of new business is a criteria subjective enough that two reasonable persons sifting through a life company's expenses and dividing them out might reach moderately different conclusions. There is no "perfect" answer. If we took the detailed methods several companies used to distinguish deferrable acquisition costs and applied them to a single company, we might get results that would be materially different, even though all of the results were in accordance with GAAP. Consistency is required, however. It wouldn't be cricket to adopt the most liberal acceptable approach for all issue years up through 1989, and the most conservative acceptable approach for all later issue years.

Some costs are relatively straightforward. Commissions paid to agents for producing new business are deferrable acquisition costs. They vary directly with production, and are primarily related to production. A claim adjusters salary is not. Over the very long term, the number of claim adjusters will in some sense vary with production, but in any case it is not primarily related to production. A home office underwriter's salary is deferrable. More production would require more underwriters, and the work is primarily related to acquiring new business. If the underwriter spends 5% of their time reviewing claims with the claims adjuster, however, an allocation should be made so that less than 100% of that salary is deferred.

Normal advertising is an example of an expense that is an acquisition expense because it is primarily related to acquiring new business. It is not deferable, because it does not vary with the level of new business. However, advertising that says, "call 1-800-INSURANCE now," may be deferrable.

The gray areas come with such things as computer department charges to issue, underwriting, branch managers salaries and expenses, the head of the underwriting department's salary, etc. These expenses must be analyzed in terms of whether or not they meet the two tests, and there is quite a bit of latitude under GAAP as to what the answer turns out to be.

Under GAAP, different amortization methods apply to different lines of business. Not only are some contracts accounted for under FAS 97 and some under FAS 60, but FAS 60 distinguishes between short-term contracts (such as automobile credit insurance) and long-term contracts, and FAS 97 distinguishes between universal life-type contracts, investment contracts and limited payment contracts. Even where the same method applies to different blocks of business, the actual models and assumptions may be quite different between the lines. Besides identifying its deferrable acquisition costs, a company will need to identify its product lines and allocate those costs to the various products. These may already be carefully allocated, and the issue may be just identifying the deferrable costs. But if not, considerable work may need to be done to properly allocate costs to lines. If a company has not done so, it may want to use this excuse to produce an allocation it can also use for management purposes, or it may wish to focus on quick and dirty, or it may want to look at choices between different reasonable allocation methods based on their effects on AMT.

I've already mentioned the need to allocate acquisition costs to product line. We also need to distinguish between contracts to be reported under FAS 60 and under FAS 97, and their various subheadings. This is pretty well spelled out under FAS 97, except for the usual caveat that it doesn't cover participating business written by mutual companies. One other issue does arise. The legislative history indicates that acquisition costs are to be deferred and amortized according to GAAP as it existed at the time the costs were incurred. If we provisionally simplify this to the year of issue, we still have a couple of questions. What was GAAP for universal life-type products before FAS 97? Different companies were using different methods, including deposit methods like FAS 97, level percent of premium amortization, and the composite method. The simplest answer to implement might be to say, "Methods like FAS 97 were acceptable as GAAP prior to FAS 97, and I am using FAS 97 for all years of issue now, so what I will do is use FAS 97." The most straightforward method for a company might be to say, "Whatever method I used for universal life prior to FAS 97 was GAAP for me. I'll use that method for all issues prior to the year I implemented FAS 97." For a company that has not had to do GAAP, things are even more open. This is a particularly interesting question, because it only affects issue years prior to at least 1989. It will only affect the opening balance and its amortization, not future deferrals and their amortization. A similar issue is, What about issues prior to the AICPA Audit Guide, when there really was no GAAP for life insurers? This was back around 1973, so it may or may not be a material issue.

Beyond this there is the choice between factor and worksheet DPAC computations. If a company is preparing GAAP reserves under FAS 60, the reserves will normally be on a factor basis, so it is likely to be convenient to use a factor basis DPAC calculation. If the company is not going to compute GAAP reserves a worksheet DPAC method may be more attractive. For universal life under FAS 97 the reserve is simply the account balance, which is presumably available, so a worksheet DPAC is likely to be attractive.

