RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 1

RECENT DEVELOPMENTS ON COMPANY TAX ISSUES

Moderator: WILLIAM J. SCHREINER
Panelists: ARTHUR L. BAILEY*
KENNETH J. CLARK
CLIFFORD R. JONES†
Recorder: WILLIAM J. SCHREINER

- Capitalization of policy acquisition expense (Omnibus Budget Reconciliation Act of 1990)
  - Provisions of the act
  - General questions and issues
  - Reinsurance questions and issues
- Latest developments
  - Court cases
  - Regulatory matters
  - Audit issues

MR. WILLIAM J. SCHREINER: Our distinguished panel is going to talk to us about Recent Developments on Company Tax Issues. We will give a lot of attention to the so-called deferred acquisition cost (DAC) tax. Our first speaker will be Cliff Jones, the national director of tax for Insurance Industry Services and a partner of Ernst & Young in New York. Cliff will provide the background of the DAC tax law, describing the law and identifying some of the issues raised by the law. Our next speaker, Ken Clark, vice president of Lincoln National, will then address the DAC tax from the specific standpoint of reinsurance issues, of which there are many. Our third speaker, Art Bailey, who is a partner of Steptoe and Johnson of Washington, DC, will speak on other recent company tax developments.

MR. CLIFFORD R. JONES: As most of you are aware, prior to the 1990 tax act, companies were allowed to deduct current acquisition expenses for regular tax purposes. This was the general rule; however, Congress, the Treasury, and the courts, from time to time, had chipped away at that general rule. For example, for alternative minimum tax (AMT) purposes, beginning in 1990, all life insurers were required to capitalize and amortize DACs on a GAAP basis. Also, the Supreme Court in the Colonial American decision, which was decided in June 1989, held that ceding commissions on indemnity reinsurance transactions were to be capitalized and amortized over the life of the reinsurance contract. In addition, the IRS, in its regulations, had held that the purchase price of an assumption reinsurance agreement was to be capitalized and amortized over the life of the underlying policies. So, we had some areas where the current deduction of acquisition costs had been chipped away. Also, there was some sentiment that all life insurance acquisition expenses

* Mr. Bailey, not a member of the sponsoring organizations, is a Partner of Steptoe and Johnson, in Washington, District of Columbia.

† Mr. Jones, not a member of the sponsoring organizations, is the National Director of Tax for Insurance Industry Services/Partner of Ernst & Young in New York, New York.

should be capitalized and amortized for regular tax purposes, as they are in other industries.

When we combine this sentiment with a significant budget deficit, and with disagreements among insurers as to how life companies should be taxed, we had a climate that was ripe for Congress to do something. In addition, the Government Accounting Office and the Treasury had come out with reports indicating, in this climate of a need for more revenue, that it felt that the life insurance industry was not paying the revenue that had been anticipated from the 1984 act.

Without going into a lot more of the history, let me mention that the initial DAC proposals were estimated to increase tax payments by life insurance companies by approximately $15-16 billion over a five-year period. Fortunately, changes were made prior to the final passage, and this expected amount was reduced to $8 billion -- still a very, very substantial amount of revenue from the industry. There is still concern within the industry about the fact that Congress had targeted a $15-16 billion amount, and that Congress is going to need additional revenue in the future. There is concern that Congress will look once again in this particular area for more money.

Let me move on to the particular DAC tax provisions contained in the 1990 act. For regular tax purposes, companies will be required to capitalize and amortize acquisition costs. This is not simply for life insurance companies, but other insurance companies that write specific types of contracts will have the same requirement. Companies are not required to actually identify those particular acquisition costs. We now have a proxy approach. Companies are required to capitalize and amortize a percentage of total net premium, which would include first year as well as renewal premium income. The amount that's capitalized, and later amortized, is known as specified policy acquisition expenses. And these specified policy acquisition expenses will generally be amortized over a 120-month period.

This requirement does not apply to all products. It applies only to specified insurance contracts. These contracts are life insurance contracts, annuities, and noncancelable and guaranteed renewable A&H products. The percentages used to determine the capitalization vary, depending on the type of contract. For annuities, 1.75% of the total net premium is capitalized. For group life, the percentage is 2.05%. For other life and noncancelable and guaranteed renewable contracts, it is 7.7%.

So, just to give a simple example, if you had a company that wrote only individual whole life insurance, and its total net premium income for the year was $100 million, it would be required to capitalize, and would increase taxable income by, $7.7 million, prior to taking into consideration the amortization. So it's a fairly significant effect. The Secretary of the Treasury has the authority to come up with new percentages, if it's determined that the percentages currently in effect require a company for a particular product to capitalize an amount greatly in excess of the actual acquisition expenses that are incurred. As you might guess, with everything that seems to be a benefit from Congress, we have a little caveat. And it works as follows: if the Secretary were to give a lower percentage to a particular product, and let's just say for example, the Secretary says disability insurance will be capitalized at a 3% rate. You take a look at the category that the product comes out of, and the percentage for that category will have to be increased. For example, 7.7% would increase to a

higher number, so that there's no loss of tax revenue from this particular provision. The IRS has said, on a few occasions, that this will probably not be an area where Treasury will exercise its authority.

The proxy DAC provision, as it's called, was effective on September 30, 1990. For 1990, rather than start with total net premium as of that date and go forward, there was a part-year allocation that took total net premium for all of 1990 and simply took 93/365 of that amount to determine the 1990 amount of DAC.

