RECORD OF SOCIETY OF ACTUARIES
1989 VOL. 15 NO. 3B

AMT -- IMPACT ON MUTUAL COMPANIES

Moderator: JAMES F. REISKYTL
Panelists: HARVEY BLITZ*
LESTER A. EDELSTEIN
MICHAEL M. OLESKE**
Recorder: JAMES F. REISKYTL

- What is alternate minimum taxable income?
  - Definition and rules?
  - Pre-1990 -- after 1989?
- Issues
  - Deferred acquisition costs
  - Life/nonlife consolidation
  - Small companies
  - Other
- Legislative proposals
  - What is the financial impact of AMT?
  - What are current tax planning issues/investment planning issues?

MR. MICHAEL M. OLESKE: Basically I am going to give an overview of the alternate minimum tax (AMT) system. I will discuss its basic components which are adjustments and preference items. I will then give a few examples that I hope will be helpful. Harvey then will be discussing some of the more important issues in regard to the deferred acquisition cost (DAC) adjustment, and Les will be explaining potential changes in the law and how this will affect financial planning.

Basically, the AMT system was enacted as part of the 1986 Tax Reform Act in response to a concern by Congress that profitable corporations were reporting high amounts of earnings to their shareholders, yet they were paying very little or no corporate tax to the government. This was believed to have caused many people to feel the tax system was unfair and, therefore, led to a decline in taxpayer compliance. To assure that corporations would be taxed on their economic income, the AMT system was established.

The AMT system is a parallel tax system. It has its own special rules for computing deductions, credits, exclusions, etc. It establishes a broader tax base with a lower tax rate. Although it is an alternative tax -- you pay the greater of your regular tax liability or your alternative tax liability -- technically it is structured so that a company pays its regular tax plus the excess amount. Only that excess amount is considered to be AMT.

If you have an AMT liability in a particular year that is attributable to timing differences between the recognition of income or the claiming of deductions under one system versus under the other system, the law allows a tax credit against the regular tax for the AMT paid in the previous years.

How is the AMT calculated for life insurance companies? The starting point for computing the AMT liability is life insurance company taxable income (LICTI). You then add or subtract adjustments which are depreciation on property put into service after 1986, certain basis adjustments, the book income adjustment (which applies for the years 1987 through 1989), the

* Mr. Blitz, not a member of the Society, is Senior Vice President at The Equitable Life Assurance in New York, New York.

** Mr. Oleske, not a member of the Society, is an Associate Tax Counsel of New York Life Insurance Company in New York, New York.

adjusted current earnings (ACE) adjustment (which will come into play next year) and net operating loss (NOL) deductions. There are special rules under the AMT for computing NOL. After you have made the adjustments, you add preference items, which are accelerated depreciation, tax-exempt interest on certain types of bonds called private activity bonds and charitable contributions of appreciated property.

After you add the preference items, you subtract an exemption amount. The $40,000 maximum exemption begins to phase out if your AMT income exceeds $150,000. At an AMT income of $310,000, the exemption is zero. The result is your AMT income. A 20% tax rate is applied to your AMT income and that amount is compared with your regular tax liability. If your regular tax liability exceeds your liability under the AMT system, then you just pay your regular tax. If the AMT liability exceeds your regular tax liability, then you pay your regular tax plus that excess amount.

MR. GORDON H. LEAVITT: Is there a time limit on carrying your AMT forward for the purpose of getting a credit against it?

MR. OLESKE: No, you can carry it forward indefinitely.

I would now like to discuss the adjustments made in calculating the AMT in more detail. The purpose of adjustments is to broaden the tax base from an income tax base to a base that more closely reflects a corporation's economic income.

The first adjustment is depreciation on property placed in service after 1986. Essentially this adjustment puts a company on the alternative depreciation system (ADS). The ADS is a system that can be elected for regular tax purposes and that must be used in the calculation of the AMT tax. Therefore, if you use the ADS system for your regular tax, no adjustment has to be made in calculations of AMT.

There is also an election under the regular tax systems to compute depreciation on the straight-line basis. If you use that for regular tax purposes, the adjustment in the AMT computation will be smaller because you will be claiming less depreciation on the regular tax basis.

There are two factors to consider with respect to depreciation. First, in the early years, you make a positive adjustment to AMT because you are claiming higher deductions for regular tax purposes than you are for AMT tax purposes.

In later years, on the other hand, while your regular tax depreciation deductions begin to decrease, your AMT deductions continue at a higher level. This elicits a negative adjustment. That's a classic example of a timing difference between the regular tax system and the AMT system. Second, since you have different depreciation methods under the AMT system and the regular tax system, your basis for any particular depreciable property may be different under the two systems. So, if there is a subsequent disposition of the property, the gain or loss you recognize may be different under the AMT system versus the regular tax system. That difference is taken into account as an adjustment.

The next adjustment of major importance is the book income adjustment, sometimes referred to as BURP. BURP stands for book unreported profits. Essentially, the book income adjustment was incorporated in the law because corporations were reporting earnings to their shareholders, yet they weren't paying much in taxes. The book income adjustment requires that 50% of the excess of your adjusted net book income over your AMT income with certain adjustments be added to your AMT income. This particular adjustment operates similar to preferences. If it is positive, you add it into income. If the adjustment is negative, then you disregard it.

There are many regulations that explain how to calculate adjusted net book income. Essentially, the regulations require you to be taxed on those earnings that you report to your shareholders or creditors or that you report in a financial statement filed with the government. The way they operate is to take your book income which is probably includable in your income but which may be buried in a footnote, added in a side letter, or some other supplemental information.

The priority of financial statements for purposes of determining your book income adjustment is set forth in the Code. The highest priority statement is one filed with the SEC. The next highest

is a certified audited financial statement. Following that is an income statement used for credit, reporting to shareholders, or for some other substantial nontax business purpose. The lowest priority financial statement is one that is not a certified audited statement and is used for credit, shareholders, or for some other nontax business purpose. In terms of priorities, if a taxpayer has two or more financial statements of the same priority, then use the statement that shows the highest amount of income.

There are special rules for consolidated returns. You are required to use the return of the parent with the highest priority. If you have a disparity between the members of the group who are in the consolidated return and those who are on the financial statement -- adjustments have to be made. Essentially income should be reflected from nonmembers to the extent of dividends received. In addition, if there is a member of the consolidated return who is not in the financial statement, you have to add that member's income to adjusted net book income.