We must also consider whether and how to apply the GAAP principles of recoverability and loss recognition. GAAP only allows as much acquisition cost to be deferred as is recoverable from future income. It would appear that we should be entitled to apply this rule in deferring acquisition costs for AMT, but if a company does not want to compute GAAP reserves, testing recoverability will be difficult. Loss recognition, where existing DPAC is written down because worse experience than expected has eliminated the ability to recover all of the existing DPAC balance from future income, is even more problematic. It is clearly required by GAAP, and affects the DPAC balances, but it could tend to create sudden movements in DPAC. For instance, if a company were to decide that a certain DPAC balance was recoverable on December 31, 1989, but had become unrecoverable during 1990, it could find itself in a situation very difficult to defend, unless the facts were extremely clear cut. Similar issues surround the DPAC unlockings that occur under FAS 97.

The statutory language says we are to defer and amortize acquisition costs. Simply bringing this through as an adjustment in conjunction with tax reserves based on CRVM would have created a double deferral. We are, therefore, at least in the general case, fortunate that the ACLI was able to obtain some degree of clarification that the double deferral, or "DPAC overlap" was to be eliminated. Bill discussed this situation and described a method for taking this into account. Are the methods he described the only possibilities? This is especially important to a company which does not have GAAP reserves available to use in making adjustments. Obviously one option is to bite the bullet and compute full FAS 60 reserves for traditional business. This might have significant usefulness for other purposes, if management decides to also prepare internal statements on this basis. On the other hand, I am sure some companies will wish to consider whether any other method of eliminating the DPAC overlap might be appropriate. One method that has been brought up is to use statutory net level reserves as a stand-in for the GAAP reserves in adjusting the DPAC for the difference between GAAP and tax reserves. Since net level reserves do not make any deferral they might approximate GAAP reserves, or at least be fundamentally suitable. One other possibility mentioned is estimating or computing the deferral implicit in the tax reserves as being equal to the CRVM expense allowance and deducting this from the otherwise deferrable DPAC in computing the amount to be deferred. Whether any of these methods could serve as a reasonable stand-in in eliminating the DPAC overlap is, at least in great part, a function of whether they produce a reasonable approximation to GAAP reserves in the particular situation.

If a mutual decides to compute FAS 60 reserves for its traditional business, it is squarely up against the problem of determining how dividends and dividend scale changes are to be handled in applying stock life GAAP to mutual companies. FAS 60 handles policyholder dividends of stock life insurers in two ways. If the amount of income on participating business that can flow to stockholders is clearly limited, for instance to a fixed amount per $1,000 per year, then dividends are ignored in computing reserves, income before dividends is spread against premiums, and the resulting income less dividends and the fixed amount that can flow to stockholders goes into a liability for policyholder surplus. Determining whether this method applies to a particular stock company situation can be complex, but isn't relevant to our current concerns. When this method does not apply and there is no income restriction, then dividends are included as a benefit in computing the GAAP reserves, and thus, income after dividends is leveled.

Clearly, in a mutual company, we cannot apply a test to see whether the amount of income that can accrue to the benefit of policyholders, rather than being paid out as policyholder dividends, is limited. As a practical matter, in actually applying GAAP and modified GAAP principles to their business, mutual companies have most often included dividends as benefits in computing GAAP reserves, and have thus leveled income after dividends. This would be my first thought of a method for a mutual. If this method is followed, the question then arises as to what is to be done after a dividend scale change.

This is a problem because normally assumptions are locked in at issue under GAAP, with only a few exceptions. Leaving all assumptions, including dividends, fixed after a dividend scale change could lead to some fairly distorted earnings patterns unless dividend scale changes precisely track changes in experience. I won't go into detail, but it is sometimes argued that prospectively unlocking all assumptions in the event of a dividend scale change is in accordance with the intentions of stock life GAAP when applied to mutual life insurance companies.