Let's turn for a moment to amortization periods. I mentioned that generally you amortize the specified policy acquisition expenses over a 120-month period. You use what's known as a half-year convention. In effect, you start the amortization in the first month of the second half of the year that you incur the specified policy acquisition expenses. So, for example, if you had specified policy acquisition expenses that were incurred in 1991, your amortization in 1991 would be 6/120 as a general rule. There is an exception to the 120-month rule. It applies to all companies that do not have a significant amount of specified policy acquisition expenses. To the extent that the company has $10 million or less of specified policy acquisition expenses in the year, then the first $5 million is amortized over a 60-month period. As specified policy acquisition expenses exceed $10 million, there is a dollar-for-dollar phaseout. At $15 million, the insurer no longer has the benefit of the 60-month amortization. As an example, let's assume that you have, for the year, $12 million in specified policy acquisition expenses. That would exceed the $10 million threshold by $2 million. Then you would reduce the maximum amount, subject to the 60-month amortization, of $5 million by the $2 million. Thus, there would be $3 million in specified policy acquisition expenses subject to the 60-month amortization and the remaining $9 million would be subject to 120-month amortization.

There is a controlled group rule, as there typically is in any provision that might be of benefit. You have to combine the specified policy acquisition expenses of your domestic life insurance affiliates, domestic property casualty affiliates, and your foreign companies that are doing business in the U.S. Those expenses would be combined for purposes of phaseout calculation. There's a special rule for companies assuming reinsurance: they're not allowed to take benefit of the 60-month amortization.

Let's talk for a moment about specified insurance contracts. I mentioned that they include life, noncancelable and guaranteed renewable health insurance, and annuities. There is a provision that says that where an annuity contract is combined with a noncancelable, guaranteed renewable A&H contract, that the particular contract is subject to the noncancelable and guaranteed renewable capitalization. As you would suspect, that's the amount that gives you the highest capitalization. We wouldn't expect Congress to go in the opposite direction.

Also, within this particular area, there's a special reinsurance rule, known as a look-through rule, where basically, rather than looking at the reinsurance contract, we look at the underlying contract.

When you look at specified insurance contracts, you get into some interesting questions. What is the definition, for example, of an annuity? What qualifies an annuity, since this is a very beneficial item? If you look at the Internal Revenue Code

(IRC), you're going to see there are many questions raised, because there really isn't a pure definition of annuity, other than under Section 72(s). So, we're seeing a number of questions in this particular area as to what constitutes an annuity.

Group life insurance is another area where it would be important if you can classify an item as group life to do so, since rather than using a 7.7% capitalization rate, you would be using 2.05%. We have some guidance as to the group life definition; however, there are still going to be many unanswered questions, even with the guidance. There are three tests to pass to qualify as group life insurance. The first test, basically, is that the contract has to be determined with relationship to a group – an employer, some type of organization, etc. Second, the premium has to be determined on a group basis. So, obviously, if you had an individually rated product, it probably would not meet the second requirement. And third, the benefits have to be payable to someone other than the employer, the organization, and so forth. This third requirement immediately raised some questions in the credit life area, where very often the proceeds are payable to the lender. There is a provision that holds that, in the credit life situation, the fact that the benefits are payable to the lender does not mean that the product would not qualify as a group life contract, assuming it meets the other tests. I think you can see there are a number of questions as to which contracts will meet the group life definition. Do you really have a group? What is a group? What makes up a group? Is it a group premium? Or is it individually rated? There are going to be many issues in this area.

Since the theory behind the proxy DAC was to capitalize your acquisition expenses, Congress felt that you shouldn't have to capitalize more than your total general deductions for the company for the year. So there is a limitation. You are not required to capitalize more than the total general deductions for the year. This is defined, for you who love to wallow in the IRC, as the expenses included in Sections 161 through 196, and 401 through 419A of the Code. Basically, this means those expenses that are included on Exhibits 5 and 6 and commissions. If the specified policy acquisition expenses for the year exceed this general deduction limitation, then only the amount of the general deduction limitation is capitalized and there is no carryover to a future year.

We talked about specified insurance contracts, but there are three exceptions to the definition. One, a very significant exception, is a contract that's issued to a qualified plan. Qualified contracts are excepted from the proxy DAC calculation. This would include qualified pension plans, profit-sharing plans, IRAs, and other types of qualified plans. The second exception is for flight insurance. And, I think, we really appreciate the fact that Congress has decided that you don't have to capitalize and amortize your acquisition expenses over 10 years for a policy that may last two, three, or four hours. And there's a third exception for certain foreign contracts that are issued by foreign branches of U.S. corporations.

What is a net premium? Basically, net premium is gross premium, less returned premium, and less premium or other consideration arising out of reinsurance. In effect, you follow the definition for life insurance companies of premium income. So, for example, premium income would include things like deposits, fees, and assessments. It would be determined on accrual basis. Items such as deferred and uncollected premiums would not be included in premium income. In addition, items

such as phantom premiums, typically, would not be included in premium income. Items such as experience rating refunds, excess interest, and certain amounts paid on supplementary contracts, where the actual amounts remain within the contract, would not be included. It's kind of a "cash in" concept. Where cash is coming into the company, that would typically be premium income. Where cash is just staying within the company, then it wouldn't be. I think this is an important point: for federal income tax purposes, these items are typically treated as a policyholder dividend out, and premium income back in; but where the cash does not leave the contract, typically, you'll find that it will not be new premium income.