There are special rules for insurance companies. The deduction for policyholder dividends is limited by the Internal Revenue Code (IRC) 809 differential earnings amount. A special provision was adopted to give the IRS the authority to adjust a life insurance company's net book income to be consistent with the calculation of income generally. No guidance has yet been issued on that subject. We're really not sure how it will develop. The adjusted net book income adjustment will expire after this year and will be replaced with the ACE adjustment. The difference between the ACE adjustment and the book income adjustment is that the ACE adjustment is directed toward earnings and profits rather than toward book income. Specifically, instead of the 50% difference between book income and AMT income, ACE is calculated as 75% of the difference between earnings and profits (E&P) and AMT income. Unlike the book income adjustment, if your ACE is negative you may reflect it to the extent of prior positive ACE adjustments. One feature of the ACE adjustment that is not present with the book income adjustment is that negative adjustments may be reflected to the same extent as prior positive ACE adjustments.

To compute ACE, start with AMT income without taking the ACE adjustment into account; otherwise you would have a circularity problem. Certain modifications are then made. First you must add back income which is excludable for the purpose of calculating AMT which is not excludable from earnings and profits. A major example of this is interest on a municipal bond. Next you must add back some significant deductions, particularly to small companies. The major one is the small life insurance company deduction under IRS 806. The other deduction is the dividends received deduction.

The first adjustment is depreciation. Now, I had mentioned that there were special depreciation rules for AMT purposes. There are also additional depreciation rules that came into effect for the ACE adjustment. These rules require you to compare the present value of the depreciation deductions that you are claiming for book purposes with the present value of the depreciation deductions that would be allowable under ACE. You take whichever of the two has the lower present value. Now, this requires that you take time value of money considerations into account.

MR. WILLIAM E. MASTERSON, JR.: What interest rate is used in discounting for these present values?

MR. OLESKE: I believe that you use the applicable federal rate (AFR) for the particular time period involved.

To determine the depreciation adjustment for ACE, you must compare book depreciation with a straight-line method for various classes of property. You can make an election to use the cumulative method. The election applies to all property placed in service during that year. If you elect the cumulative method, you take the lesser of accumulated book depreciation and accumulated ACE depreciation less amounts that were taken in the prior years. Note that this election is irrevocable.

There is language in the Senate report which indicates that if you make the election in the first year that ACE becomes effective, then it applies to all property placed in service before 1990. This language did not appear in the conference report. So, I'm not quite sure where that's going.

Another ACE adjustment requires a life insurance company to add back insurance inside buildup of life insurance annuity contacts. In addition, if you have an exchange of debt pools, then you have to add back any loss that was recognized for regular tax purposes.

An adjustment which I will only make passing reference to is DAC (deferred acquisition cost) adjustment. The DAC of life insurance companies have to be capitalized and amortized under GAAP. This rule applies only to life companies, not to property and casualty (P&C) companies.

One other adjustment which is really under the heading of DAC, although not a DAC issue, is the election of small property and casualty (P&C) companies to be taxed only on investment income. This does not apply with regard to ACE.

As I mentioned earlier, the AMT has its own special rules for determining NOLs, and in lieu of a regular NOL deduction, you take this special AMT deduction. You compute AMT NOLs essentially by using the AMT system with the exception that certain preferences are disregarded if they did not provide tax benefits, and the charitable contribution of depreciated property is not adversely affected.

One factor regarding the AMT NOL deduction that makes it somewhat risky is the fact that your AMT NOL can be consumed by future years' AMT income even if you're not subject to AMT. So, it may be that you have an NOL for AMT purposes that you may never use because it has been depleted without providing tax benefit.

These are the basic adjustments which are made to taxable income in the calculation of AMT income. The next items which affect the AMT tax base are called preferences. But before I go to preferences, does anyone have any other questions about these adjustments?

FROM THE FLOOR: Is there a formal definition to inside buildup?

MR. OLESKE: No there is not. There is language in IRS Section 72 which states that inside buildup is essentially the surrender value of the contract less the previous year's surrender value. But I am not sure if there is a statutory definition.

FROM THE FLOOR: If your surrender value happens to be equal to your cash value, will the inside buildup equal the increase in reserve?

MR. OLESKE: The short answer is that it would equal the increase in your reserves if your reserves are based on your cash value. If your reserves are based on Section 807 mortality tables and interest rates, then it would not be the same.

MR. LESTER A. EDELSTEIN: Could premiums paid be backed out?

MR. OLESKE: There is an adjustment that is made for the cost of insurance. Essentially it says that premiums to the extent they cover the cost of insurance are subtracted from the inside buildup.

MR. JAMES M. MERWALD, JR.: Doesn't the inside buildup issue just apply to corporate-owned life insurance or annuities?

MR. OLESKE: Right. We're talking about corporate-owned life insurance policies. I didn't mean to scare you. It has to be income to the taxpayer; therefore, it's a policy that is owned by the life insurance company as an asset.

MR. GODFREY PERROTT: You just made a comment that applied to policies owned by life insurance companies, but the application within AMT is to any corporate-owned life insurance.

MR. OLESKE: Yes. These rules apply to all corporations, not just life insurance companies. Now let's move on to preferences.

The first preference which is of concern to insurance companies is accelerated depreciation on property placed in service prior to 1987. This preference is equal to the excess of accelerated depreciation over straight-line depreciation. The next preference relates to interest on private

activity bonds. The interest on these bonds issued after August 7, 1986, is subject to AMT. You must reduce the preference income by any deductions that would be allowable if the interest were taxable. Another preference item of concern is charitable contributions of appreciated property. Basically, for regular tax purposes, if you give appreciated property to charity, you are generally allowed to claim a deduction for the fair market value. Congress thought that was an abuse. So Congress imposed the requirement to compute the deduction by using the adjusted basis of the property rather than the fair market value. You do get a small break since you take the aggregate basis of all the properties that you contribute to charity during the year. Therefore, if you happen to have contributed depreciated property to charity, you get some degree of offset. But, as a general rule, taxpayers don't contribute depreciated property to charity because the deduction for regular tax purposes is limited to the fair market value. So it is more advantageous to sell it at a loss than to make a charitable contribution.

I would now like to discuss AMT planning by using a few examples. The examples highlight what tax planning you may do if you are in an AMT in a particular year but do not expect to be in an AMT position the following year. First, in any case, identify the cause. If you are in an AMT position because of tax preferences or other items that don't relate to timing differences, the best planning is to accelerate income into the current year out of the later year. The reason is simple. You are subject to a 20% tax rate in the current year while income in the future year will be taxed at a 34% rate. To the extent that you can move income from the year with the higher tax rate to the year with the lower tax rate, you will achieve a permanent tax benefit. Exhibit 1 shows that a taxpayer with income of $1,000 in 1989 but with AMT income of $1,910 in the same year will be in an AMT position in that year. In the following year it is projected that he would not be in an AMT position. The total amount of tax that would be paid under this example is $790. If income were accelerated into the earlier year, the permanent benefit would be essentially 14% of the amount of income that is accelerated. The example shows $300 of income being shifted to 1989 from 1990. The shifted income of $300 times the difference in tax rates yields a tax savings of $42.

