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ALTERNATIVE MINIMUM TAX

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Recorder: BRUCE D. BENGTSON

- o Changes occurring in 1990 under current statute
- o Deferred acquisition costs
  - -- Existing guidance
  - -- Planning for 1990 tax return
- o Investment planning
- o Legislative proposals

MR. BRUCE D. BENGTSON: We're going to be talking about Alternative Minimum Tax (AMT). I'm with the firm Deloitte & Touche and I have a very distinguished panel here because I don't know all there is to know about this very complicated topic. Alan Kunkel is a tax partner in the Minneapolis office of Deloitte & Touche, and he is a Regional Director for Insurance Company Taxation. Marty Chotiner is a Vice President for Prudential in the area of tax planning and legislative proposal evaluation. Bill Schreiner is the actuary with the American Council of Life Insurance.

What we are going to try to do is go through the overall perspective of AMT based on adjusted current earnings as opposed to book on reported profits and then go into some of the detail with regard to clarifications or attempted clarifications of how you deal with one of the adjusted current earnings (ACE), which is deferred acquisition costs capitalization as opposed to expensing. After that we will get into a little bit of analysis in terms of investment planning and other legislative proposals which are out there or could be out there.

Alan Kunkel will get into a general overview of AMT. And then Bill Schreiner will come in and fill in the details on all you ever needed to know or wanted to know about deferred acquisition costs and reserves related to same, etc. And I put that in because there's a lot of stuff in there that changes on a relatively short notice basis. And then Marty Chotiner will fill in the rest of the details in terms of legislative proposals and investment planning.

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OPEN FORUM

MR. ALAN KUNKEL: What I want to do is spend some time walking you through sort of a broad based perspective of the AMT, specifically, the move from book under-reported profits to the adjusted current earnings concepts. I first want to give you a little bit of a historical perspective, then go through those adjustments in some detail, kind of walking you through the statutory provisions. Then I'm going to come back to the one that is perhaps of most interest to many of you and that's the deferred acquisition cost (DAC) adjustment and get into some of the issues associated with that.

First of all, I think it's important to understand the AMT from a historical perspective. The AMT as we basically know it came into the law in 1986. Prior to that a minimum tax was imposed on corporations but it was strictly an add-on minimum tax. The change was done to ensure that no taxpayer with substantial economic income could avoid significant tax liability by using exclusions, deductions, and credits. The prior law, it was felt, failed to do this for a couple of reasons. Primarily, it was not a comprehensive income base and, second, it did not attempt in Congress' view to measure major economic income.

The new law is composed of three items. One is the taxable income of the corporation before any adjustment, followed by an addition of some specifically identified items, and, finally, an adjustment to attempt to get at what we refer to as substantial economic income. In the years 1987 through 1989, this adjustment was in the form of the book unreported profits (BURP) preference and in 1990 and following we're faced with the adjusted current earnings adjustment. The first three years, under what accountants and so forth referred to as the BURP adjustments, were placed in there for a very specific reason. At the time of the 1986 statute, there was a lot of controversy over the fact that there were many very large corporations, who while they were reporting unprecedented earnings to their public were not paying much of anything in terms of current tax liability. So by tying the adjustment into reported earnings it was felt that some public confidence could again be restored in the overall corporate tax structure. Thereafter, Congress thought that if it could restore that confidence what it wanted to do was to return to a system that was specifically designed by the code. Second, it was at least as broad as the book income for financial reporting purposes. You'll note that most of the references to book earnings have been eliminated in the 1989 Act and there's some specific language dealing with that in a House committee report. And the third principle was that it wanted it to be based on the tax principles in order to facilitate the integration with the general tax system overall.

If we look at BURP as it existed prior to conversion to ACE, it was basically a preference in which a corporation's alternative minimum taxable income (AMTI) was increased by 50% of the difference between its adjusted net book income over the tentative AMTI. Under the BURP adjustments there were no negative adjustments. It could only be a positive adjustment. As we move onto ACE, the adjustment becomes not 50% but rather 75% and the amount that we use as the base to determine the adjustment is the excess of adjusted current earnings over AMTI, again, without regard to this adjustment or any alternative minimum tax net operating loss (AMTNOL) deductions. Unlike the BURP adjustments, the ACE adjustment does allow for a negative adjustment to AMTI. The catch in that or the caveat is that the 75% negative adjustment can never reduce you to a cumulative negative adjustment. In other words,

to the extent that you have positive adjustments in prior years, you can have a negative adjustment to AMTI and reduce your adjusted current earnings.

The definition of ACE is the AMTI determined with regard to the adjustments in Section 56(g)(4) and without regard to the ACE adjustment itself or the AMTNOL. A brief overview of the adjustments in 56(g)4 shows that depreciation can be either positive or negative. (See Table 1.) The next three are all earnings and profits (E&P)-related adjustments, which are essentially all positive with the exception of some of the 312 adjustments. Debt pools are only positive adjustments. Insurance acquisition expenses could be either positive or negative. Those adjustments related to changes of ownership again are only positive adjustments.

TABLE 1

Section 56(g) 4
Adjustments for the ACE Calculation

Positive	Section	Negative
Depreciation	56(g)(4)(A)	Depreciation
Earnings & Profits Inclusion Items	56(g)(4)(B)	
Earnings & Profits Deductions	56(g)(4)(C)	
Section 312(n) Items	56(g)(4)(D)	Section 312(n) Items
Debt Pools	56(g)(4)(E)	Insurance Acquisition Expenses
Insurance Acquisition Expenses	56(g)(4)(F)	Depletion
Depletion	56(g)(4)(G)	
Ownership Changes	56(g)(4)(H)	

There are potentially four categories of depreciable assets the company still holds: post-1989 property acquired and placed in service under MACRS, pre-1990 additions that were being depreciated for regular tax purposes underMACRS, pre-1990 accelerated cost recovery system (ACRS) property and pre-ACRS property. In general, the deductions for adjusted current earnings are determined under the depreciation system under 168(g) which in general terms uses a longer life and a straight line depreciation. If you look at a 1990 acquisition of property with a $500 cost, the general regular tax depreciable life would be seven years for particular assets, such as office equipment, etc. Ten-year life under 168(g) and for 168(g) purposes we assume a half-year convention. The regular tax will depreciate the full $500 in seven years (eight years counting the half year with the half-year convention). Tax depreciation takes the full ten or eleven years and, likewise, with the adjusted current earnings depreciation. If you look at the end of 1993, (see Table 2) the summary numbers aren't there, but at that point we would have claimed $343 of regular tax depreciation, only $215 of AMT tax depreciation and a further reduction down to $175 of adjusted current earnings depreciation. The difference between the $215 and the $175, that is, between the AMT tax depreciation of $150 and ACE 168(g) depreciation yields is $30 or $31 and 75% of that will ultimately reach the ACE adjustment.

TABLE 2

Example
Depreciation Adjustments Post-89 Property

Tax Year	Regular Tax 200% DB	AMT Tax Depreciation 1505% DB	ACE 168(G) Depreciation	Amount Versus ACE
1990	71.45	37.50	25.00	12.50
1991	122.45	69.40	50.00	19.40
1992	87.45	58.95	50.00	8.95
1993	62.45	50.10	50.00	.10
1994	44.65	43.70	50.00	(6.30)
1995	44.60	43.70	50.00	(6.30)
1996	44.65	43.70	50.00	(6.30)
1997	22.30	43.70	50.00	(6.30)
1998	--	43.70	50.00	(6.30)
1999	--	43.70	50.00	(6.30)
2000	--	21.85	25.00	(3.15)
	500.00	500.00	500.00	0.00

If we look at the depreciation for property placed in service prior to 1990 under MACERS, the depreciation deduction is based on the adjusted basis of the property for AMT purposes amortized for ACE purposes over the remaining life under 168(g) on a straight line basis. Looking at it very briefly (see Table 3), at the beginning of 1990 that same $500 asset would have an AMT tax basis of $334.