If you had a significant cession of reinsurance, it is possible to have a negative premium that exceeds your net premium income. Where you have negative premium for the year, you can get some benefit. Typically what you do is go through your capitalization calculation, and the negative premium for a particular type of contract would be multiplied times the percentage applicable to that group. And, if on the total basis, you had a negative capitalization amount, you can recoup, to the extent of that negative capitalization amount, prior years' amounts that you have capitalized, and get an immediate deduction. You cannot carry that amount forward, though. So if you haven't had prior years' capitalization amounts, you get no benefit from them. If you had a negative capitalization in 1990, since the law was not in effect in prior years, you would get no benefit from it.

One last item: the alternative minimum tax. I mentioned right at the beginning that life insurers, beginning in 1990, were required to capitalize and amortize their acquisition costs on a GAAP basis. Because we now have a regular tax provision, there was no need to continue the provision for amortization of acquisition costs under the AMT. As a general rule, that provision is repealed effective September 30, 1990, the effective date of the proxy DAC provision. Most companies will be required to capitalize and amortize, for AMT purposes in their adjusted current earnings calculation, their acquisition expenses for 1990 on a GAAP basis. Once again, it is on a prorated basis. You do the calculation for the entire year and pick up 272/365 of that amount in your AMT calculation. This rule does not apply to small companies -- companies with less than $500 million in assets. There's a controlled group rule and several other rules for this. So if it's a possibility that the AMT would affect you, then you ought to look at it. For those small companies, the actual AMT calculation is repealed effective the beginning of the year. So you don't have any AMT amount that you have to pick up for those particular companies.

We excluded certain foreign contracts from the proxy DAC, but we can't totally leave things simple. You have to add a little complexity. These contracts require capitalization and amortization of acquisition costs on a GAAP basis for AMT purposes.

MR. KENNETH J. CLARK: Those of you who followed the tax law last fall will recall that, at one time, Congress considered and Treasury supported the DAC tax based on direct premiums only, not net of reinsurance. The IRS was familiar with some of the problems that reinsurance can cause in the area of taxation. But Congress wanted to be rational; they thought that the profit followed the premium; therefore, the DAC tax should follow the premium. And what we have is a tax based on net premiums.

FACT: Net premiums are net of "return premiums on such contracts and premiums and other considerations incurred for reinsurance on such contracts." Rules of Section 803(B) apply.

But Treasury did get a provision in the law that says that if the premiums are ceded to a non-U.S. taxpayer, then they can't be deducted by the ceding company. This was an attempt to close off what might have been a loophole.

FACT: Premiums and other considerations incurred for reinsurance may be deducted in calculation of net premiums only if included in gross income of an insurance company taxable as an insurance company or under Subpart F.

There have been some people who have suggested that the reinsurance company has to be paying U.S. tax currently for the ceding company to receive this treatment. I think the language, though, is pretty clear that if you're ceding the business to a company that is making a 953(d) election, for example, they would be treated as a U.S. taxpayer, or doing a U.S. trade or business, filing a U.S. tax return, or if it's subject to Subpart F, that premium ceded to such foreign companies should be deductible by the cedent. Whether the company's currently paying a tax ought to be irrelevant. It would appear, though, from the way it's worded that a company assuming business from a non-U.S. taxpayer and then retroceding it to a non-U.S. taxpayer still has to include the premium that it assumed in its tax base.

There was concern that cedents and reinsurers wouldn't treat the reinsurance consideration consistently.

FACT: Secretary shall prescribe regulations to ensure consistent treatment by cedents and reinsurers.

Treasury will issue regulations to ensure industry-wide consistency. In the committee reports, there is some guidance as to the rules that will apply until such time as the Treasury does issue final regulations. But it also says that Treasury is not bound by these preliminary, temporary rules, and that the final rules don't have to comply with the temporary rules. It's obvious that these regulations will be a major factor in determining how the DAC tax will be shared between cedents and reinsurers. Lobbying will probably occur. In fact, it has already begun, in terms of what those regulations will say with respect to defining a reinsurance consideration.

FACT: For classification purposes (life, disability insurance [DI], group, etc.), reinsurance contract is classified same as contract reinsured.

It's quite logical that the reinsurance premium should be classified in accordance with the underlying contracts. Reinsurance premiums reinsuring an ordinary life policy ought to be classified with ordinary life, the 7.7% class. However, when you get into nonproportional reinsurance, bulk treaties (some group may not be group for this purpose), retrocessions, it gets very confusing. Even though the rules may be very clear, administration may not be as simple.

FACT: Small company rule allowing five (not 10) year amortization excludes reinsurance premiums, but not from phaseout calculation.

I think what was intended here, in this small company rule, was that a company would compute its direct premiums, minus its ceded premiums, and that net amount of premium would get the five-year treatment. If it has reinsurance assumed, it would also deduct from those reinsurance assumed premiums any retroceded reinsurance premiums and apply 10-year amortization to that calculated amount. However, if you read the law and if you read the committee report, it would seem that, instead, direct premiums get five-year treatment, and reinsurance assumed minus direct ceded minus reinsurance retroceded get 10-year treatment. A quite different result. And it's not clear whether this might be an exception to no negative premiums. I can imagine, if this is an exception, then a company which passes through a large volume of business, retrocedes most of it, could actually have a negative tax for five years and a positive tax for the following five years, and actually get a tax benefit from this rule and a negative net tax cost.

FACT: Ceding commissions incurred after September 30 under contracts reinsuring specified insurance contracts shall not be capitalized (repeal of Colonial American).