EXHIBIT 1

AMT PLANNING

1. AMT caused by preferences
   Strategy: Accelerate Income
   Example: Move $300 of income to 1989

   A. Before

	Regular Tax		AMT	
	1989	1990	1989	1990
Taxable Income	$1,000	$1,200	$1,910	$1,800
Tax	340	408	382	360

   Total 1989 + 1990 = $382 + $408
   = $790

   B. After

	Regular Tax		AMT	
	1989	1990	1989	1990
Taxable Income	$1,300	$900	$2,210	$1,500
Tax	442	306	442	300

   Total 1989 + 1990 = $442 + $306
   = $748

   Tax Savings = $42

Exhibit 2 shows the same amounts of taxable income and AMT income except now the AMT is caused by timing differences. This example shows that to the extent that the AMT is caused by timing differences, you are allowed a credit in the later year against regular tax. Essentially, what you would then want to do is to defer income or accelerate deductions because you will get the value of the deductions right away.

PANEL DISCUSSION

EXHIBIT 2

AMT PLANNING

1. AMT caused by timing items
   Strategy: Defer Income
   Example: Defer $300 of income to 1990

   A. Before

	Regular Tax		AMT	
	1989	1990	1989	1990
Taxable Income	$1,000	$1,200	$1,910	$1,800
Tax	340	408	382	360
Minimum Tax Credit	----	(42)	----	----
Tax	340	366	382	360

   Total 1989 + 1990 = $382 + $366
   = $748

   B. After

	Regular Tax		AMT	
	1989	1990	1989	1990
Taxable Income	$700	$900	$2,210	$1,500
Tax	238	306	442	300
Minimum Tax Credit	----	(84)	----	----
Tax	238	426	----	----

   Total 1989 + 1990 = $322 + $426
   = $748

   Result: One-Year Deferral of $60

This example shows what would happen if you deferred $300 of income from 1989 to 1990. You would get a tax savings of the time value of part of the payment. In this example, the result is a one-year deferral of 20% of the $300 of income that was postponed. If you are in AMT because of timing differences, you pay tax in the earlier year at the 20% AMT rate on the affected items. When the same items are subject to tax the next year under the regular tax system you pay 14%. You are allowed a credit of 20% for what you paid the previous year. Therefore, you achieve a tax savings if you can postpone paying some of the tax.

Now I would like to discuss some possible strategies that you may use to minimize your AMT exposure. The first strategy considers depreciation elections. If you elect to use the straight-line method for regular tax, you will have less of an adjustment under the AMT system. Another alternative is to elect the alternative depreciation system. If you use the alternative system, then there is no adjustment under the AMT system because you are already using the appropriate system. In addition, if you use a faster depreciation method for book purposes, there will be savings under either the book income adjustment or ACE. There will be savings under the book income adjustment since it compares your AMT income and your reported income for book purposes. So, if you have a more accelerated method for book purposes there will be less of a bad adjustment. The same holds true for ACE since ACE requires a comparison for your book method to the method prescribed by ACE. To the extent that your book method is at least as great as ACE, you will not have any negative effect from your book depreciation method.

You should avoid having a negative ACE adjustment in 1990, the first year that ACE is in effect. An ACE adjustment can be a negative adjustment, but only to the extent of prior accumulated positive ACE adjustments. If you have a negative ACE adjustment and it exceeds the cumulative prior positive ACE adjustments, you can't carry it forward or backwards. You've just wasted what could otherwise have been usable. So therefore, if you have a situation where you feel that you may have negative ACE in 1990, you may seek ways to increase your earnings and profits at least to make ACE be zero or positive for the first year that it goes into effect.

MR. HARVEY BLITZ: Let me say that in the context of this speech I hate using initials as opposed to words. But there are four sets of initials I will use constantly. One is IRS, which obviously stands for the Internal Revenue Service. Another is DAC, which stands for deferred acquisition costs, which is my main topic. The third is GAAP, which stands for Generally Accepted Accounting Principles. Stock companies are probably more familiar with GAAP than mutual companies. And the fourth is FASB, which stands for Financial Accounting Standards Board, which is the group that promulgates the accounting rules that apply for GAAP.

As Mike noted, the adjustment for DAC is probably the single most important adjustment in determining a life insurance company's AMT. I would like to take you through a little history of this adjustment and then discuss its application, particularly on mutual companies that have no particular background with it.

As you undoubtedly know, stock companies have been dealing with DAC for a long time. GAAP accounting for life insurance companies has always required that DAC be capitalized and amortized over a period relating to the life of insurance policies. Mutual companies that are governed by statutory accounting generally do not do that. Some mutual companies have developed methodologies for measuring income that involve some deferral of acquisition expenses for internal reporting purposes. This may be relevant in a discussion of DAC under the AMT. But, if you use a standard other than GAAP, some significant adjustments may have to be made.

Now, I have the fortune, or misfortune as it may be, of coming from The Equitable which decided in 1983 to use a system very close to stock company GAAP for its internal accounting. So, in fact, we have accounting records that come very close to what you need for the AMT. I believe this is the exception rather than the norm among mutual companies.

I would like to emphasize that companies not using the GAAP standard for deferred acquisition expenses will have a very difficult time implementing the minimum tax rules. It is extremely complicated to set up a system that accurately measures income for AMT purposes and whatever system you use to comply with the law will be very significant for a long time in terms of the minimum tax results.

Let me say just a brief word about why we have a DAC adjustment in the AMT. The conceptual reason is very simple. Tax law people, congressmen, and staff people like to think that the tax law comes close to measuring economic income. And there are many people in the life insurance industry -- some of whom might even be in this room -- who think that DAC ought to be capitalized as GAAP does rather than written off immediately as statutory accounting does. Congress, sensitive to this, designed a minimum tax that, as Mike described, was supposed to catch those people who have economic income but are not paying enough tax. Congress, therefore, decided that this kind of an adjustment belonged.

The other reason is political. There were certain revenue targets that had to be met, so it seemed like a good idea to include a DAC adjustment. In fact, a logical question some of you might ask is, "Why is this only in the minimum tax? Why isn't it in the regular tax, too?" If conceptually it is a closer measure of economic income to defer acquisition costs rather than deduct them, one might have thought that Congress might have put that into the regular tax.

The short answer to that is it may still happen. Up until now the industry has had the political power to avoid it, but putting DAC into the regular tax has been on the list of options that the Joint Committee of Taxation has prepared for Congressional consideration. So, it may yet happen some day.

The second question is, why did Congress use GAAP as a standard? Why didn't they just create their own rule for acquisition costs?

One reason is that Congress thought that GAAP was precise. It shows how little they know, because, in fact, GAAP is not precise at all in terms of setting up a fixed set of rules that would have all companies calculating acquisition costs and their amortization in exactly the same way. But Congress thought if the accountants had a set of rules, it was probably a good way for them to go. It is very unusual for tax laws to follow book accounting. This is almost unique in the tax law. But the theory was that if we had something already in place, it's easier to adopt that than to start from scratch. And that probably is true. Using GAAP does provide some structure.