The following is an outline of what must be done to accomplish the practical exercise involved in deferring and amortizing acquisition costs:

1. Identify product lines
2. Identify acquisition costs by line
3. Determine amortization methods
4. Determine "overlap" approach and methods
5. Develop required systems
6. Select actuarial assumptions
7. Calculate factors to use, or develop worksheets
8. Develop opening balance

Some of the items you will need to consider in doing this include:

1. Current reserve system design
2. Current design of cost accounting information
3. Level of precision and detail desired
4. Tax effects of choices
5. Effort required
   a) Cost accounting
   b) Actuarial
   c) Systems
   d) Tax

The authoritative sources for GAAP for stock life insurance companies are FASB's *Statements of Accounting Standards 60 and 97.* In addition you should have a copy of the *AICPA Audit Guide for Stock Life Insurance Companies.* This was the basis for FAS 60, and while FAS 60 is the authoritative document, the audit guide is more generous in length. The AICPA is currently considering revising the audit guide to cover FAS 97. In addition the AICPA has in draft form a proposed Practice Bulletin on applying FAS 97.

As actuaries you will want to be aware of the Actuarial Standards Board and American Academy of Actuaries guidance on GAAP. The ASB's Actuarial Standard of Practice on "Methods and Assumptions for Use in Stock Life Insurance Company Financial Statements Prepared in Accordance with GAAP" supersedes the earlier Academy guidance insofar as it disagrees with it, and otherwise leaves it intact. You will want to particularly notice the Academy's Interpretation I-1 which covers indeterminate premium life insurance, both because of its guidance on that subject, and because it comes into the discussion of how to handle dividend scale changes for mutuals.

For more practical discussions you might take a look at Ernst & Young's *GAAP for Stock Life Insurance Companies.* This was published in 1974 and written by Bob Posnak, currently Ernst & Young's National Director of Insurance Services, and is still frequently consulted about FAS 60 GAAP. For FAS 97, Ernst & Young has a Financial Reporting Developments paper available. Tillinghast also has a paper on FAS 97, as I'm sure some other competitors do.

MR. MICHAEL V. ECKMAN: I have two questions with respect to FAS 97 business. One is that the financial statement treatment was made retroactive, and we had to restate prior years. My intention in implementing this was to treat all the business that is currently accounted for under FAS 97 in the same way for ACE purposes. What you said was different in that a company who issued business prior to the effective date, could use the method it was using then.

MR. OLMSTED: Obviously the simplest way, since we are all using FAS 97 now for all years of issue, would be simply to use FAS 97. The original committee reports, however, do have specific language about using GAAP as it existed at the time the costs were incurred. FAS 97 was retroactive, but at the time some of this business was written, it did not exist. So you might want to at least consider the approach that what you used as GAAP then was GAAP then, and therefore use that method for those issue years. It is something that you will want to take a look at. Take a look at the legislative history and see what you think.

MR. ECKMAN: That is a part of my second question, which involves the practical implementation of this. If I go to the business units and tell them they have to do that, then because of those prior years of issue they have two different methods of computation for deferred acquisition costs. Then I take what Bill said for issues for 1989 and later and, as I understood what you said, instead of using the account value to calculate the interest margin or the surrender charge, I use the tax reserve and come up with an estimated gross profit stream. Now, I have a different method of valuation for that than what they are currently using for GAAP. I have several different methods, which is a real practical problem. In addition, if I do that, it reduces the interest spread, because I am earning interest only on the CRVM reserve, and I am crediting it on the account value, and my surrender charge in the early years will probably be reduced to zero because the tax reserve will be right down at the cash value level. What that may do is to generate negative margins, which will cause problems under FAS 97, or it may push the deferral of the deferred acquisition costs way out into the future and may force us into an AMT position in the current year. So am I interpreting that right? Do I actually go into that estimated gross profit model, substitute the tax reserves for the account value and do my calculations?

MR. SCHREINER: What I am suggesting is that in the GAAP calculation, you obtained a stream of profits on which you then base your amortization. When you go to your tax calculation, you will similarly find a stream of profits. Because in your tax calculation, you will utilize the premium, which will come in as income, and the reserves will be an offset, and in this way you will obtain projected gross tax profits from a dummy tax calculation.