For those of us who were involved in the Colonial American decision, it was a pleasant surprise that this tax was passed as a DAC tax, even if a proxy tax. As a result, it was logical to repeal Colonial American for all reinsurance, except for the contracts that are not specified insurance contracts and not subject to DAC. It clarified a lot of issues. AMT is now not as perilous. You can plan much more easily. It is a plus to have a DAC tax that is predictable (five- and 10-year amortization), and repeal of Colonial American, as compared with the prior environment.

ISSUE: Computation of "net premium," attributable to reinsurance, is not clear for many specific items under various forms of reinsurance. Types: coinsurance, modified coinsurance, and combined coinsurance/modified coinsurance. Items: initial premiums, initial ceding commissions, annual allowances, benefit payments, modco adjustments (including interest), surrender values, state premium taxes, policyholder dividends, interest on funds withheld, funds withheld, experience refunds, risk and expense charges, termination payments, and effect of tax/statutory reserve differential.

The big issue is going to be: how do we compute a net premium, the pieces that are attributable to reinsurance contracts? We have different types of reinsurance contracts with possible different treatment and with different timing of the elements. It seems clear that initial premiums paid on bulk treaties will be treated as premium. Initial ceding commissions and allowances probably will not be, but there are private letter rulings in the federal excise tax area that may suggest otherwise. It would seem, though, that if you're going to include these items in the specified expenses in the cap, you shouldn't also treat them as reinsurance premiums. Benefit payments: probably not. Modco adjustments: probably; they're mentioned specifically in the committee report. Surrender values: possibly; as mentioned, there are some federal excise tax rulings that treat those as negative premium. State premium taxes: they'll probably be a reimbursement, like an expense item, and probably treated like commissions. Policyholder dividends: probably; they're in the committee report. Interest on funds withheld: it'd be consistent with the interest on the modco reserve adjustment (MRA) to include that item. Funds withheld: it's very possible that Treasury may say that you don't deduct either a premium or a commission that's

withhld until it's paid in cash; that is, until there's actually a cash transfer, there's no recognition for purposes of computing premium. Experience refunds: yes. Risk and expense charges outside the contract: probably. Termination payments are explicitly mentioned in the committee report with respect to coinsurance contracts. They'll probably treat modco the same way. That is, on termination of a reinsurance contract, the large payment of the reserve to the ceding company will be treated as a negative premium. And, also, as mentioned, there won't be any phantom premiums included in these calculations. It'll be the tax reserve that'll be used as a basis for determining these initial amounts and commissions.

ISSUE: Large bulk reinsurance transactions can result in negative net premiums. The Act allows credit for negative premium, first to reduce amount of capitalization for that class of specified insurance contracts, then other classes. Any remaining negative balance can be applied to unamortized balance from prior years. Any remaining negative balance may not be deducted or carried forward.

There was reference to the process that you go through if you have a negative premium for a class of contracts. In large bulk reinsurance transactions, it's very possible to have a large negative premium. If you go through the steps, you may have a balance that's unused. There's no provision for carrying that balance forward or carrying it back. It's simply lost. And that amount can be very large if a company is selling off a large block of its business. What a company might do is assume business in the year in which it enters into a very large retrocession contract.

ISSUE: Since reinsurance affects "net premium" and thus amount of DAC tax payable by cedents and reinsurers, in what situations might Treasury apply 845, claiming "significant tax avoidance effect"?

There's reference in the committee reports encouraging the application of Section 845. This section authorizes the Treasury, in a case where there's a significant tax avoidance effect, to reallocate the effect of that transaction among the parties. It's not been applied to date. I would hope that it's not applied aggressively in this DAC area. If it is, it may be applied in some of the other areas where they have been reluctant to apply 845. There should be encouragement to use 845 (to be consistent with the committee reports in 845 as well as 848) where a company enters into a reinsurance transaction for purposes of avoiding the loss of net operating losses (NOLs) that are going to expire.

ISSUE: Amount capitalized by an insurance company cannot exceed that insurance company's general deductions limit, not calculated on a controlled group basis. One can imagine possible abuses.

Congress may have been too clever here, in trying hard to make this law look like a DAC tax, without actually going through all the steps of making you identify your actual expenses, actually capitalize them, and actually amortize them. So Congress adopted this proxy tax, which is really a deferral of deductions. Since it didn't make any sense to defer expenses you hadn't incurred, they put in this cap. The problem with the cap is that, in theory, one could cede a large block of business or blocks of business to a small company that has very low expenses. Assume a small company has only $1 million of expenses and it accepts on a risk premium reinsurance (RPR)

basis $2 billion of premium, which would generate $154 million (7.7% x $2 billion) of deferred income. But it only has $1 million of expenses, and only $1 million gets deferred. The result of that would not be a shifting of tax to the reinsurer, but an avoidance of tax. The premiums would just disappear and not be part of the tax base that's supposed to generate billions of taxes. Those of us familiar with 820 modco that the industry will take advantage of provisions like that, if they think they are legitimate. Treasury's been made aware of this problem. I think there will be some solutions suggested to them. One might be a very broad interpretation of general deductions. There could be a reallocation of the expenses among the parties. They could change the DAC tax law. They may decide they have to change the law to close this loophole. And Treasury has the power to apply a section, Section 269, which provides that with respect to any company formed after the DAC law was passed, Treasury could effectively ignore the transaction. If the reinsurance company was formed after the tax was passed, Treasury could apply that section to reverse the effect. It's in the industry's interest to solve this problem. I can imagine a scenario under which the industry effectively cuts the tax burden 30 or 50%; you can imagine what the next tax law would look like.