Another reason is stock companies were already using GAAP accounting for DAC. So, at least for half of the industry, the trouble of developing a new kind of adjustment was substantially lessened by using GAAP.

Mike has already commented that our minimum tax unfortunately works in two different bites. You have 1987, 1988 and 1989 which use BURP, or book income reference, and 1990 and later that use ACE.

The original minimum tax rules (BURP) that were passed in 1986 had no DAC adjustments for mutuals. There was automatically a stock adjustment for DAC because the stock company's book income was based on GAAP. And since GAAP had a DAC adjustment, the tax law automatically had one. But mutual companies generally were using their statutory statements for minimum tax purposes. Statutory statements have no DAC. They are deducted immediately. So, the mutual companies had what might have been perceived as an advantage.

The stock companies thought it was an advantage, so they went to Congress and said, "Not fair! You're supposed to treat this industry evenly." So, in 1987, effective January 1, 1988, Congress changed the language for the book income adjustment. They added a special clause which says:

> To the extent provided by the Secretary, such additional adjustments shall be made as may be necessary to make the calculation of adjusted net book income in the case of any life insurance company consistent with the calculation of adjusted net book income generally.

INTERNAL REVENUE CODE SECTION 56(f)(2)(H)(ii)
It is difficult to determine what was actually meant by this. The legislative intent was that GAAP should apply to all life insurance companies, both stock and mutual companies. The original drafts of the clause referred to any mutual life insurance companies. Mutual companies reacted negatively since all stock companies do not use GAAP. So that language would have effectively not applied to stock companies who did not use GAAP. So Congress said, "We will cover them too."

It started with just stock companies. Then they said, "You ought to cover the mutuals." So they got covered. Mutuals said, "You ought to cover the stocks that don't use GAAP." So they got covered. Now all life insurance companies have a deferred adjustment in calculating book income. The language, though, is not really clear as to how it applies to mutual life insurance companies.

First, there are not specific GAAP rules for how you treat traditional dividend paying mutual life policies. So you begin with the problem of having to use GAAP, yet no GAAP actually exists.

Second, the introductory language of the statute, "To the extent provided by the Secretary" is "legalese" to indicate that the Treasury Department is supposed to promulgate regulations to explain how to comply with this provision. No regulations have yet been announced or issued. So in the absence of regulations, the question becomes, "How should mutuals file their tax returns?" I believe that until you get some guidance from the Secretary of the Treasury in the form of regulations, mutuals are probably within their rights in simply filing a tax return that makes no DAC adjustment at all for minimum tax in their book income preference. Now, that's only 1988 and 1989. Shortly, we are going to talk about what happens in 1990 and later. But, at least for the moment, it makes sense to file your tax return without an adjustment. Now, the Treasury Department may promulgate regulations that are retroactive and, therefore, force you to amend your return or to make some adjustments on audit. This may very well happen. Although it is not clear when these regulations are going to be adopted, it is extremely unlikely that these regulations will be adopted before the 1989 returns are due in September 1990.

Let me turn now to what happens in 1990 when the ACE approach is adopted. This clause 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.

INTERNAL REVENUE CODE SECTION 56(g)(4)(F)
This is very specific language applying to all life insurance companies. It states that acquisition expenses of life insurance companies are capitalized and amortized in accordance with GAAP. Now, that seems fairly clear. It is a clear adoption of GAAP as the tax standard. This means that those involved in tax planning will have to become experts in how the accounting works. This will be particularly difficult for mutual companies since nobody may be particularly familiar with the intricacies of GAAP accounting for DAC.

Now let's discuss what I view as the most important aspects of GAAP accounting for DAC.

First, there is significant discretion involved, unlike what Congress intended. Even stock companies that have been using GAAP for a long time have material differences in what they believe should be capitalized as acquisition expense and how they should amortize those acquisition costs over the lives of the policies. The guidance that comes from the financial pronouncements are FASB 60, which applies to traditional products, and FASB 97, which applies to universal life. Basically they have the same definition for what constitutes an acquisition expense, that is, items that vary with and are primarily related to the acquisition of new or renewal business. Two primary categories of expenses fall into this definition: sales and issue expenses. Some examples of sales expenses are commissions (initial and renewal), sales office personnel, sales materials, mail order solicitations, and printing of applications. Some examples of issue expenses are underwriting, medical exams, and processing of applications. Both are very broad categories.

The real problem is that not many mutual accounting systems are designed to capture acquisition expenses in a separate category. Stock companies may have viable accounting systems for tracking acquisition expenses since they have been dealing with GAAP for many years; mutual companies most likely do not. As a mutual company, you will first have to determine which expenses relate to acquisition. Then determine the budget codes of these expenses. You will find that any one code will have a mixture of expenses that do and do not qualify as acquisition expenses. Therefore, you must extract the nonacquisition expenses from each category or make gross estimates of the percentage of expenses that constitute acquisition expenses. All in all, it will be very difficult to accumulate the necessary data.

The second part of the GAAP accounting problem is how to amortize acquisition expenses. I have already identified the acquisition costs that have to be deferred under GAAP. You can amortize them over the lives of the policies. The answer is not that you use a straight-line approach which, for example, would say, amortize your acquisition expenses over 15 years if the average life of your policies is 15 years. Instead, FASB 60 requires you to amortize acquisition expenses to get level profit as a percent of premium (for traditional policies). This requires much estimation. You would not naturally do this unless you were using GAAP accounting or you were required to use GAAP accounting because of the minimum tax.

For universal life products, FASB 97 requires a life insurance company to measure profit differently than as a level percent of premium. Specifically, income is not equal to premium; instead income is the sum of the charges made in the policy for mortality, expenses, interest spread, and surrender. You then amortize acquisition expenses in relation to that stream of income. This is again a fairly complicated process. I can't tell you whether it's easier or harder than the first one but the fact that it's different means the work is twice as great.

FASB 97 does have one aspect that may be important for the minimum tax computation. Specifically, upon replacement of a traditional policy by a universal life policy, FASB 97 requires that DAC be written off on the old contract. That can be a substantial earnings effect if your earnings are calculated on GAAP. If you are not using GAAP, this may be beneficial since it gives you a substantial write down for AMT purposes in the years in which this happens.

Let me say a few words about DAC. If you noticed, as I discussed the language of the statute, I stopped before the last phrase. And the last phrase is of critical importance, particularly to mutual companies. The last phrase starts with "As if" and the words are, "As if this subparagraph applied to all taxable years." In the language of the tax trade we call that a fresh start. It is a major tax benefit. What it says is that the ACE rules go into effect January 1, 1990. Therefore, as of December 31, 1989, you determine the cumulative amount of DAC that would have been on your books for the policies inforce as if you had been doing this computation when you first began issuing existing policies.