MR. OLMSTED: The first question you had asked was on the practical issue of having different sets of GAAP for pre-FAS 97 and post-FAS 97 for universal life, and I think it is important to focus on those practical issues in your decision making. One thing you have going for you if you are going to argue that you can use FAS 97 for all issue years is that even before FAS 97 there were companies that were using deposit methods. Those methods were considered to be acceptable under GAAP, so that while you may not have been using a deposit method, at least the deposit method was GAAP at that time.

MR. CHARLES D. FRIEDSTAT: I have some comments in relation to Mike's comments. I think that there are a number of people who see an apparent conflict in the wording, or at least a need for clarity, in terms of the reference to what was GAAP at the time the policy was issued, while at the same time, having FAS 97 apply retroactively back to the date of policy issue. I think that some people might make the interpretation that FAS 97 should be adopted for all years of issue. From a practical point of view, I think that many companies might find, what we found with stock companies, which is when they went back and revalued under FAS 97, in some cases, they didn't have materially different net GAAP liabilities between whatever method they were under before and what they had under FAS 97. If that is the case, they might be able to argue that they are reasonably close, and that FAS 97 for all years will give a reasonable approximation, even if they interpret it the way you did.

Second, maybe I can clarify Mike's question, because I do agree with Bill Schreiner. A lot of people who first look at FAS 97 start looking at this concept of estimated gross profits, but I think it is easier to see why Bill's explanation has some validity if we translate it into something more reasonable. Assuming that there are no deferred acquisition costs, no nondeferred acquisition costs, and no overhead expenses, the formulas for estimated gross profits simply come down to pretax GAAP income. And I think what Bill is saying is that under FAS 97 you have a stream of estimated future GAAP gross profits. If you then substitute the increase in the tax reserve for the increase in the account value, you have a stream of estimated future tax gross profits, and could amortize the DPAC in accordance with that stream. I think that is a reasonable interpretation of the wording, even without the background that Bill gave. One additional thing that I think should be brought out is that it gives a more favorable answer than other interpretations, because what this will do is to accelerate your stream of estimated future tax income, and you will amortize your deferred acquisition cost faster under that method. Maybe that will help clarify Mike's question, because I think it was a question that a lot of other people had when this first came out. How do you compute tax gross profits taking into account tax reserves rather than GAAP reserves? I think the explanation that Bill gave is certainly a reasonable one.

MR. SCHREINER: It accomplishes the objective that we had when we talked to the Treasury and the Joint Committee which was not causing a dislocation in AMT income taxable income in 1990 because of this switch. If you work through it, this interpretation is consistent with the way the amortization is treated under the book income adjustment in prior years.

MR. FRIEDSTAT: While we will be getting into many of these issues, perhaps in more detail in the workshop than may be appropriate for an open forum, one of the things that Dave mentioned was the treatment of dividends, and I think that is really an open issue. Dave is correct in that there probably is not a uniformity of approach in terms of how mutual companies have taken into account dividends in their GAAP when they have gone to an alternative basis. I think, though, that some people are arguing that you should amortize DPAC excluding dividends, in accordance with predividend income and that a number of people think that is really what the intent is. Perhaps Bill has some observations, but I am not sure that this issue was addressed in terms of whether it was predividend or postdividend income and whether these reserves should include reserves with dividends.

My own reaction is that when you look at the differential earnings amount and the add-on tax, if you view the add-on tax as a reduction in your dividend deductions, you really get into some theoretical problems with taking into account dividends. What about dividends that aren't going to be fully deductible for tax purposes? I think there are an awful lot of complications with dividends that lead me to give some merit to the theory that the whole idea here should be to level the predividend income on FAS 60 products. I really am not comfortable with how this limitation on deductions for dividends on a tax basis should be factored in here, and I think that I wind up going back to the predividend income partly as a default, partly because I don't think that anybody really considered this. I know that other companies are at least looking at whether they get a better answer, taking into account dividends or not taking into account dividends in these pseudo-benefit reserves. But I think from a practical point of view, you may find that it is easier to use an approximation technique if you ignore dividends, and you avoid the problems of whether you are supposed to unlock, what is material, changing all your factors. From a practical point of view, I think a lot of companies are considering this, and I think there are some good arguments in the tax law for just avoiding the dividend issue. But that is certainly an issue that companies have to deal with -- how are they going to handle dividends, if at all, in this scheme of things?