TABLE 3

Example
Depreciation Adjustments Pre-90 MACRS

Tax Year	AMT Tax Basis	Tax Depreciation	168(G) Depreciation	ACE
1987	500.00	37.50	0.00	0.00
1988	426.50	69.40	0.00	0.00
1989	393.10	58.95	0.00	0.00
1990	334.15	50.10	44.25	5.55
1991	334.15	43.70	44.25	(0.85)
1992	334.15	43.70	44.25	(0.85)
1993	334.15	43.70	44.25	(0.85)
1994	334.15	43.70	44.25	(0.85)
1995	334.15	43.70	44.25	(0.85)
1996	334.15	43.70	44.25	(0.85)
1997	334.15	21.85	22.29	(0.44)
		500.00	334.16	0.00

The depreciation claimed for ACE purposes would be straight-lined in the fourth column over seven and a half years and the resulting difference is the ACE adjustment. For property placement under ACRS the depreciation is again straight line over the remaining 168(g) life, but instead of using the net book value on an AMT basis, we use the net book value on a regular tax basis. Table 4 shows that after five years for a property placed in service in 1986, $500 original cost, the 1990 regular tax basis would be $105. That would be claimed 100% in the fifth year for regular tax purposes but would be spread over the next six years for 168(g) and for ACE purposes, and you end up with a fairly significant adjustment in the year 1990. For property placed in service prior to 1981, that's prior to ACRS, since that depreciation was based on the economic useful life for regular tax purposes, it's also based on the same economic useful life for ACE purposes and there is no adjustment.

TABLE 4

Example
Depreciation Adjustments ACRS

Tax Year	Amount Tax Basis	Tax Depreciation	168(G) Depreciation	ACE
1986	500.00	75.00	0.00	0.00
1987	425.00	110.00	0.00	0.00
1988	315.00	105.00	0.00	0.00
1989	210.00	105.00	0.00	0.00
1990	105.00	105.00	17.50	87.50
1991	105.00	0.00	17.50	(17.50)
1992	105.00	0.00	17.50	(17.50)
1993	105.00	0.00	17.50	(17.50)
1994	105.00	0.00	17.50	(17.50)
1995	105.00	0.00	17.50	(17.50)
1996	105.00		0.00	0.00
		500.00	105.00	0.00

The next three ACE adjustments are all E&P related with the first one being the E&P inclusion item. Under the E&P inclusion item any amount which is permanently excluded from gross income and also AMTI, but is included in the calculation of earnings and profits must be added to the adjusted current earnings subject to the one additional benefit, that to the extent that there were deductions related to that income which were not claimed as a deduction because they were related to tax-exempt income or income not included, can be claimed against your adjusted current earnings.

Examples of inclusion items include the tax-exempt bond interest net of the related carrying charges, inclusion of inside build-up on life insurance contracts, and life insurance death benefits in excess of the adjusted base that's in the contract for ACE purposes. And it should be noted that the prior adjustment, the inclusion of the inside build-up effectively increases your basis for adjusted current earnings purposes so you don't have a double inclusion of the amount. And, finally, in certain circumstances it's

sort of a soft issue at this point, but lessee improvements on real estate that's owned can potentially impact earnings and profits and would also be included.

The next E&P adjustment is the E&P deduction item. There basically are two categories of the E&P deduction item. The first category is a deduction that's not allowed for E&P purposes and is not allowed also for ACE purposes. Examples of these types of deductions would include the Section 806 small life company deduction. It is essentially a rate adjustment when you think about it from an economic perspective. And dividends paid on the employee stock ownership plan (ESOP) are not deductible but would have been deductible under 404(k) for regular tax purposes. And generally nonaffiliated and non-twenty-percent-owned dividends-received deductions are not allowed in calculating the ACE adjustment or not allowed in calculating ACE. Some exceptions or the basic exceptions to this set of add-backs is that to the extent the dividends are paid from an affiliate and would otherwise be eligible for a 100% dividends-received deductions and to the extent that they're paid from a corporation that's more than 20% owned, as well as certain corporation, those items do not have to be added back provided that the payor had included their earnings in taxable income and it was subject to regular U.S. tax. For example, for a corporation located in a U.S. possession also known as a 936 possessions corporation, there's a progression of the amount of the earnings that's deemed to have been subject to U.S. tax based on the amount of the possessions credit that had been claimed.

The second category of E&P deduction items are those items deductible for E&P purposes which are not deductible in arriving at AMTI and then, therefore, are also not deductible for ACE purposes. Included are federal income tax, foreign income tax, distributions to shareholders, and capital losses and excessive capital gains, as well as various disallowed 162 expenses, excess charitable contributions, and a variety of other items which have generally been restricted by Congress in terms of the deductibility on the grounds of public policy and those deductions otherwise being in conflict with public policy, such as, the antitrust treble damages, and fines and penalties.

The last category of E&P deductions is the other E&P adjustments which basically follow the 312 Code Section E&P provisions. These generally slow down or eliminate certain deductions in an effort to better yield the result that is more closely equivalent to the economic gain of a company. These would include the post-1989 intangible drilling costs which for regular tax purposes are deductible as incurred under the 312 provisions. There's a 60-month amortization of those deductions, as well as circulation expenses and organization costs which are not deductible for purposes of determining E&P. And for installment sales in taxable years after 1989, the entire installment gain is generally picked up for E&P purposes. The exception being if you've elected to pay the applicable federal interest rate on the taxes that are being deferred, then you don't have to pick it up for E&P purposes and, therefore, also don't have to pick it up for ACE purposes. Finally, there's a special provision which deals with not having to include in adjusted current earnings any amounts that are excluded from income under section 108 which deals with the discharge of indebtedness.

The next item of adjustment is the add-back of a loss on exchange of debt pool. Under this provision no loss is allowed for adjusted current earnings purposes on the exchange

of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturity. What's left unclear in the code and, certainly, in the initial regulations that have been issued is whether or not they're dealing with only a specific exchange from one owner of a pool of assets with another or whether or not they may introduce into that thinking rules comparable to the Wash Sale Rules. The Wash Sale Rules are the general rules that say that if you acquire a substantially identical security within 30 days of disposition at a loss of a life security, then the loss is deferred. I could see them moving to that kind of an analogy since they basically are looking at this as mass assets and that you're no better, no worse off if you exchange the pool of assets for alike pool of assets. Also left unclear is whether or not if you've had the deferral of the loss for AMT purposes and for ACE purposes, whether or not you were permitted subsequent amortization of that premium that you now have for ACE purposes on that pool of assets that you now hold.

Next is the life insurance acquisition expenses. The acquisition expenses of any policy for ACE purposes must be capitalized and amortized in accordance with GAAP. We'll come back to this and discuss it in further detail and, ultimately, we'll focus quite intently on that item.

The next item is depletion and for any property placement service after December 1989, depletion is limited to cost depletion. There's no age depletion permitted in calculating the adjusted current earnings. The final adjustment under 56(g)(4) is that it deals with certain ownership changes and the provision states that if there is an ownership change as defined in Section 382 after December 31, 1989, and that date has changed from the original statute, it's changed to part of the 1989 Act. For ACE purposes the adjusted basis of the corporation's assets cannot exceed the allocable portion of the price paid for the corporation. In other words, you can have no built-in adjusted current earnings losses. For purposes of 382 which has some very, very complicated ownership change rules, suffice it to say that the general rule is that if there is more than a 50% change in ownership, whether or not that occurred as a result of a sale of existing shares outstanding or whether or not it occurs as a result of dilution created by issuing new shares, it can cause that ownership change and in those circumstances you then have to look to see whether or not there was effectively negative goodwill that would otherwise be allocated back against the hypothetical AMT basis of the assets. I could see that this could become a real accounting nightmare to try and track the basis in assets for AMT purposes.