ISSUE: Calculation of general insurance expense limit needs clarification: (1) general expenses, (2) ceding commissions, and (3) What if cap is negative? Need to prevent abuse.

There are issues regarding how to compute general expenses and how to compute the limit in the cap. It would appear that ceding allowances received by a ceding company would not be a deduction from expenses. Even though using Exhibit 5 and Exhibit 6 was mentioned in Committee report, there's some question whether the IRS will allow you to reduce your cap by negative commissions, the allowances you received on business that you cede. And there is no mention of a negative cap. The question is, What if the cap is negative? If, in fact, you can deduct allowances you receive, it's conceivable that the cap could be negative. The absence of any reference to a negative cap may be evidence that you cannot deduct ceding allowances received.

Again, it'll be interesting to see how the IRS and Treasury address some of these issues. Will there be retroactive solutions? Will they be prospective only? Will there be grandfathering when they make some of these changes? There definitely is uncertainty.

ISSUE: What effect (if any) do funds' withheld features have on treatment of reinsurance contracts?

I mentioned before the possible conclusion that a fund's withheld feature for a premium or a commission may defer the actual recognition of that item until it's paid in cash. There's some basis for that in the IRS position on other tax issues.

I can understand why Congress carved out certain classes of business not subject to 848. When they repealed Colonial American, Congress also said the repeal did not apply to those classes of business that 848 does not apply to. That's no problem for flight insurance and short-term A&H because the useful life of the business is very short. Even if you are required to capitalize and amortize ceding commissions on

these classes of business, you write it off fast. It's probably not an issue. But pension business? It doesn't make any sense. Perhaps they were trying to create a level playing field with mutual funds and banks. That's the reason stated for excluding tax-qualified business. Why have Colonial American still apply to reinsurance of that business, which has a long, useful life? It doesn't make sense. I don't think any reinsurance treaties recognize the DAC tax; to the extent the reinsurer has a premium, the reinsurer must pay the tax on that premium for in-force business. On new issues, we don't know how that's going to be resolved. Reinsurers will try to raise their prices. Ceding companies will try to raise net cost of their products. It'll be decided in the marketplace.

ISSUE: When DAC credit is to be denied because reinsurer is not a U.S. taxpayer needs to be clarified. Retroactive adjustments? Committee report reference to NOL limitations creates uncertainty.

Foreign reinsurers shouldn't have an advantage. It's true they don't pay a DAC tax. But the ceding company has to pay a DAC tax on that premium, so it should put foreign reinsurers not subject to DAC tax in the same competitive position in the U.S. marketplace as a U.S. reinsurer.

Some companies have large bulk reinsurance treaties in force. They were entered into two years ago, five years ago, whenever. There may be cause or reason for them to want to recapture these large blocks of business. Recapture will generate DAC tax for the recapturing company and a tax benefit for the reinsurer. I doubt if the IRS will have any sympathy for the recapturing company. They'll argue, "Well, those premiums that supported and built up that reserve weren't taxed five, 10 years ago. They weren't subject to DAC tax, so what are you beefing about?"
It's always possible, unfortunately, that these tax percentages will increase in the future. It seems that a provision that required the cedent to reimburse the reinsurer for any DAC tax incurred just won't be workable in practice. We have premium tax reimbursement provisions, but a DAC tax reimbursement provision is going to be very difficult to administer. A company selling a large block of business is going to have the problem that was described earlier. There are $1 billion, $2 billion transactions done that would generate huge, negative, unusable DAC tax credits for the ceding company, at the same time they generate DAC tax for the assuming company. That's the cost of doing business.

Treasury has implied or suggested that they would get regulations out in time for filing 1990 returns. Some people don't think they will meet that deadline. Companies may have to file without any guidance, except what is in the Congressional reports and the law itself. You can make a case that Treasury's not motivated to move quickly. That's been the case in a number of areas involving reinsurance. They see a benefit in uncertainty.

MR. ARTHUR L. BAILEY: These folks have given you a real dose of DAC taxes. I've got everything else to talk to you about. Before turning to the everything else: on the subject of regulations in the DAC area, I think I tend to agree that the predictions are usually more promising in terms of when regulations are going to come out than the reality. It is clear from the contacts that I and others have had with people at the Service that they're very actively working on the DAC regulations.

A couple of comments on what we might see in those DAC regulations: Steve Hooe, with the IRS, certainly is focusing, because it's in his own interest and the interest of people in the industry, on the reinsurance issues, many of which Ken has focused on, and among other things, on points that Cliff raised about the rule with respect to phantom premiums and cash in the company. Although, in my recent discussions with him, he did point out that they have focused on 1035 exchanges, and see those as giving rise to DAC premiums, clearly when they come from outside exchanges. Just to be fair, I think Steve's inclined to tell you that if you have an inside-the-company exchange of policies, he may want to give you a DAC tax on the deemed premium coming in on that exchange. So, whether the regulations come out by September or not, it's clear that they are working on those issues and saying that they're interested in hearing from us.