MR. SCHREINER: Bud, you are correct that we did not deal with that issue when we discussed it. The assumption is that you look to the law, and it says use GAAP. Now, you get to wrestle with what GAAP is. We made no attempt to clarify that issue.

MR. OLMSTED: I can't help but suspect that Congress probably was not as aware as we are that there isn't a GAAP for mutual companies and that these problems were going to arise for us.

FROM THE FLOOR: This is for Jonathan on the Downey proposal that you briefly covered. I have done some arithmetic with that, and they have a floor in the bill of 40% of first-year premiums for capitalization. For one of our companies which does a significant amount of annuity business, that exceeded total commissions, not just 50% of commissions. What is the procedure going to be there? You can only capitalize what you spend, so will there be another test that if the 40% exceeds your commissions then you would only have to capitalize your commissions?

MR. CHAPMAN: Actually, that situation is covered in the Downey bill. To the extent that disqualified commissions (either the 50% or the 40%, and in your case you have the 40%) exceed commissions, they then look to other expenses that would otherwise be deductible under Section 162. Effectively, they have reached into expenses that are deductible under Section 162 other than commissions, and they force you to capitalize that number and amortize it.

MR. OLMSTED: Is there anyone here who might have been involved previously with the Downey bill and know whether low commission lines were considered and what thoughts there were?

FROM THE FLOOR: I was at one meeting of the mutual group and there was a problem on the annuities. As I understand it there are going to be two fixes. One will be that no reinsurance premiums or commissions will be involved, because otherwise there would not be any revenue. The other change will be something on the annuities and other single-premium products to lower the percentage of premium to something like 4% or 5%.

I have one comment on GAAP. Many years ago, I wrote a discussion on mutual company DPAC. In that paper, I was able to show that the dividend fund that is used by many companies, for example, the Metropolitan's formula and the Don Cody-New England formula, turns out to be equal to the FAS 60 GAAP reserve. And recently I was able to show that under broad assumptions, FAS 97 and FAS 60 give you the same result as well. So if you are using a reasonable dividend formula in your mutual company, you can just get a hold of your dividend fund, plug that in, and that is the end of your work.

MR. SCHREINER: It's never safe to make any predictions about what is going to take place in Washington, and it is not clear that there will indeed be a tax bill this year affecting life insurance companies. Probably what is a good bet, however, is that if there is a bill affecting life insurance companies, it is going to include something in the area of amortization of acquisition expenses, which will, in turn, presumably have an impact on the AMT calculation. Because if you are taking care of it in the regular tax, you are going to have to make some modification of what is currently being done in 1990 for the AMT ACE calculation, and it may well be that you drop it totally.

MR. CHAPMAN: It would appear that this proposal really has extended the overlap into the regular tax situation, so that what we have under the AMT provisions of the present law is extended into the regular tax. So instead of getting relief for AMT, what they have done is to double the problem.

MR. FRIEDSTAT: I think one of the problems that makes it really difficult to plan is that it appears that, with the exception of the Heinz Bill, the proposals do not change the current situation for 1990. In addition to the Downey Bill, there are at least two other bills that are presumably in some stages of being marked up, Kennelly and Stark, and my understanding is that these bills would also be applicable to 1991. They would involve some sort of amortization of commissions. They have various different parameters. The proxy tax might not be in one of them, whereas it was in Downey. The big thing that makes it very hard for us to plan is that we have some differing interpretations, and we have a procedure that may or may not be in place for just one year. How do we adopt that? We also do not know what is going to be in place for 1991. The discussion that we've all just heard makes it clear to me that companies that have not gotten very far, ought to get moving because, according to everything we see, this is going to be in effect for 1990. There is so much disagreement and so many differences between these proposals that, anything that does come out is going to be for future years.