Several other miscellaneous items that I threw in for completeness is that while we refer to the adjusted current earnings in the context of earnings and profits, it is not intended that the definition for adjusted current earnings should, in fact, impact the definition for earnings and profits under the variety of judicial precedent that's been established over the years and the code provisions of 312. Second, to prevent double inclusion of any items as a result of affiliated entities and multiple-tiered ownership structures, the treasury is directed to prescribe regulations to prevent any double inclusion. And, finally, in determining the limitation on a negative ACE adjustment, the limitation is to be determined on a consolidated basis rather than on a company-by-company basis in a consolidated return.

Having covered the spectrum of ACE adjustments let's now return to the 56(g)(4)(F) capitalization of DAC item. The issues that I want to talk about briefly I have in basically three or four categories. One is definitional, the next is amortization methods under GAAP, and the impact of timing differences and then, finally, the potential impact of the Colonial American decision. First dealing with the identification of the deferrable costs, what is the definition of that? Under the proposed regulation the definition is that it includes those expenses that under generally accepted accounting principles in effect at the time the expenses are incurred are considered to vary with and to be primarily related to the acquisition of new and renewal insurance policies. As actuaries and as accountants I think we all know that we can be pretty creative in trying to determine at what point we cut off variability, whether or not it's directly variable or sort of variable and you get into a lot of different conclusions, depending on which way you want to lean. For example, if your agency forces are under a salary arrangement with commissions and you capitalize the salary portion in addition to the commission, if it's straight commissions it's fairly straightforward and that would appear to be directly related and very directly with production. Other departmental costs to the underwriting department and so forth have some incremental marginal costs. There are also some overhead costs which tend not to vary at least very directly with production. And I suspect the same would be true for other costs in other departments. So it's going to take some effort to determine which costs we throw in to the DAC pool and which costs we leave out.

In determining the DAC adjustment the rules indicate that we are to start with a fresh starter now. That is to apply the DAC capitalization as though we had been applying these rules since the inception of the company. Generally speaking for GAAP purposes, DAC is amortized probably over not more than a 30-35-year period, although conceivably it could be longer. And this means that for fresh start purposes to determine your opening balance you've really got to go back into a lot of financial history and for those companies who have not captured that information because they were reporting on a statutory basis and were not reporting on a GAAP basis, the implication is that there's a tremendous amount of work to go back and capture those costs. The result in my mind is where that long appeared a history, it's going to require some significant estimation and modeling techniques dealing with closed blocks of business and open blocks of business and segregating business based on whether or not there's any change in the way that the DAC relates to that particular line of business as agency compensation changed over the years and so forth. It would also seem to me that if we had been reporting on a GAAP basis, there's probably a need that has some consistency with the other GAAP assumptions that were used in prior reporting. From a planning perspective it would seem to make sense to maximize costs capitalized on lines with declining sales. That would give you the biggest fresh start and, perhaps, to minimize costs that are being capitalized on growing lines on the basis that would give you the least amount of current adjustment to add back to adjusted current earnings. I would caution you, however. I think we'll get into it a little bit later regarding legislative proposals which would require some capitalization and amortization of that and to the extent that we set a precedent in the AMT area, whether or not that precedent would carry it forward from an accounting method perspective to any required capitalization and amortization under regular tax purposes if we have legislative changes. Once costs have been identified we then have to deal with the amortization of those costs for adjusted current earnings purposes.

Under GAAP accounting for DAC costs there are a couple of different methods, both the factor versus the worksheet method. Under the worksheet method one of the selections you can make is whether or not to use an interest worksheet method or a noninterest method. Generally speaking, public reporting companies have used an interest method because it tends to slow down the DAC amortization. I think you may want to review that in determining whether or not that makes sense when we're dealing with this for ACE purposes and you may want to choose one method versus the other. Also, it may be an issue of static versus dynamic persistency assumption. Under GAAP rules generally once the persistency has been set from an accounting perspective, we have to look to see whether or not those DAC costs that are on the books are recoverable, not necessarily whether or not there's a perfect match in terms of amortization. There isn't necessarily a true-up in terms of persistency year in and year out. And you make take some liberties and do some looking at whether or not with hindsight you would have set up status persistency assumptions and you would have set up some dynamic persistency assumptions and what impact might that have on your existing capitalization as well as your amortization and your creation of your fresh start in that.

We also need to make sure that the GAAP rules in place 35 years ago are the same as the GAAP rules we have in place today and I think that needs to be looked at. Under FAS 97 I said that there's a potential negative amortization. Bruce has corrected me and says there is no such thing as a negative amortization for FAS 97 purposes. But what I was really referring to is that there's basically a cumulative true-up under FAS 97 and you can end up with amortization in a given period based on anticipated net profit stream and later decide that the net profit streams are different or are going to be greater than your prior projection and true-up the amount of the DAC amortization you had taken in prior periods and, in fact, put some of it back on the books. It's not clear how the IRS would deal with this in that context because that would essentially result in a negative amortization if we do senior adjusted current earnings. The regulations talk about reasonable allowance for amortization and make reference to proportionate to gross premium and investment income. To me that's a little bit of a muddying of the FAS 60 and the FAS 97 concept and the IRS didn't really deal with it very squarely and I think it is still grappling with that. The regulations ask for an awful lot of assistance from the interested parties and if you have a mind to respond to them I would suggest you take a look at the regulation. I think the response date is by next September.

Safe harbor on amortization says that we can amortize and use the DAC figures from our GAAP financials so long as we're doing it in the same manner as we're doing for any SEC reporting on our financial statements. It's a little unclear to me as to what they mean by the same manner. Does that mean using the same amortization life, the same periods, or the same costs, or all three? And I would argue we could be using the same life and the same amortization method in a different dollar amount or the same dollar amount and slightly different other assumptions. When we look at DAC amortization one of the other things we ask ourselves is what's the impact of timing differences? Bill's going to talk specifically about the tax-versus-GAAP reserve issues and potential controversy. I want to throw out several others as potential issues, specifically, financial reinsurance as one. Often when we do a financial reinsurance transaction for GAAP purposes it is treated as a financing transaction even though for regulatory purposes and for tax purposes it may be treated as a sale. We may be generating significant taxable

income. It's unclear. There is no guidance in the statute dealing with the treatment of the capitalized DAC for AMT purposes if we've had what constitutes in my mind a sale for regular tax purposes and the amount of DAC is still on my GAAP financials. I refer you back to the safe harbor that said we could handle it in the same manner and yet we may not have handled the reinsurance in the same manner when we've done a surplus relief treaty or what have you. It's also unclear as to how we would handle a later recapture by the ceding company of any amounts we reinsured and what we did with our DAC for ACE purposes. The 1986 general explanation does provide in my mind some guidance insofar as it refers to the fact that for ACE purposes, while the items are treated differently in many instances, the structural issues, such as, when a taxable event occurs, were intended to be the same as for regular tax purposes. If that's true and I've had a sale of a block of business effectively for regular tax purposes, then arguably I've had a sale for ACE purposes and I ought to have a shot at writing off any DAC balance related to that. Also, in the area of selling interest strips on investment securities, if we have a sale where we're going to recapture the business in some period of time out into the future, it may be true that we would allocate our DAC costs to that revenue that we've given up over the period in which the reinsurance was going to be in place and leave in place the DAC related to revenues that we'll have when we recapture the business. Since under the regulations, investment income is specifically stated as an item that can be taken into account and establishing my amortization of DAC, the question then becomes what about the fact that we have differences in recognition of investment income between generally accepted accounting principles and tax rules? The ones I've enumerated include the market discount on bonds, unrealized gains and losses on securities, reserves for loan losses or bond write-downs, and potential depreciation on real estate.