I'm going to survey briefly four areas – legislation, regulations, audit issues, and litigation – and give you an update of recent developments in the company tax area. The first item in legislation is actually somewhat easy to deal with, because for the first time in recent memory, we're not sitting here with Congress in session and a major tax bill on the table. There are no proposals for a major tax bill right now and no proposals for a major hit on insurance companies right now. That's not to say that we don't live in fear that that's going to start up at any moment. You may have noted Senator Grassley spoke to an industry group last month and was widely quoted in the papers for saying that Congress may look at industry taxes and look at DAC again. My own assessment is that sometimes these speeches are created to have something to say, instead of really meaning that they intend to do something to us. I think the consensus in Washington is that we're not slated for major congressional attention this year. While we're not in the bull's-eye of a major tax bill, however, I'm sure many of you are aware of various nonglobal legislative proposals that would affect insurance companies.

First, in the last couple of weeks a bill was introduced by Congressman Donnelly (as I go through this, you'll see he's been very active in the last couple of months, in the proration area). As you know, the differences that apply to the life and the property/casualty companies in the tax treatment of tax-exempt bonds, municipal interest, and so forth, have been a source of some tension within the industry. Last year economist Henry Aaron gave a proposal to Congress for uniform proration, which would have improved the life company proration a little bit and disimproved the property/casualty company proration treatment, and left individuals alone. Donnelly's bill takes a somewhat different approach. He borrows on the general proration rule that applies to banks and corporations generally, wraps it up in a policyholder share system, and basically puts a big hit on the property/casualty companies, and individuals, without proposing changes on the life side.

Within the two weeks that this bill has been alive, it has gotten significant attention from the state and local bond lobby which is inundating the Ways and Means Committee with complaints. The reason for the proposal is that Donnelly has a bill, and the system now is you have to pay for anything you want. So this proposal pays for something he wants. His bill would permit a deduction for separately stated sewer and water fees charged by local townships. Apparently, in his neighborhood back in Boston, these fees can be significant. Maybe they're expected to be more significant. In any event, he would have a deduction for those items, which the IRS,

under current law, says are not deductible. And pays for this with the proration bill. His bill is House Bill 1552.

Another bill that's pending in the House (actually there are a couple of versions that have received attention from insurance interests) relates to intangibles. Donnelly was first out on this one, as well. He proposed a bill that was very unclear in what it's intent was with respect to insurance issues. The basic thrust of the bill is to disallow an amortization deduction for customer-based intangibles. In his supporting statement, Donnelly made reference to including insurance in-force. Whether he was referring to customer list or whether he was referring to amounts paid to buy a block of business, that reference got industry attention, and resulted in a bill, sponsored by Congressmen Vander Jagt, Andrews, and Anthony, and Congresswoman Kennelly. That bill makes clear that the current law treatment of customer list, insurance expirations, and similar matters would not be changed. Obviously, this issue is mostly of concern to property/casualty agencies where these sorts of assets can constitute half the value of the agency. The Vander Jagt bill sets up a standard that says you can get this amortization deduction so long as the item has a value that is separate from goodwill, and it has a limited and determinable useful life. So we have those two bills, proration and intangibles, which are being monitored by insurance companies.

Now, the product side. We have a corporate-owned life insurance (COLI) bill, actually a couple of COLI bills. We can expect to see some joint committee revenue estimates very shortly on those bills. The attention here is that some joint committee people are saying, these bills, while they are intended to cut back on COLI, are really indirectly reaffirming the ability to have COLI and borrowing under those policies. And so there have been some claims that, rather than being revenue raisers, these bills might be revenue losers. Obviously, if that were the case, they would get some significant attention. And I'm sure many of you know Senator Bradley and Congresswoman Kennelly have accelerated benefit rider bills that seem to be sort of simmering right now.

That's legislation. To sum up: there are no big global issues there; just some important lesser bills. The other $8 billion that Cliff referred to is not yet on the table.

Turning to regulations, probably the number one life company regulation that we're interested in is the DAC regulation that I referred to before. Outside of that, the main items that are under consideration at the Service and the Treasury are Section 7702 and 7702A related. Once you get rid of the product tax regulations and you get rid of DAC regulations, what you're left with is one regulation that was issued a month ago: proposed regulation dealing with salvage and subrogation. Salvage and subrogation is obviously a property/casualty provision. It has its roots back in some temporary regulations that were published by the Treasury, I believe in late 1987, where they said they were going to change what had been the rule, or what everybody had thought had been the rule for the last 40 years, and require salvage and subrogation to be taken into account on an estimated basis, not on a when received basis in the calculation of the loss incurred deduction under 832. That proposal obviously was very controversial. The Treasury backed away from it. But while they backed away from the proposal under existing law, they came out with a budget proposal that was to institute this rule for the future. The rule has, as you

know I'm sure, significant fresh start benefits and other transitional issues or relief provisions. Even so, a somewhat brief regulation was issued a month ago, clarifying how the Service would apply the transitional rules, and providing what I consider to be the appropriate relief in the absence of any salvage recovery pattern data, which the Treasury is in the process of gathering.

There are proposed regulations under Section 953. The 953 provisions defined something called insurance income for purposes of the controlled foreign corporations (CFC) rules. These are CFCs that are substantially owned by U.S. taxpayers. In the last couple of tax bills, Congress has taken significant steps to expand the reach of the U.S tax laws with respect to the activities of foreign companies and, in particular, foreign insurance operations. The 953 regulations are a complete rewrite of the existing 953 regulations to bring them into conformance with the new rules. The 953 regulations may not be of widespread interest, but if your company has foreign operations, you're certainly interested in these. It's an interesting set of rules. It makes distinctions between income that your foreign company earns in its home country, and income that your foreign company earns on dealings outside of its home country. It makes distinctions between underwriting income and investment income. It makes distinctions between related party foreign income and nonrelated party foreign income. There's an interesting twist to these regulations that I will mention to you when I talk about some litigation that I've been involved in recently. But nevertheless, these are 150 pages of regulations that just came out. They're out yesterday. They are significant if you have foreign operations. One thing that was hoped for in those regulations and received a fair amount of attention at the ACLI was an answer to what happens when your foreign company issues a policy that doesn't qualify under 7702? You want an 807(c) reserve when you calculate the taxable income of your foreign company. If you're a U.S. company, that treatment would be in doubt if you had a nonpolicy. Notwithstanding the fair amount of contact between industry people and the Treasury over the last couple of months on this issue, it was not dealt with in the regulations. It was specifically withheld and industry comment was requested.