Jonathan, if Downey is adopted, how would that affect the remaining DPAC balance for AMT purposes? I know that in future years it would not enter the AMT calculation, but does the Downey proposal talk about the remaining balance at all?

MR. CHAPMAN: The Downey proposal repeals Section 56(g)(4)(F), and it is under that provision that we have the fresh start amortization. So I would have to say that a literal reading of the Downey proposal would simply remove that amortization for purposes of the ACE calculation. I don't see any other mechanism under the ACE rules that would allow you to amortize the DPAC.

MR. FRIEDSTAT: My point is that if we knew that or some other proposal was in effect, and we were planning for or looking at alternative methods for calculating the deferred acquisition costs, and we knew it was going to be in place for one year, we might make certain decisions differently. And that is what makes it so hard to plan. Initially, I think companies were anticipating that this was going to be a long-term thing. They were weighing the possibilities of different approaches and considering the consistency that Dave talked about. One approach might benefit the opening balance, but if you applied the same procedure to new business you might get a different result, and you had to weigh the two. Now companies are in a situation where they may have to look at the alternatives differently, and in these gray areas evaluate it as if it is going to be in effect for a shorter period of time.

MR. OLMSTED: Whether or not we do end up with a change for 1991, we can clearly say that consistency and permanence haven't been the keynote of our tax law lately.

One would hardly want to sit down with this and say, "I want to compute the present value of the tax effects over 20 years and base my decisions on that." One would want to look at what happens this year or maybe over a few years rather than over the longer term.

MR. CHAPMAN: We have a small window here if the Downey proposal does go through and the effective dates remain intact. In that case, we will effectively have one year of amortization of the fresh start DPAC for 1990. Recognize that in terms of actually reporting what your DPAC adjustment is going to be, as a practical matter, won't occur until September 15, 1991 when you file your 1990 tax return. So it does give you a window of some flexibility where, to the extent that, from a systems basis, you can maintain that flexibility and you can wait and see what happens with the Downey Bill. And if it does go through, then you can hopefully adjust your position somewhat to get the best result in 1990 possible.

The other practical problem here is that, as Bud points out, some companies are not as far along with this exercise as perhaps they should be, and some companies are looking at it from the perspective of filing their 1990 tax return. Just to address a very mundane item, there are estimated taxes due in June and many companies are required to annualize their 1990 income. As part of that annualization, AMT is included, so it is a more immediate problem than some companies might think.

MR. MICHAEL PALACE: In the sentence that refers to the calculations, we read about generally accepted accounting principles. In your opinion, does that mean that if as long as your audit firm has agreed to a position you have taken on a GAAP basis with respect to reserves or treatment of various types of arrangements such as financial reinsurance or something else, that the IRS would also be willing to accept that? Or are we likely to be in a situation where we are going to have two sets of GAAP audits, one by a CPA firm and the other by the IRS?

MR. CHAPMAN: A fair amount of flexibility in the statutory language itself. The flexibility is limited. I would have a problem if, in compiling your DPAC numbers, you took a different position in terms of the composition of DPAC for GAAP purposes in your financial statement than you did for tax return purposes. The flexibility comes with respect to the amortization of that number. The statute tells us that the DPAC should be amortized in accordance with GAAP principles. That is substantially different than saying that the DPAC adjustment is the DPAC component of your finan- cial statement. There is enough flexibility there, as well as in the legislative history as expressed in the 1989 Act that Bill discussed, would allow us to determine a different amortization number for tax purposes than what we might have for the GAAP financial statement.

MR. OLMSTED: Obviously we would have a slightly different situation if the DPAC numbers were coming straight out of the audited financials and going into the tax return. Given that we are not directly using those, we don't have quite as strong an argument. But certainly in so far as part of your calculation is, for example, the DPAC in the accounting statements, and those numbers have been audited, that has certainly got to be helpful to you. And any kind of support you can get from your outside auditors that this is in accordance with GAAP, should be of some value.