Finally, I believe that issues may come into play dealing with the Colonial American decision. Under the Supreme court case in Colonial American, ceding commissions on indemnity reinsurance were required to be capitalized and amortized just as on assumption reinsurance where we would amortize the value of the insurance in force. What's unclear is whether or not the capitalized ceding commissions or the in-force value, if it were truly assumption reinsurance, would reduce the incremental DAC that we would set up and/or amortize for AMT purposes. In my view, this would be consistent with the treatment of DAC as a cost of acquiring for ACE purposes a stream of revenue. If we're doing it for regular tax purposes we shouldn't duplicate it doing it in our ACE calculations. The revenue ruling has not been issued yet. The authority or the support is for changing to the capitalization and the reinsurance transactions, but it's generally understood that there's likely going to be a spread on the recognition of the cumulative effect of the Colonial American. If that spread is granted and let's say it's granted to give us a three-year spread on the profit and loss (P&L) impact of the capitalized ceding commission, then the question is what impact does that have in any ACE that I might set up? There is authority out there that suggests to you that when you have an accounting method change the spread has no identity; that is, it is not a partial pickup each year of the ceding commission in terms of capitalization. But generally speaking, the amount has deemed to have been capitalized all at once and the spread is just simply an accounting convenience for fairness issues related to the taxpayers.

Finally, whether or not in a reinsurance arrangement if you've got capitalized DAC, what's the appropriate measurement in terms of life of the business to amortize the DAC over? If we're dealing with a reinsurance context can we look at the life of the reinsurance agreement as opposed to the life of the underlying insurance contract? In my reinsurance arrangements the recaps or provisions are not specifically stated. There may be incentives in place economically to get the ceding company to recapture the business, but they're not necessarily overly stated for regulatory reasons. And, therefore, it's unclear as to whether or not we can look at the reinsurance contract or whether or not we have to look at the underlying block of business.

As you can see, the ACE adjustments for insurance companies are a blend of a variety of very complex rules -- the regular tax rules, the AMT tax rules, the ACE rules and GAAP rules. In my view, the complexity and absence of specific regulations provides ample room for exercise of judgment in arriving at a tax base which meets the stated objective of the treasury to substantially capture economic income. If the ACE adjustment is not legislatively eliminated or altered I believe it will be an area of ongoing controversy with the IRS for many years. With that I'd like to turn it over to Bill Schreiner who's going to get into some of the more nitty-gritty of the reserve issues for DAC amortization.

MR. WILLIAM J. SCHREINER: I've been asked to speak to you on the important subject of the AMT as it applies in 1990. Unavoidably, I will cover some of the same ground that Alan has, but my fundamental focus will be somewhat different. My aim is to clarify the unclear clarification of the amortization of acquisition costs under ACE, which is contained in the House and Senate Committee Report for the Budget Reconciliation Act of 1989. And 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, 1988, and 1989, and a second different formula would apply starting in 1990. During 1987 through 1989, an important addition to the AMTI was 50% of book income. In other words, 50% of what a company was telling the world it was earning was added to the AMTI base. And then that was subjected to a 20% tax rate and compared to the tax calculated under the usual income tax rules. And if the result of the AMT calculation was the larger, that was the amount of tax that the company paid for that year.

In 1990 a new system, adjusted current earnings or ACE replaces the book income adjustment. Under the ACE system 75% of adjusted current earnings rather than 50% of book income is added to the AMTI to determine whether taxes are paid under the regular tax system or under the AMT system. Let's 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." There's then a list of adjustments and under the sixth item it says "Acquisition Expenses of Life Insurance Companies." It says, "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." Now, 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 costs must instead be capitalized and amortized. The last part of the sentence is also relatively clear where it says that 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 purposes of this calculation, a life insurance company starts 1990 with a theoretical inventory of capitalized and as yet unamortized deferred acquisition costs. These are 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.

Returning now to the beginning of the sentence it says, "That acquisition expenses are to be capitalized and amortized in accordance with GAAP." This means that 1990 acquisition expense charges will be determined from the constructed inventory of unamortized pre-1990 acquisition costs, plus, the 1990 current acquisition cost using generally accepted accounting principles. The next question I guess is, what is GAAP accounting as applied to life insurance companies? Does this mean for those companies that have a GAAP financial statement they will merely pluck out of their statements the GAAP financial numbers, the GAAP acquisition cost charges of the current year and just drop them into the federal tax calculation? And what about those companies, both mutual companies and stock companies, that did not prepare GAAP statements? How are they to proceed? The lack of certainty in what this sentence and 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 the companies that already were preparing GAAP financial statements. Their concern was not administrative. It was financial. And this is so because some accounting firms were suggesting that such companies should use their actual GAAP amortization charges in the ACE adjustment. And these companies saw that if they were just to pluck the amortization figures out of their GAAP statement, their AMTI would rise significantly, assuming that they were selling more business each year and, moreover, it would rise beyond what could barely be considered economic income. And this is so because under such approach GAAP acquisition costs to amortization would be prepared with the Commissioners Reserve Valuation Methods (CRVM), in the calculation of AMT. As you know, the CRVM is based on a preliminary term, "reserve concept," which sets up little or no reserve in the early contract years. 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 expenses. Clearly, amortizing acquisition expenses together with establishing reserves based on the CRVM would distort the recognized income of the company and would have the effect of pushing the income for the early years of the contract. And in recognition of the inappropriateness of a tax-based system which combines amortized acquisition charges with CRVM reserve,

in 1989 the American Council of Life Insurance went to both the Treasury Department and Congress' Joint Committee on Taxation to discuss the need for clarification of the intent of this sentence in the Internal Revenue Code. In doing so, the ACLI obtained agreement from the Treasury and from the Staff of the Joint Committee on Taxation of the Congress on a specific clarification and, as a result, three identical sentences appeared in the House report and in the Senate report with respect to the Budget Reconciliation Act of 1989. Of course, the main reason why I'm here speaking to you is because there are some people who are not sure that these three sentences clarified the issue. Well, my objective is to go through these sentences with you so that you will understand exactly what this clarification means.

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." Now, those of you who have a good visual memory will recognize that this sentence is nothing more than a recasting of the sentence that appears in the Internal Revenue Code about the required capitalization and amortization of acquisition expenses under ACE for life companies.

So let's move to the third sentence in our tale, the second sentence in the House and the Senate report. It is, "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." Now what does this sentence say? It says that if life insurance reserves have anything to do with determining the amortization schedule, then tax reserves should be used in determining that amortization schedule. This clearly says that you toss out actual GAAP amortization changes and recalculate the amortization charge on the basis of tax reserves. I'd 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 computation arising from the fact that there are two different amortization schemes applicable to life insurance products and to GAAP. Financial Accounting Standard 60 applies to what might be termed traditional life insurance contracts and Financial Accounting Standard 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, and I'm quoting, "are those costs that vary with and are primarily related to the acquisition of new and renewal contract." That reasonable people may differ in the application of this standard to a specific expense need not concern us. It will concern some of us later.