This is a tremendous tax benefit. In the first year, for example, in 1990, a large DAC will be set up. In addition, you will receive an extra deduction in 1990 for the portion of the cumulative balance on December 31, 1989 that you would have been allowed to write off in 1990. The net effect of the DAC adjustment in the first year is substantially dampened by this "fresh start" rule.

Of course, with benefits come problems. The biggest problem is how do you develop data that show what your DAC would have been if you do not have records that go back to when you started issuing the policies? In fact, you may have to develop data for policies that you no longer issue but are still part of your inforce. So the benefits bring problems.

The assumption is that companies are going to try to develop factors that would approximate what would have happened if they could have gone back to the issue year. There is no guidance from the IRS on what standards they are going to apply when they audit this. But it seems that if you do a reasonably good job of implementing this, it is going to be very difficult for the IRS to do a better job when they come in and audit.

So there is a premium on paying attention to how you set up the cumulative balance on December 31, 1989. The factors that appear favorable on December 31, 1989 in determining the cumulative balance may not be favorable in the future. It is not going to be easy to use favorable factors to set up the cumulative balance and different factors for the future. But, certainly, it would be in your interest to build up this cumulative balance to the greatest extent.

As a practical matter, what methods you use to handle DAC for internal accounting purposes will limit the methods you may use for tax purposes.

Let me just say a few quick words on planning issues. First, this goes into effect January 1, 1990. Since you do not have to file your income tax returns for 1990 until September 15, 1991, you will have two years for planning. The bad news is that it will probably take three or four years to collect the necessary information. So, do not get too comfortable with the time you do have. If you wait until the end, you probably will not do a good job. And if you do a poor job, you will be "stuck" with what you did to the extent it benefits the IRS.

Second, unlike the BURP adjustments. where mutuals may not have to act without additional regulations, I think everybody is going to have to try to estimate the adjustment to the extent that the AMT will affect them. So, if you are confident that you will be an alternative minimum taxpayer, it would be beneficial to do a thorough job when setting up the opening balance.

I want to say just a word about small companies. They are particularly subject to the AMT. There are two reasons for this. One reason is due to the small life insurance company deduction. The small life insurance company deduction says that on the first $3 million of taxable income you may take a special 60% deduction to reduce the amount of regular tax that you have to pay. This deduction phases out between $3 million and $15 million of income. In addition, though, to take advantage of the small company deduction a company must have less than $500 million of assets. So, if you have assets over $500 million, you are not treated as a small company for tax purposes.

If you are a small company and you take advantage of the 60% deduction, you will be disappointed to know that you do not get the benefit of this deduction for the calculation of the minimum tax. It gets added back in calculating this ACE adjustment. Because of this, you may find yourself in a minimum tax position very quickly. In addition, small companies tend to be growing faster than large companies so they are likely to have a larger increase in DAC in any given year. This adds to the problems. The small companies have complained bitterly about the seeming inequity of this greater likelihood of being subject to the minimum tax. They have complained bitterly to Congress, but, as of now, Congress has made no changes. I would not be overly optimistic about getting this changed.

The final item that I would like to address is life/nonlife consolidation. This is a fairly specialized problem. The tax law permits companies to file a consolidated return between their life companies and nonlife companies. One significant rule does exist; that is, the offset from losses of the nonlife company is limited to the lesser of 35% of the life company income or 35% of the nonlife loss. This 35% limitation rule is supposed to be carried forward to the AMT as well. This rule does lead to computational problems since you generally use a consolidated approach in the

calculation of the AMT. The ACLI has come up with five different mechanical approaches, each of which gives different answers that could either be beneficial or harmful to individual companies. So eventually there probably will be some guidance from the Treasury Department on life/nonlife consolidation.

MR. DANIEL J. KUNESH: If you were a recently acquired company subject to purchase GAAP, how would you define DAC? Would you take two cases under a 334B2 election of 338 and a nonelection?

MR. BLITZ: Well, the one that leads to the interesting questions is the 334B2 to the 338 where you get the step up in basis. From the text of the regulation it would appear that you are treated as a new company, and therefore, this cumulative balance which you initially determine would not technically appear to apply to the period before acquisition. This potentially gives you a substantial disadvantage, although it is offset in part by the fact that you have acquisition expenses for this insurance inforce which you are writing off for both regular and AMT tax purposes. But in fact, you will probably be somewhat worse off if you've done that type of acquisition for AMT purposes in relation to the regular tax. But there are no regulations. That's just the way I interpret the words. I think it is the generally held view that you have a "loser" here. I'm sure that it will be argued out at length. If you just acquire a company in a normal transaction, then I think the corporation itself, the life insurance company, is deemed to be continuing. I do not think this holds here though.

MR. MICHAEL PALACE: I'm a little curious as to whether there's any position taken regarding the calculation of the reserves which is the other side of the DAC. The Federal Income Tax (FIT) promulgated method is Commissioners Reserve Valuation Method (CRVM), which already makes recognition of acquisition expenses.

MR. BLITZ: It's a great question and I skipped it because I was running out of time. Les will address this issue in his remarks.

MR. PERROTT: I wanted to comment on two items that you mentioned which are closely coupled. They are growth and the importance of planning for 1990. The whole effect of the DAC adjustment is growth driven. By and large your existing business gives you a negative adjustment and your new business gives you a positive adjustment. It is this balance that will determine whether you fall into AMT. So you may be in a situation now or in 1990 where AMT does not affect you, but it might affect you in the future. The other side of that is as you said, the IRS is going to be "snowed" in 1990. Anyone who does a decent planning job is probably going to get through with it. You can bet, though, that you will not be able to change anything in the future to your advantage. You will have to live with what you do in 1990.

MR. JAMES F. REISKYTL: Our next speaker, Les Edelstein, is an actuary. Les will address the financial impact of the AMT as well as proposed changes in the tax law.

MR. EDELSTEIN: What is interesting about being a tax actuary is you work with professionals from various disciplines. We're used to working with lawyers and now we're going to have to work closely with accountants.

My first topic is legislative changes. And this, like many things in taxes, is in a very confused state. There have recently been budget reconciliation bills before the two Houses of Congress. The House Ways and Means Committee developed a bill that was passed by the full House. Later, the Senate Finance Committee also developed a bill, and a so-called "stripped-down" version of the Senate Finance Committee bill was passed by the Senate. So we have three different bills to consider. The House Ways and Means bill passed by the House, and the Senate Finance Committee bill both contain changes relevant to the AMT. Also, we must consider the Senate "strippeddown" version which contains no changes relevant to the AMT. I understand that soon the House and Senate bills will go to conference. I will not make any predictions as to what will happen.

The first legislative change that I want to discuss is the expanded credit. Before discussing that I'll mention very briefly what I call the 170% rule that applies to the AMT. It is basically a function of the different tax rates in the AMT system and the regular tax system (20% versus 34%, respectively).