Next, I want to turn to audit issues. I'm going to try to cover four points: two in the general area of audits and two in substantive issues. On the first point, the tax press has been giving a fair amount of attention (*The Wall Street Journal* had an article the other day, quoting the Commissioner, Fred Goldberg) to the fact that the Service is overwhelmed by the big company and the rich taxpayer audit. They're basically doing a very good job of auditing you and me, because all of our income is wrapped up in information returns and they can do 95% of what they have to do with the computer audit. What's evident is that the Service lacks the resources to conduct the kinds of audits that it feels it has to do in the large case area, and in particular in the insurance area.

Apropos of this, I'm sure more and more of you are aware through your own contacts with the Service, that they are engaging outside actuarial consultants to assist them in the audits of your companies. In the 1990 tax bill the Service got some clarifying language which reinforces its view that it is allowed to share your taxpayer information with a consultant in the conduct of an audit. And so they're going full bore on that. And those of you who are actively involved in 1984 act audits, I suspect, are learning more about the level of that involvement at this time.

Having said that, let me comment on where the Service is in performing their audit function. How far along are we? I'm in the process of working on a completely informal, unscientific survey which leads me to predict that probably a third of you have wrapped up your audits of 1984, the first year of the 1984 act. And probably somewhat less than a third of you have completed, wrapped up that appeal, or not had an audit, with respect to the 1985 tax year. That kind of progress in auditing a new tax law is striking. When you look at what was the case in the 1959 act, where we basically had the first 10 or 15 years of the 1959 act open forever, to see the kind of progress that we've made here, I think it is indicative of two things. One, that this law is by a mile a lot simpler than the 1959 act. And second, what there is in this law to audit is, I won't say beyond the capabilities of the Service, but they need assistance and they're getting assistance. And I think the audits, as they progress in the later years, are going to be more protracted.

On audit issues in particular we were identifying and discussing the arguments, pro and con, on an issue that has become not uncommon within the companies. This is the reserve area, and particularly the start-up years of the 1984 act. Many of you have found, given the timetable from when the 1984 act came into being, and when you had to start complying with it, that there was just too much to do in too short a time. And some estimating and some approximating was done in the reserve computations and more so in the 1984-85 period, maybe, than later. What you have done in the meantime is to fine-tune those calculations that have revealed errors which, in many cases, you want to correct. When I last spoke on this subject, we had identified that as an issue and we had the Service in a defensive mode saying, "No, we're not going to allow you to go back and correct these numbers." And the Service was doing some extraordinary things. If you had your numbers on your tax return, and then the correct set of numbers, they'd pick and choose which set of numbers gave you the worst possible answer. Just outrageous.

Well, sanity has come to the process. And the recent development here, for those of you who were not in attendance at the Federal Bar Association meeting in Washington in February, Walter Harris, who is the insurance coordinator for the IRS based in New York, was on the program. And he spoke to this issue. And I've taken notes of what he said. I'm going to repeat them here. "Under the new law," Walter said, "the taxpayer must follow 807. It is binding on the taxpayer and it is binding on the Internal Revenue Service. There is no discretion to vary the computations specified in the statute." Well, that's what we had said, in wanting to correct the numbers. This statute is self-executing. It's not based on what's in an annual statement. It's not based on some outside thing. The statute tells you what your reserves should be and how they should be calculated. And the Service shouldn't resist that. He says, "You must look at all the facts and circumstances and the burden is on the taxpayer." Well, that's fine. The burden's always on the taxpayer. Then he says, "If the taxpayer can prove that the reported reserve is erroneous, that it is based on either a math error or a clerical error, and not the error of judgment, then the taxpayer is able to correct the reserve." That's, I think, about 99.9% of the correct answer. There is clear precedent in the case law that says you're not allowed to bring new judgment to old facts and change your reserve computations. But where it's not a judgment issue, where it's a math error or a clerical error, you should be able to get the right number. He's been asked, what does he mean by -- the $64,000 question -- "What's a math or clerical error?" He

answers the easy ones. "If it's a table mistake, a wrong mortality table, that's an error, a math error. If it's an interest rate error as to what is the prevailing rate, for example, that's an error that you correct." The vast land of what's in between, between an error of judgment and those obvious examples, remains to be defined. That was February. In the last couple of weeks, there have been contacts with the Service on this issue again. Yes, they stand behind the statement they made at the Federal Bar Association. Then they direct their agents to do three things. Look exactly at how the reserve was, in fact, computed. Look exactly at how the correct computation is made. And is the difference a big one? And having a big difference is a good thing. Because he'll let you change it if it's a big difference. He really doesn't want you fine-tuning these things. And you don't want to, either.

I guess the most important thing to say for the two-thirds of you who still have the 1984 year open: if you find yourself in a situation where you guessed wrong as to your fresh start amount, you ought to be considering taking a look at getting those correct numbers in, assuming you guessed wrong in their favor. And that should be available to you.