Now, let's consider first for a given level of acquisition costs how the amortization should be determined for FAS 60 products. 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." This, however, is in the context in which level premium reserves are utilized. What needs to be done in

a CRVM context is we need to seek a deeper penetration of the truth. And we look to the 1972 audit guide on which FAS 60 is based. It 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." And, as I'm sure all of you know, apart from provision for adverse deviation this means that for FAS 60 products, profits emerge as a level percentage of premium. This is the fundamental principle of FAS 60 profit recognition. Moreover, the audit guide specifically indicates and I quote, "Policy benefits and unrecovered acquisition costs may be accounted for by means of a single valuation reserve." Now, it was then decided to display the two elements of this single reserve separately; nevertheless, they are linked to the profit as a level percentage of premium contract. And if we transfer this to an ACE context, we see that FAS 60 products require an adjustment in regular GAAP acquisition cost charges 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's a dollar-for-dollar adjustment I guess up to the point where you run out of amortized acquisition costs. Since premiums are the same in each case, that is, public reporting GAAP and ACE, for every dollar the CRVM reserves are less than GAAP reserves, a dollar must be added to the comparable GAAP amortization charge if the level percentage of premium profit requirement is to be met. 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. Now 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 contracts. Both the Joint Committee and the Treasury Department were fully awarded of the implications of this clarification for FAS 60 products when they agreed to put it in the committee report. And 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 addition, the ACLI argued that there is no indication in the 1986 legislative history, that 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 the reserve basis and the amortization basis. Both the Treasury Department and the Joint Committee found this argument to be compelling. Thus, a third sentence specifically indicates the tax reserves rather than GAAP reserves should be used in determining the amortization schedule for ACE purposes.

Let's 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 expected to be realized over the life of the book of contracts." Now, this a very different rule than applies to FAS 60 products where the reserve basis and the amortization scheme and effect can be combined to make sure that a level percentage of premium profits results. Instead FAS 97 contracts have a specific acquisition cost amortization schedule dictated, one that's based on the present value of the estimated

gross profit expected to be realized over the life of the contract. So what does this clarification mean with respect to FAS 97 contracts? The answer's straightforward. Amortization should be based on the present value of estimated gross profit amounts expected to be realized. Those gross profit amounts are the amounts that will emerge in the federal income tax calculation when CRVM reserves are used. 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 from these contracts. Now, the capital listener may point out that this requires that life insurance reserves be relevant in determining the amortization schedule. Under FAS 97 are life insurance reserves relevant? Some might note that the universal life contract FAS 97 does not utilize reserves in determining the stream of profits to universal life contracts. It doesn't consider premiums to be revenue and, therefore, there's no requirement for offsetting reserves to maintain consistency between the income statement and the balance sheet. The accounting scheme is similar to that which a bank uses with respect to its deposit account. So you might ask what do reserves have to do with determining profits for these products? 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 blind use tax reserves based on CRVM without recognizing the effects on the calculation of the amortization of acquisition costs, front-ending of taxable income will result. If the Treasury and the Joint Committee agreed this front-ending of taxable income was not intended by the switch from book income to ACE under the AMT, therefore, for the AMT ACE adjustments amortization of acquisition costs of universal life products should be based on the estimated present value of gross tax profits.

Let's move now to our fourth sentence. This is the last sentence in the House and Senate clarification. 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 contract. Now with the background that I mentioned earlier about the winning argument for the Treasury and the Joint Committee that ACE is not intended to treat acquisition expenses more harshly in 1990, that 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 stopped after the phrase, "On the ACE provision," if we put a period there instead of a comma, again, I think few would have any difficulty with what was intended and how it should be applied. And, fortunately, there are 31 more words in this sentence. And those 31 words seem to contradict this sentence and a half that precedes it. They indicate that the tax reserve method and the income tax treatment of acquisition costs are not connected; nevertheless, 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. Well, it had no difficulty with the recognition of tax reserves in the AMT ACE context for amortization of acquisition cost purposes. It was not

prepared to make a statement that would appear for all time and forever to link tax reserves and acquisition costs in all circumstances.

There are government officials who do not believe that even CRVM reserves are appropriate as a regular tax deduction for life insurance companies. In fact for some, all the deductions for policy reserves assess that; although others would be willing to recognize policy cash value increases as appropriate deductions. It's in the context of this issue that the Treasury was reserving its right at some future time to come up with a different approach with respect to life insurance reserves without having to turn on the acquisition cost side when that took place by precedent under ACE AMT. For example where amortization of acquisition costs was required for FASB 60 products in the regular tax calculation, a new reserve approach could be completely undone by a dollar-for-dollar acquisition cost amortization adjustment. And while few here would think much of a tax system that front-ends its profits for tax purposes, that's ultimately a political issue and the Treasury was not prepared to allow such an issue to be decided by an AMT precedent.

And there's probably one final matter to touch on with respect to these three sentences. This three-sentence clarification we've been reviewing appears in both the House and the 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 and because there was complete agreement on the language by the two committees. So I'd like to review now and summarize this clarification of last year's attempted clarification once more.

The first sentence is nothing more than a recounting of the applicable statutes. The second sentence tells us what we need to know for determining the amortization schedule for AMT under ACE. Tax reserves are to be used in that determination. For FAS 60 products, there's a dollar-for-dollar increase in amortization charges for every dollar if the increase in tax reserves is less than the increase in DAC reserves. For FAS 97 products, there is a proportional increase in acquisition cost amortization; the increase being proportional to the increase in the present value of future tax profits for a given year resulting from the use of CRVM reserves. Finally, the last sentence tells us why the 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.

Now, as I'm sure you know, a few weeks ago a new shoe dropped. The Internal Revenue Service announced a public hearing on ACE in September and issued a notice of proposed rule making. Included in the document was discussion of the policy acquisition expenses of life insurance companies. The document's particularly interesting because it makes no mention of the 1989 agreement we've just been considering. Even more interesting, however, is the fact the proposals in the notice are totally inconsistent with the statutory requirement that amortization be accomplished in accordance with GAAP. The notice discusses the reasonably estimated life of an acquired policy. It suggests that rules of the FASB or the AICPA be followed to determine this period even though this concept is not present in FAS 60 or 97. It also indicates that a reasonable

allowance for amortization might be in proportion to gross premiums in investment income, another concept that's totally foreign to GAAP. Well, lastly, we at the ACLI sat down with representatives of the IRS and the Treasury to try to determine what they meant in the proposed rules. And the sense that I got from the meeting was not that they had particular problems with last year's clarification of what GAAP meant for acquisition costs, but that they were extremely uncomfortable with having to audit and administer a requirement to handle acquisition costs in accordance with GAAP. Their orders are not trained in GAAP and they'd be very happy if there was some sort of mechanical formula for spreading acquisition costs that could be ordered as easily. Their objectives for the proposal were two: first, to provide some reliable general guidance prior to the issuance of regulations and, second, to initiate a dialogue in the hope of finding a simple way to accomplish their objectives. The notice specifically invites comments on the issues of the amount of acquisition costs to be deferred and in the methods that should be used to assign the deferred costs to various periods. The problem that they had though is that they are seeking a "simplified amortization approach that would not reduce revenue." My expectation is that unless simplification would say significant administrative expenses, it's unlikely that insurance companies that would pay higher taxes under a simplified approach would be willing to adopt it. Of course, those that paid less would adopt it, so I don't think they've achieved the objective of not reducing revenue. The thought I'd like to leave you with is that as long as the GAAP requirement remains in the law, life insurance companies are going to be able to determine their ACE adjustment to deferred acquisition costs in accordance with the now clear 1989 clarification.