Suppose you have a regular taxable income of $100 (see Exhibit 3). In addition, suppose you have $70 in add backs for AMT purposes giving you an AMT income of $170. Your regular tax is going to be 34% of $100 or $34. Your minimum tax is 20% of 170 or $34. (Actually the excess of this over your regular tax would be your minimum tax.) So your extra tax or AMT in this case is zero. In general, if your AMT income is 170% of your regular taxable income, you break even. Let's say you had $100 of add backs so that you really did generate an AMT. According to the current law, your entire AMT then would be considered to be due to timing items. Right now you can have permanent items up to 70% of the regular taxable income, or $70 in this example, without generating any permanent extra tax. If your AMT is considered due to timing, then you have a credit in a future year. If you have more than $70 in permanent items, then any AMT due to this excess over $70 would be a permanent extra tax.

EXHIBIT 3

170% RULE

1.	Regular taxable income	100
2.	AMT add backs	70
3.	AMT income	170
4.	Regular tax = 34% x 100	34
5.	Minimum tax = 20% x 170	34

Extra tax (AMT) is zero

The change in the law states that all extra AMTs would be considered due to timing differences. So all of them would involve an acceleration of tax rather than a potential permanent extra tax. This change was in the House Bill. It was in the Senate Finance Committee bill. And of course, it was not in the Senate's stripped-down bill. So it made both Committee bills and actually was passed by the House, but it was not in the final version passed by the Senate.

The second change I want to talk about is a supposed clarification of the DAC rules. Now, as we mentioned before, for tax purposes, we generally use the CRVM, which already amortizes or is supposed to amortize part of your acquisition expenses. In fact, that's the whole rationale for allowing companies to use CRVM reserves instead of net level premium reserves. As I understand GAAP, your benefit reserves are really of a net level type. Using CRVM to determine your income, you really have already amortized some of your acquisition expenses. So, if you have to amortize the full DAC used for GAAP, you are essentially getting a double hit. This was brought to the attention of Congressional and Treasury/IRS staffs by the ACLI. In response, both the House bill and the Senate Finance Committee bill had the following "clarifying" language:

ACQUISITION EXPENSES OF LIFE INSURANCE COMPANIES

> 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. 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. 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.

Some people might interpret the last half of the second sentence to say that the tax reserve method should not be considered in determining the amortization. This is not completely consistent with what was said earlier.

I've talked to some of the ACLI staff who were active in trying to get clarifying language into the law and this language was not exactly what they proposed. They said that the meaning of the last half of the second sentence is that, in the future, if tax reserve rules are changed to increase life

insurance company income, such changes might drop to the bottom line and not necessarily be offset by changes in the amortization of your DAC.

An additional consideration, as I understand FASB 97, is that companies do not actually set up reserves. So to what extent the reserves that we do set up will be relevant in determining the amortization schedule is perhaps another unclear point. Since you are supposed to be consistent with book income treatment, I think you could probably make a good argument that you should take the reserves into account. But you should make your own interpretation of the language.

The third change that was in the House bill but not in the Senate Finance Committee bill is a change in the depreciation rules for the AMT or the ACE adjustment under the AMT.

Presently, as Mike mentioned previously, the method of depreciation used in determining book income in some cases determines the depreciation that you use for your AMT.

For example, if you were to buy a new building now, you would have to depreciate it over 31.5 years. That gives you a depreciation deduction of $3.17 a year for every $100 of depreciable property. So in determining your regular taxable income, you deduct $3.17 a year. In determining your AMT income, you have to go to a 40-year basis so you have to add back 67 cents to bring your deduction down to $2.50, i.e., 1/40 x 100.

However, suppose for determining your book income you use a 50-year amortization schedule. That only allows you $2 a year depreciation. The difference between the $2.50 and the $2 is an ACE adjustment. So 75% of that has to be added into your income. You basically get a deduction of $2.12 a year instead of the $3.17 for regular tax or the $2.50 that you would have had if you did not use the book income method slower than 40 years. As I said, the House bill eliminates any references to the book income method but this did not make it into the Senate Finance Committee bill.

Harvey Blitz had mentioned that DAC amortization could come into the regular income tax basis in which case it will not be a separate DAC adjustment even though many of the same problems may be involved.

There were some hearings on life insurance company taxation on October 19, 1989. One Congressman testified that he is thinking of or intending to introduce a bill that would include capitalization and amortization of DAC for regular tax purposes. Finally, as has already been mentioned, the small companies take a big hit under the AMT because the 60% small life insurance deduction does not apply for AMT purposes. It's an ACE adjustment and 75% of it gets added back into your AMT income. Nothing appeared in either the House or Senate bill that would change that.

The next subject that I'm going to address concerns the financial impact of the AMT. This is obviously something that is going to vary from company to company. Some companies will not pay any AMT and therefore, it will have zero financial impact. Other companies will be on the AMT for the foreseeable future, so it could have a significant impact. I would now like to give some examples that highlight the possible financial impact of the AMT.

Again, in determining the financial impact of the AMT, the 170% rule is important (see Exhibit 3). To determine the impact of AMT, you cannot look at the amount of adjustments or preferences that get added back to your AMT base and the amount of your regular taxable income in isolation. The relationship between the two is important and is governed by the 170% rule. For example, a high income company may have high preferences and adjustments yet not be affected by AMT. Likewise, a low income company will be affected by the AMT with few adjustments and preferences.

A year or so ago there was some movement to change the tax rate in the AMT from 20-25%. It appeared on one of the option lists. A change in the tax rate would, of course, change the 170% ratio.

Another important financial consideration is the extent to which the AMT is due to timing differences or permanent differences. Timing differences lead to only an acceleration of tax while permanent differences lead to a permanent extra tax. For example, if you pay $100 of AMT

this year due to timing differences and the following year you use it as a credit, the net cost may be about $10. On the other hand, if you pay $100 of AMT due to permanent differences, the net cost will be $100. From a tax planning standpoint, a company should try to minimize the tax due to permanent differences. Remember, though, that a company may have permanent differences equal to 70% of your regular taxable income without generating permanent AMT.

For the rest of my presentation, I am going to assume that the AMT is due to timing differences and not permanent differences. The next idea I would like to discuss is the concept of a current tax and a deferred tax. Exhibit 4 highlights the tax position of two different taxpayers -- A and B. A has $100 of regular taxable income. B has a regular taxable income of $101. I want to show the marginal effect of that extra $1 of income that appears in the regular tax base.