MR. MARTIN P. CHOTINER: I get pleasure in talking about what is not presently in the law or, perhaps, what might actually happen down the road. Right now, there is one bill that was submitted by Senator Hines that tries to deal with deferred acquisition costs for the small life insurance companies. What it basically says is, don't make them included in their alternative minimum calculation. Well, that would make their life considerably easier. Now will that get passed? I guess if there's one thing that I've learned in the few years that I've been working on legislative types of activities it's do not predict what's going to happen in Washington, so I will not do that. Okay, that is the only bill at the present time that relates specifically to the alternative minimum.

However, there is another bill that's been proposed by Representative Downing and Representative Moody that could significantly affect what you've just heard. That proposal makes deferred acquisition costs part of the regular tax. So although we've spent probably an hour or so reviewing all of those very simplified rules on deferred acquisition costs, they may be gone if, in fact, the Downing and Moody bill get enacted.

Now what does this bill really do? Again, it tries to propose that a certain amount of capitalized costs be deferred for the regular tax and it effectively eliminates any adjustment that would be needed for alternative minimum. However, there are some substantial differences between this particular proposal and what you presently see in the AMT. What I'd like to do is go over a few of those, talk a little bit about where they may be helpful in terms of simplification but, at the same time, they may be disadvantageous in terms of the revenue that could be generated. Basically, it requires a seven-year amortization of the costs and we'll talk about which costs, in fact, do have to get

capitalized; a seven-year amortization of capitalized commissions or deferred acquisition costs, however you want to refer to it. You might wonder how they could possibly have gotten a seven-year life and that doesn't seem to equate too well to perhaps the life of the policies. A couple of places where they looked really came up with this. One is that there was a bill actually passed and it is in effect in the United Kingdom that has, in fact, a seven-year amortization period for capitalized costs.

The second thing is that there were computations that were done that would suggest that when you factor in persistency and you do some kind of present value calculations, they're taking deferred acquisition costs and amortizing them over a seven-year period of time, they might give you a reasonable approximation of what would actually happen under the GAAP types of computations.

Now that certainly would be a significant simplification from the information that my two cohorts here have been describing to you, to tell someone to just take the costs and amortize them on a straight-line basis over seven years. One of the, I guess I'd say the disappointing things about this bill, however, is that it does not build in a fresh start adjustment. Now, remember, that is the adjustment that basically says that you make an assumption that you've been capitalizing these costs all along. Okay, this bill doesn't do that. It basically says you have to start from scratch in the year of enactment and let's assume that the year of enactment is 1991. What it does is it builds in a phase-in period of time and I'll get to that in a second, which is what Table 5 shows. This bill also shows or provides for some small company exceptions. It says that if you have less than $25 million worth of capitalized costs you are allowed to take the first $10 million as a current deduction and the balance will be amortized over a four-year period. So they've made some concessions, if you will, for the small companies.

TABLE 5

Transition Rules					
	1991	1992	1993	1994	1995
1991	5/7	2/21	2/21	2/21	
1992		4/7	3/28	3/28	3/28
1993			3/7	4/35	4/35
1994				2/7	5/42
1995					1/14
Small Company Transition Rules					
1991	3/4	1/8	1/8		
1992		1/2	1/6	1/6	1/6
1993			10M	1/4	1/4

Now, let's get back to this transition rule. What have they done? Well, they've said it would be really, really harsh to fully change the law all in one year. So what they've done is they've built in kind of an amortization schedule where they'll give you 5/7 in the first year and then over the next three years, if you will, you'll get 2/21 each year. Now what is that? When I looked at the bill I tried to figure that out for a little

while. What the bill actually says is take your 2/7 and amortize that over three years. That really gets you to 2/21 in the next three years. When we were looking at the bill we wondered why they wanted to do that and, in fact, the U.K. method was a lot easier. It said take the 2/7 and take 1/7 in the second year and 1/7 in the third year. The best that we can tell is whoever wrote the provision on this misinterpreted what the U.K. bill was and that's what they came out with and then they continued along.

In 1992, they said, well, now we'll give you 4/7 and then the balance of 3/7 should get amortized over four years instead of three years, which would have made a little bit more sense to us again. Okay, so anyway that continues on until 1995, when effectively what you're getting is a seven-year amortization with a half-year convention, i.e., 1/7 times a half year, 1/14. That's what most companies would be facing. However, as you've probably noticed already, not everything is simple in taxes and so they had to build something into the small companies as well. And so they built in a phase-in for those companies. And what they really did was say, if you're a small company we'll let you take 3/4 of your costs in the first year and then the remaining 1/4 over the next two years. And then in 1992, they said, we'll give you 50% of those costs in the first year and then the balance over three years. And after that occurs you can go back to the basic method that I talked about which is to allow you to take $10 million in the first year and spread the balance over a four-year period of time. Now, as I said, the big problem with this is that it doesn't build in a fresh start and that's a significant impact. I've done some calculations that would suggest that there are possibilities that could double the type of tax costs as compared to a fresh start type of calculation.

The next question really is, well, what costs would get included in the deferred acquisition costs for purposes of this proposal? Effectively what they say is it's commissions, renewal fees, or similar amounts incurred on specified insurance contracts. Now I sat there and I started scratching my head. I wondered what they meant by similar amounts incurred and is that going to kind of muddy the waters, if you will? What we should be trying to do is make it simple. You know, pick a line off the annual statement and use that as your guideline. You could look at this in a couple of different ways. One is it kind of gives the IRS or a government an option to say that you haven't picked up all of your costs that should be capitalized. Another way of looking at it might be to say, well, they wanted to put this in to make sure that someone didn't try and do something special on their annual statement to try and avoid capitalizing some of their acquisition costs. And one of the other pieces in the description was specified insurance contracts. What do they mean by that? Well, they basically said it includes everything except for and the "except for" was pension plans, pension plan contracts under Section 18A. And except life or A&H with a term not more than one year and which is not guaranteed renewable. And I read that as saying, if you've got a one-year policy then there really isn't a need to capitalize and amortize costs. That's very generous of them.

Okay, well, one of the things that the proposed bill does is it kind of describes the portion that should be capitalized in kind of a negative way. It says the amount that should be capitalized and amortized is the disqualified portion which means that they say certain of your commissions should be allowed as a deduction for those that are not. Okay, well, how much? What is that? How do you go about doing the calculation? What they've done is they've said that the disqualified portion or again the amount that

should be capitalized and amortized is 50% of the greater of commissions less 2% of premiums or 40% of first-year premiums. Now, again, you ought to be able to go to the annual statement and pick those lines up off of the annual statement to, hopefully, make things simpler. A couple of questions though came up in looking at the bill. The first one is, well, do they want to include reinsurance ceded and reinsurance assumed in these numbers for purposes of the commissions? The answer that we've really gotten is, yes, those are, in fact, included so that what you're really talking about is a net commission number. Some people aren't happy with that. Some people are thrilled by that depending upon which side of the business they are in terms of whether or not they're ceding or assuming more business. Also, it includes single premium policies and one of the things that was noted is that if you have 40% of first-year premiums and it relates to single premiums that's probably going to be significantly higher than what kind of commissions you pay. I don't think there was a great focus on that. I think the intent was to try and get the single premiums out from this particular capitalization, but it's in there and so 40% of first-year premiums on a single premium policy is going to be a big problem. You'd probably want to make recommendations to put in something specific for single premium; the floor ought to be let's say a lower percentage of your first-year premiums.

Okay, in really wrapping this thing up, again, I want to cover the key points that I see as part of this Downing bill. The first is that there is no fresh start and that is just an extremely important concept here as it relates to the regular tax. That is something that is built into the AMT. It does represent a repeal of the provision referred to as deferred acquisition costs for purposes of the AMT. One of the statements that Bill made was in reading the regulations that the IRS is looking for ways of simplifying the law but can't afford to lose any revenue to go about doing that. How does the Joint Committee on Taxation even go about doing these calculations? What do they use for purposes of the tax rates to people who are going to pay and what kind of a year do they use? Do they use a calendar year? What do they use? Now, the answer is that they use the fiscal year of the United States government and that can come up with some odd results if you're not careful. It really tells you that you treat the taxes based upon more when the estimated taxes of corporations are made as opposed to the full year of a company. You can get some real anomalies. The other thing is that they don't assume a 34% tax rate. They assume more of a rate that would apply kind of to corporate America as a whole. I don't know 28%, 26%, somewhere in the 20s and so you just can't take these numbers and multiply them by 34% to figure out what the revenue would be to the government as a result of a change in the law.

Now, what I'd like to do is kind of shift what we've been covering. I'd like to talk a little bit about planning opportunities as they relate to investments. One of the things that happened in 1989 was that there was a change in the AMT rules. It doesn't make any difference why you incur an AMT any longer. Whatever reason causes you to be in the AMT you will still be allowed to offset that tax against subsequent years' regular taxes. That is really critical. If your company is going to be in the AMT for a given year, one year, or two years, but then at some point in the future it is going to be back in the regular tax, it ought to think of the AMT tax as a timing issue. That is a change that was made in the 1989 act applying to 1990 and going forward. Previously you had to physically figure out whether or not why you were in the AMT was attributable to timing types of items or to permanent types of items. And if it was attributable to permanent

types of items then that portion of the AMT would not have been creditable against subsequent years' taxes. Okay, so this change really helps us out. It makes anything that causes us to be into AMT tiny in nature.

Now, what I want to do is talk a little bit about how from an investment perspective you might go about determining whether you ought to invest in a tax-preferred type of investment versus a fully taxable investment. I guess I've heard a number of people speak on this topic. There are a number of different approaches that can be used. What I'd like to do is give you the way we approach it at our company. What our investment professionals have told us is when we go to evaluate a tax-preferred investment, we would like to know what that rate equates to for a full taxable investment. Sometimes we refer to that as a pretax equivalent rate and the way we get there is we provide them with some kind of a gross up-type of factor. (See Table 6.) What I did was I started with a fully taxable rate of 10%. Well, you don't really need to do anything for that, because that's really a pretax rate, so that's still 10%. The investment professional wants to know if I'm analyzing a 100% fully tax-exempt, let's say, bond type, hypothetically, that has a rate of 6.6%, what is that on a pretax basis? Okay, what I do is provide him with a gross-up rate and in Table 6 that happens to be 1.515 and that gets me exactly the 10%. Now I have this 10% tax-preferred investment which I can compare to a comparable fully taxable investment.

TABLE 6

	Taxable Obligation	Tax-Exempt Obligation
Rate	10.000%	6.600%
Gross-up	1.000	1.515
Taxable Equivalent Rate	10.000%	10.000%

$$\text{Gross-up Calculation} = \frac{1}{(1\text{-Tax Rate})} = \frac{1}{(1\text{-}.34)} = \frac{1}{.66} = 1.515$$

AMT for 1 Year = (20% + (14% Discounted 1 Year))

Assume 6% Discount = (20% + 13.2%)
= 33.2%

AMT for 2 Years = 32.5%

AMT for 3 Years = 31.8%

The question is how do you get to that gross up rate, if you will? What we've done is we've said that the numerator in your calculation ought to be that portion of the tax

preference that is not taxed. So I've got a 1 in the example. That means that 100% of it is not subject to tax and, obviously, for life insurance companies that's going to be unusual. If you've got bonds, get dividends, receive deductions, you've got proration. You have to modify this calculation significantly but the principle still applies. And the numerator of the calculation deals with taking kind of the inverse of your tax rate. Take 1 minus whatever the tax rate is for the year, work through the formula and get back to that 1.515. Now why do I even bother to show you the calculation and the 34% numbers? The reason is to try and incorporate what you do with the AMT. Okay, now, remember, what I said is that the AMT could be considered a timing difference. If you really believe that it is going to be a timing difference for your company, meaning that you're going to be in the AMT in one year or two years, but then you're going to be a regular taxpayer, you ought to try and calculate these gross-up factors with that timing concept in play. And I showed just that; if you're going to be in the AMT for one year, what you're really talking about is that the tax rate or the benefit on the tax rate is 20% for that year and you're going to get the balance of 14% in the second year. So what you really need to do is discount that 14% back. In my example you get the 33.2%. Then you plug that in instead of the 34% tax rate that I've used in the first example. And that goes on. You can do that for two years, three years and so forth. And that applies again if, in fact, you consider yourself to be in the AMT on a temporary type of basis.

Okay, now, there are going to be some companies that potentially are going to be what I would call permanent AMT payers. What comes to mind to me is that it is possible that you could be a small company out there and you could have the special deduction for small companies which for AMT purposes is an add-back. And we've also talked about the fact that deferred acquisition costs are included for purposes of AMT. That might make you a permanent type of AMT taxpayer. If that's the fact I believe that your AMT tax system is a very irregular tax system. You ought to be pricing your investments, if you will, in this manner but use a 20% rate for the calculation because that's the tax rate that you're working off of. You're not working off of a 34% rate. Some people have suggested that you take 34% and then you add the 20%. I don't believe that. I believe that your AMT system becomes your regular tax system and in terms of trying to come up with this gross-up factor you ought to use the 20% rate.

One of the things that we began looking at when, in fact, we had the issue of whether or not we were in a permanent differential or a tiny difference attributable to AMT is if you were contemplating that you were going to be an AMT taxpayer, what should you do about it? Should you go crazy, get rid of some of these tax-preferred investments that you had, generate all kinds of gains or losses? You really go nuts with the computations. With the change in 1989, again, assuming you are going to be in the AMT for one year or two years, what we concluded is that you don't want to rush around trying to get yourself out of this AMT. What I did in this example is I assumed that you could not change the level of preference items that you had or you wouldn't want it. In other words, let's say you had tax-exempt bonds and it was a bad time for you to sell them in the market. The only thing you could possibly do would be to accelerate income or somehow defer expenses, something that would help you get out of the AMT situation.

If you had taxable income of $200 and your tax rate again is 34%, you had a $68 regular tax. (See Table 7.) On the AMT side I assumed again the starting point was regular taxable income of $200. So you had preferences of $300 and, therefore, your AMT taxable income was $500. At a 20% rate that generated a $100 AMT. Therefore, the excess of the AMT over the regular was $32 in this example. Now, the way the mechanics of the way AMT work though is if you try and bring in more income, watch what happens in the second part of Table 7. Let's assume I bring in $230 of taxable income into that particular year. Let's say I accelerated some receipts of income from 1991 into 1990 hypothetically. My regular tax is not based on $430 of taxable income and at the 34% rate. My tax is $146. Go over to the AMT side and you get the same $146. So I've now accomplished the goal that I set, which is to get myself out of the AMT. And guess what else I've done? I've paid $46 to the government before I needed to; not the type of tax planning that I get paid to do. Okay, let's take a step back. We don't want to go ahead and try and get ourselves out of an AMT necessarily if we believe we're going to be a regular taxpayer in the future and this is just a one-year type of problem. If, in fact, you've done the proper calculations of your tax-exempt versus your taxable, you're not going to want to do that. You may, in fact, want to conclude that you want to reduce taxable income maybe, which would lead to smaller tax payments to the government even though a larger amount would be identified as being attributable to AMT.