EXHIBIT 4

EXAMPLE OF CURRENT AND DEFERRED TAX CONCEPT

		A	B
1.	Regular taxable income	$100.00	$101.00
2.	AMT add backs	100.00	100.00
3.	Total AMT income = (1) + (2)	200.00	201.00
4.	Regular tax = 34% x (1)	34.00	34.34
5.	Total tax = 20% x (3)	40.00	40.20
6.	Amount of total tax available as future credit = (5) - (4)	6.00	5.86

Let's say for both of these taxpayers the AMT add backs are $100. So A has a total AMT income of $200 and B has $201 of AMT income. The regular tax for A is $34 (34% of the $100). The regular tax for B is $34.34 (34% of $101). The total tax that A and B will pay for the year will not be the regular tax because both of them are going to be subject to the AMT. In the case of A it's 20% of the $200 or $40 and in the case of B it's 20% of $201 or $40.20. A has an AMT, the excess of the total tax over the regular tax, of $6. B has an AMT of $5.86. Again assuming these amounts are usable as credits in a future year, the extra dollar of B's regular taxable income increases the current tax by 20%. In addition, the usable credit for a future year decreased 14% (equivalent to a deferred tax of 14%). In general, each dollar of extra income generates a current tax and a deferred tax such that the total sums to the tax rate, i.e., 20% + 14% = 34%.

Now I would like to give a few examples of marginal tax analysis. Let's say you expect to pay an AMT for a certain number of future years or you want to analyze what would happen if you were going to pay an AMT for a certain number of future years. The first example (Exhibit 5) is an employee stock ownership plan (ESOP) loan. These loans are less popular now than they were a number of months ago because there is a potential legislative change to regular taxable income that would eliminate the tax advantages of these loans except in certain special situations. But they are still useful for a few special situations and they provide a helpful example of the application of the AMT.

EXHIBIT 5

ESOP LOAN EQUIVALENT TO 10% FULLY TAXABLE LOAN

	ESOP RATE
Regular taxpayer	7.95
Alt. Min. Taxpayer becoming a regular taxpayer in:	
1992	8.03
1996	8.32
2000	8.59
Never	9.70

Let's say you have a 10% fully taxable loan and you ask the question, "What ESOP rate do I have to earn to provide the same after-tax internal rate of return as I would earn on the ESOP loan?" This example was done for a three-year ESOP loan where the principal remains level during the

three years. Interest is paid at the end of each year. I've used a surplus tax differential earnings rate of 6.5% in doing the example but that has virtually no effect on the results.

If you're a regular taxpayer over these three years, you would have to earn 7.95% on your ESOP loan to yield the same after-tax internal rate of return that you would have on the ESOP loan. If you are an alternative minimum taxpayer now, and your turnaround year is 1992, that is you become an AMT taxpayer in 1992, you would have to earn 8.03%. Notice you need an additional eight basis points. You might ask, "Why do I need a higher return in order to have the same after-tax rate of return as you would on a fully taxable loan?" The answer hinges on tax advantage. For a regular taxpayer, 50% of the interest is exempt from tax. For an alternative minimum taxpayer, 75% of that 50% exemption must be added back. Therefore, an alternative minimum taxpayer has to earn a higher rate.

Of course, the lower your tax, the less the tax advantage is worth. If we were living in a society that had zero tax rate, you would have to earn 10% on an ESOP loan in order to have the same after-tax rate of return as you would have on a fully taxable loan. Consider again the current and the deferred tax concept. If you're going to become a regular taxpayer in 1992, your 1990 tax is 20 cents now and 14 cents in 1992. So, you receive two years of timing advantage on the 14-cent tax. For 1991, your tax is 20 cents now and 14 cents in 1992. Here you receive a one-year timing advantage on the 14 cent tax. In 1992 you pay a regular tax plus the deferred 14 cent taxes. The savings due to the time value of money gives you a lower composite tax rate which means you need a higher break-even point.

If you are an alternative minimum taxpayer now and will be a regular taxpayer in 1996, the required ESOP rate would be 8.32%. Similarly, if you become a regular taxpayer in 2000, the rate increases to 8.59. And if you are an alternative minimum taxpayer forever, that is you are basically a 20% taxpayer, the rate increases to 9.70%.

These results take into account the "feedback effect." I am not going to discuss it in any detail but it relates to the fact that the surplus tax depends on mutual company earnings. If a mutual company has higher earnings, it affects the surplus tax that it will pay in future years. You would actually have slightly different tax rates than I used here (i.e., 34% regular tax rate and 20% AMT rate) for a mutual company with a large surplus relative to other mutual life insurance companies. For example, the results would be somewhat different for a company such as the Metropolitan.

Exhibit 6 illustrates how the calculations for the ESOP example were performed. The first calculation I would do if I want to know if the ESOP loan will yield the same rate of return as say a 10% fully taxable loan is to determine the after-tax rate of return on a fully taxable loan. This calculation is done in Exhibit 6. On January 1, 1990 you invest $100 in the loan. On December 31, 1990 you receive $10. At the end of 1992 the principal and interest are paid back.

EXHIBIT 6

COMPUTATION OF FULLY TAXABLE LOAN INTERNAL RATE OF RETURN (IRR)

	Cash Flows		
Time	Pretax	Tax	After Tax
01/01/90	-100.00		
12/31/90	10.00	3.34	6.66
12/31/91	10.00	3.34	6.66
12/31/92	110.00	3.34	6.66
12/31/93			
12/31/94			
12/31/95			
12/31/96		6.94	-6.94
IRR	10.00%		4.83%

This example assumes you are an AMT taxpayer until 1996. The tax for 1990 to 1992 is $3.34 annually, including the surplus tax. The after-tax cash flows are the pretax cash flows less the $3.34 tax or $6.66 a year. Notice that I continue my cash flow lines down to December 31, 1996 since in 1996 a deferred tax of $6.94 will have to be paid.

If you compute the IRR of the after-tax cash flows, you come out with 4.83%. Notice how low the marginal after-tax rate of return is with the surplus tax.

The next step in the process requires some trial and error. You would just guess at some ESOP rate before tax rate, calculate your taxes, calculate your after-tax cash flow, and determine a rate of return. After you go through this trial and error procedure, you would find that 8.32% is the ESOP rate that gives you the same after-tax rate of return, i.e., 4.83% as for the fully taxable 10% loan. Therefore, 8.32% is the answer to the question if you have a 1996 turnaround year (see Exhibit 7).

EXHIBIT 7

COMPUTATION OF ESOP IRR

	Cash Flows		
Time	Pretax	Tax	After Tax
01/01/90	-100.00		-100.00
12/31/90	8.32	2.79	5.53
12/31/91	8.32	2.79	5.53
12/31/92	108.32	2.79	105.53
12/31/93			
12/31/94			
12/31/95			
12/31/96	2.65	-2.65	
IRR	8.32%		4.83%

Exhibit 8 gives some flavor as to the equations required to actually calculate the taxes in the tax column of those two previous cash flow charts. You have a current tax rate of 20%. The 20% is applied to your tax base. The first term of the tax is .5 times I (Interest). In other words, your current tax base includes one-half of your interest which is also included in your regular tax base. The next term is .75 times one-half of interest which is added back for AMT purposes. The following term is .5 times the differential earnings rate (DER) which, for this example, is 6.5%. DER is the assumed difference between the mutual earnings rate and the imputed stock earning rate. This is then multiplied by $200 plus investment income minus the current year's tax, $100 of the $200 is your surplus at the beginning of the year or your carrying value of the ESOP loan. The second $100 of this $200 is the start of your computations as to what surplus may be at the end of the year. Note that the current tax is in both the left- and right-hand sides of the equation. Since this is one equation and one unknown, you can solve for the current year's tax.

EXHIBIT 8

ESOP TAX FORMULAS PRIOR TO TURNAROUND YEAR

Current Tax:

$$T_N^C = .2\,[.5I + .75\,(.5I) + .5\,(DER)\,(200 + I - T_N^C)]$$

Regular Tax Generated:

$$T_N^R = .34\,[.5I + .5\,(DER)\,(200 + I - T_N^C)]$$

Deferred Tax Generated:

$$T_N^D = T_N^R - T_N^C$$

The next step is to determine the regular tax generated by this ESOP. This requires an expression similar to your AMT tax base except you do not have the add back of one-half of the interest. In addition, you apply a different tax rate (34%). Note in determining the surplus tax term, I used a current tax which is the tax that is actually payable in that year since that affects your statement surplus which is what determines your surplus tax. The current tax has already been determined in your first step of the calculation. So, you can now calculate the regular tax.

The third tax calculation you would perform for that same year would be to determine the deferred tax generated. The deferred tax is equal to your regular tax minus your current tax. Eventually, you will pay the deferred taxes in the turnaround year. Actually you will pay in the turnaround year something a little less than the sum of the deferred taxes since the additional deferred taxes will decrease your surplus tax.

As a final example I would like to consider a real estate investment. There is a building that you're going to buy on January 1, 1990. It's going to be 80% depreciable property and 20% land. I'm assuming for the purposes of this example that you are going to have 4% in appreciation in market value a year and that you are going to sell the building at the end of ten years. In addition, I am assuming that your cash flow will be a constant percentage of beginning year market value. So, your cash flow will go up 4% a year, too. And that question is, "What before-tax rate of return do you need to earn on the real estate to have the same after-tax rate of return as if you had invested in a 10% mortgage that is fully taxable?" Exhibit 9 gives the results. If you are a regular taxpayer you only need to earn 8.68%. If you're an alternate minimum taxpayer becoming a regular taxpayer in 1992, you have to earn 8.71%. Since you are earning 4% from appreciation, you have to earn 4.71% a year from the cash flow.

EXHIBIT 9

REAL ESTATE INVESTMENT EQUIVALENT TO
10% FULLY TAXABLE LOAN

Real Estate Return	
Regular Taxpayer	8.68
Alt. Min. Taxpayer	
Becoming a regular taxpayer in:	
1992	8.71
1996	8.86
2000	9.07
Never	9.27

If your turnaround year is 1996, the additional deferral gives you a lower tax rate which means you need a higher return on a tax preference investment, 8.86%. If your turnaround year is 2000, you have to earn 9.07%. If you're always going to be an alternative minimum taxpayer, the rate increases to 9.27%.

There is one difficulty involved with this type of analysis that should be of interest to those of you involved with the financial reporting side. When we were looking at the ESOP bond and real estate marginal tax effects, you actually had lower tax rates in the AMT years than if you were a regular taxpayer. So, on the margin, this one extra investment is generating less tax than it would generate if you were a regular taxpayer. On the other hand, the company as a whole is paying more tax than it would pay if you were just a regular taxpayer. Also, the AMT allocated to a new investment or product is not necessarily clear. Suppose you have $100 of regular taxable income, $70 of add backs and a new investment or product adds another $5 of add backs. There will be a $1 AMT. Should all of the AMT be allocated to that one investment or new product? Or, since you have $75 of add backs now, should you be spreading that AMT over the full $75? If you do that, what you're going to allocate to this one investment is a lot less than in your marginal pricing model. But that's a contradiction that I haven't found any way to get around.

I am going to briefly mention a few planning issues. One is the importance of financial projections. I think these examples illustrate that. In other words, the effect of the AMT depends greatly on whether (or when) you are going to become a regular taxpayer in the future. If you are a regular taxpayer now, the AMT has no effect. If you are an alternative minimum taxpayer this year, but next year you are going to be a regular taxpayer and the AMT you pay is creditable, there will be a very minor effect. On the other hand, if you're not going to be a regular taxpayer until 2010, then the AMT is going to have a very big effect. Therefore, you must perform projections if you want to determine the effect of the AMT. You must project what your regular tax will be, what tax preferences you will have, and the interaction between both.

The second planning issue addresses the permanent difference trap. That is, if you project that you will have a very low taxable income for some year, even a small amount of permanent

differences can cause a permanent extra tax rather than a timing difference. So, if you're holding tax-exempt bonds, stocks which you're holding for income or ESOP loans which cost permanent preferences, and you believe your taxable income is decreasing, you might want to sell them since many tax advantages for that year or group of years when you would experience very low taxable income might disappear.

FROM THE FLOOR: I have a question that relates to CRVM reserve. As you know, a lot of stock companies like CNA, AETNA, CIGNA, etc., sell ordinary par products. Virtually all of them set up a reserve for all future policyholder dividends and it is included in the benefit reserve calculations. How are stock companies, let alone mutual companies, going to reflect this dividend reserve in their ACE calculation?

MR. EDELSTEIN: Would one of the stock actuaries want to make a comment on how those reserves are affected in GAAP?

MR. PERROTT: I think the real problem goes back to the comment you referred to earlier in the interpretation of the language. It sounded from the clarification of the law that it is still a combination of tax reserves with nontax DAC. Under that basis, dividends have no effect. If it really goes to a total GAAP reserve basis, then the reserve for future dividend would just be part of the benefit reserve. Resolving the issue of which pieces are being matched up is the critical question.

MR. EDELSTEIN: One possible way of looking at it is that under GAAP your profit should be a constant percent or premium. Then you would have to determine your amortization schedule so that your profits under the tax reserves would be constant percent of premium and, in that case, your dividend reserves would not matter for either the stock company or the mutual company.

MR. BRUCE D. BENGSTON: I'm wondering if any of the esteemed panelists had a chance to look at what the implications are with FASB 97 of DAC amortization versus a lock-in principal on traditional products? What impact might that have?

MR. BLITZ: The answer is yes and I don't know. Conceptually, if you just follow the statute, whatever you do for GAAP accounting ought to be what you do for tax accounting for AMT purposes. And, in fact, if you talk with Treasury staff or those involved in the Joint Committee, they would agree with that. I believe when the IRS drafts regulations, the product will not be straightforward. They will make adjustments when they see abuse on the side of the taxpayer. But certainly until regulations are drafted, I think you're more than entitled to assume that whatever you actually do for GAAP is suitable for AMT purposes.