TABLE 7

	Regular Tax	Alternative Tax
Regular Taxable Income	$200.00	$200.00
Preferences		300.00
Alternative Minimum Taxable Income		500.00
Tax Rate	34%	20%
Tax	$68.00	$100.00
Excess Amount Over Regular Tax		32.00
Total Payment to IRS		$100.00

Attempt to Eliminate AMT by Accelerating Income

	Regular Tax	Alternative Tax
Regular Taxable Income	$430.00	$430.00
Preferences		300.00
Alternative Minimum Taxable Income		730.00
Tax Rate	34%	20%
Tax	$146.00	$146.00
Excess Amount Over Regular Tax		0.00
Total Payment to IRS		$146.00
Increase in Payment to IRS		$46.00

MR. BENGTSON: I appreciate the clarity that you've added to AMT where such clarity has been hard to find.

MR. GERALD ANTHONY SCHILLACI: I understand that ACE is to be used from some sort of federal environmental facts. Could you describe what that is and how it's to be calculated? Could you describe what the environmental tax is that ACE is to be used in the calculation of?

MR. KUNKEL: I think you're probably referring to a tax which was based on the old AMT basis less $2 million, and effectively since the AMTI, it now simply includes an ACE adjustment rather than book unreported profit adjustments. The basis for calculating that effectively includes the ACE adjustment.

MR. JAMES E. FELDMAN: I was just wondering under FAS 97, where you make a series of assumptions to come up with your future gross profits, whether there would be any necessary linkage between the assumptions you're using for GAAP reporting and those that you'd be using for ACE.

MR. CHOTINER: You should probably ask an accountant. My personal view is that you're going to have a tough job explaining to your auditor any decision that you've made for your taxes that was inappropriate for your GAAP financial. Maybe you can find a way to do that, but I think that's going to be something that immediately jumps out like a sore thumb for him and he's going to come after you on it. Does anybody else have a view?

MR. KUNKEL: I think I'd agree with that. Basically, you're looking at most of the differences once you take into account the fact that tax-exempt income really isn't exempt for ACE purposes. It says that the total economic income ultimately is going to be the same between GAAP and tax. And then the question is one of timing in your present value calculation under FAS 97. Whether or not you can take into account timing differences as to when that income would be recognized. The present value could be different because the income may be recognized at a later date for tax versus the GAAP or vice versa.

MR. FELDMAN: I guess I was just thinking of the situation where the tax auditors are going to have access to your GAAP statements or is it up to the tax auditor to perform an audit and say, yes, this is done in accordance with GAAP principles?

MR. SCHREINER: Let me ask a question. If you were a tax auditor would you peak at the guy's GAAP? I think I would.

MR. CHOTINER: Yes.

FROM THE PANEL: You know part of the concern that it has been trying to address is it really doesn't want to go through trying to audit and figure out whether or not GAAP is correct or not, and that's part of the reason for some of these suggestions for simplification. The IRS does not tend to have a lot of people who will understand that. They would be kind of caught up not knowing what to do and it seems evident from

reading the regulation, certainly, that they'd love to have something that they could audit and do it fairly simple and figure out whether or not you did it right or wrong.

MR. KUNKEL: One other comment in that regard is that we've worried for years about whether or not the IRS would come in on a publicly reporting company and simply audit the deferred taxes and figure out what its cushion was and what its real deferreds were and, therefore, how much exposure must there be. From a practical standpoint, the IRS has never understood deferred taxes and, therefore, it has never gone in and done it. It has had no reason to look at it from a GAAP perspective. In this instance it was effectively charged with looking at it those GAAP numbers from a legislative perspective, from a historical perspective.

FROM THE FLOOR: Under FAS 97 you're required to capitalize front-end loads; sometimes you refer to it as deferred revenue items. You've talked about deferred acquisition costs. What's the treatment or is there any guidance as to the treatment of those deferred revenue items under FAS 97?

MR. BENGTSON: Let me try to take a stab at this one. I think what you're referring to is the unearned revenue reserve calculation for FAS 97 and if I understand Bill correctly you're looking at gross taxable income as your revenue stream. I would presume that would define the reserve side and that having to set up an unearned revenue reserve would not be appropriate for this particular calculation.

FROM THE FLOOR: But the point is that the deferred revenues are excluded from gross profits or amortized in the same way as deferred acquisition costs. According to Bill, you're trying to get out expected tax gross profits using the tax reserves.

MR. BENGTSON: Right.

FROM THE FLOOR: It just seems like you're missing an item of DAC here without also worrying about those front-end loads of whatever it is that caused your deferred revenue.

MR. CHOTINER: One of our concerns is not that we're missing DAC, but that we're including it more than once, actually. I think the first thing is you have to realize that for tax purposes they're not treating the FAS 97 contracts any different than any other reserve computations. And I think if you go through where Bill might be coming from that issue perhaps doesn't come into play. Because you really have to treat the deferred acquisition costs in a different light, I would argue. One of the things that the wording tends to say and I've raised questions myself is it says *generally required* under generally accepted accounting principles and I always like to try and read the extra words that are there. It could have said *that are required* under generally accepted accounting principles and it doesn't. It says *generally required*. So, again, I tend to think that there is some room for interpretation when there are added words in there.

MR. SCHREINER: I'm inclined to agree with Marty on that point although I wouldn't want to carry it too far, because I've seen the Treasury attempt to interpret the words

generally required under generally accepted to ignore GAAP entirely. So there is a limit to how far you can go. I think you have to at least be within touching distance.

MR. CHOTINER: You know some companies don't file, don't do GAAP numbers. My company certainly would be one. Small stock companies don't. What is GAAP for us? That's another question. Well, we use some of the principles that are in GAAP, but kind of interpret that generally as kind of how we think we should until we hear otherwise.

MR. SCHREINER: Marty, I would expect your greatest difference to be in the amount of expenses amortized than in the method.

MR. CHOTINER: I agree.

FROM THE PANEL: Some companies are more vigilant about tracking down acquisition costs than others are.

FROM THE FLOOR: If a company's gone through an acquisition and elected a 338 treatment of this acquisition, now for the AMT does it set up a DAC or are there any instructions on that particular problem?

MR. KUNKEL: I guess my view of that would be that the general rule is that when you've done a 338 election, that it's been treated as an asset purchase and that the other tax characteristics do not follow those assets that have been acquired. Therefore, when you set up your value of in-force, typically, that would represent a substitute for DAC and you wouldn't go back and trail the old DAC costs associated with that.

Having said that, there really isn't any specific guidance in that regard. It really speaks to the same issue that I raised relative to Colonial American which would treat ceding commissions as though they were costs incurred in acquiring business from an assuming company's side. And, therefore, is that the same as DAC? But my view is you wouldn't duplicate. You would, in fact, use in-force valuations and amortize over a method and life consistent with the way DAC would be amortized and that there would be no further adjustment.

MR. BENJAMIN GEORGE PETERS: Some years ago the states pretty much gave up on income tax and went to a premium tax. Is the federal government in any mood to consider this simplification and how hard would we fight it?

MR. SCHREINER: Occasionally, you hear it mentioned as part of the discussions of the taxation of life insurance companies. There is a constituency for the existing system that I think could be very hard pressed to overturn. Presumably, the government wouldn't be interested in going to a premium tax unless it could raise them more money, which would mean the industry would be against it. The industry wouldn't be interested in going to a premium tax unless it saved them money, which means the government wouldn't be for it. So I think the likelihood is relatively small.

MR. CHOTINER: I can tell you though that there was a proposal put out to have a premium tax placed on the life insurance industry and it was based on tax on net premiums. It would eliminate the corporate income taxation of life insurance profits on the underwriting side. There are arguments that were proposed for and against it. It deals with some issues between segments of the industry which we don't want to really get involved in here, but there was, in fact, a proposal made and there were pros and cons addressed as it relates to it.