I do want to now cover a couple of items on the litigation side. I'm sure many of you are interested in what's happening in the United States Auto Association (USAA) case. That's the 818(c) case in Universal Life. Not very much has happened other than that the case was argued recently, here in New Orleans, at the Fifth Circuit. My own judgment is this is a good court to bring a complex issue like that. You probably can expect as fair a shake here as anywhere. People in attendance at the argument said it went reasonably well. So, they're hopeful and optimistic. But we've probably got a couple months or more before we're going to know what the Fifth Circuit has to say on 818(c) for Universal Life. Those who are in audit, waiting for that case, have obviously experienced that the price of settlement has gone up since the tax court decision. My own assessment here is if they make you turn into being a beggar, you ought to just wait and see what the case comes out with. There continues to be a significant difference in the settlement postures in the various appeals offices. And, obviously, if you're in one that is fairly good, then you want to take advantage of that.

I'm sure many of you have had your attention drawn to the tax court decisions, the trilogy of late January 1991. The court decided the captive issues that had been raised in the three cases, Harper, Americo, and the Sears-Allstate case. There is significant industry pleasure in the victory that the taxpayers realized in those cases. The tax court was almost unanimous and these were reviewed opinions. There was one dissenting judge, Judge Whalen. The court adopted a three-prong standard: Does this transaction purport to insure an insurance risk? Is there risk pooling? Does the transaction seem consistent with general notions of insurance? The third standard's a little vague. Without respect to the first standard in all three cases: these were pretty straightforward property/casualty type risks that were on the table. With respect to the risk pooling issue, as I'm sure you know, the government has a very hard-line position here. If you are a wholly owned insurance subsidiary, they don't care how much outside risk there is. Evidence their decision to pursue the Allstate-Sears case, where the outside risk exceeded 99%. The court was certainly comfortable with the outside risk in Sears. And then having stepped on that slope, they looked at 50% outside risk and seemed comfortable, and then looked at 30%

outside risk and seemed just as comfortable. These cases all now are ready to be appealed. The government has yet to make its appeal decision formally. The difficulty the government experiences here is that the worst case, for them, is Sears. And that case goes to the Seventh Circuit, which will hear and probably decide the case, maybe a year before the Ninth Circuit will get to hear the companion cases. And that's the worst set of facts for the government. So they face a difficult decision there. You ought to know, and it's too bad in a sense, that the Sears case was so widely looked at for the captive issue.

There's another very important issue in there for property/casualty companies on their mortgage insurance loss incurred calculations. The government took a very hard-line position and had a spectacular victory. The mortgage insurance is insurance on somebody's mortgage; if the mortgage borrower goes in default, the insurance company pays the lender. The industry practice -- the annual statement practice -- is if this thing's in default for, I think, four to five months, then you set up an annual statement liability, and then you take a loss incurred deduction on your tax return. The IRS takes the position that, "Look, four or five months doesn't mean that you have a loss incurred. I want to wait until you either pay the loss or you have foreclosed on the property." Basically taking payment as the loss incurred event. A very hard standard. They won on it. It should be appealed by Sears-Allstate, and maybe even the subject of amicus participation by industry groups.

The last case that I want to talk about is near and dear to my heart, because it was a case that I worked on. I tried it two and a half years ago in the tax court. The taxpayer was Phoenix Mutual. There were four issues in the case. All four were decided in the favor of the taxpayer. The court issued two opinions, and these have come out recently. A couple of these issues are industry-type issues. The first deals with something called prepayment penalties on corporate mortgages. Are they entitled to capital gain treatment or are they interest income? Now these, by the way, are 1959 act issues. The background here is that the tax court had decided this issue in favor of the government in the Prudential case. That case went up on appeal, and the tax court was reversed. Both the tax court opinion and the Appellate opinion looked at this question on the basis of fact and common law principles: are these amounts like interest or are they not? And said, in the case of the tax court, they're like interest, and in the case of Third Circuit, they're not like interest. When we took this case to the tax court, we argued a statutory argument that you ought not apply these common law principles. Statutory Provision 1232 says that amounts received in the retirement of a corporate obligation are treated as amounts received in the sale or exchange of capital asset. That and the language of 804 told us that it wasn't interest income. The first opinion issued in the Phoenix case said, "Yes, these are entitled to capital gains treatment. No, they're not interest income." And significantly, the court overturned its own prior decision in Prudential. The rule in the tax court generally is if they lose in one circuit, they press their position in the other circuits. In a reviewed opinion, the tax court unanimously decided to abandon its own prior opinion, and to rule in favor of the taxpayer. So we like that.

The next opinion came about 10 days later. The court separated the opinions for reasons of the fact that the first opinion was a reviewed opinion. All 15 judges signed on to the capital gain issue. The next three issues were matters of first impression and there was no need to get the whole court on board. So the opinion

was issued separately, 10 days later. Three issues were involved: two reserves and one expense allocation. The reserve issues dealt first with waiver of premium or extended death benefit under group life. Is it a life insurance reserve? The taxpayer, Aetna, has won that issue in the claims court, and it is on appeal to the Federal Circuit, argument forthcoming. The tax court agreed with Aetna and wrote a very good opinion. The Aetna opinion in the claims court is not all that helpful. The result is terrific, but the opinion is abysmal. This opinion's a good one, and hopefully will help Aetna in its federal circuit appeal from the government.

The other issue was an extension of the standard life and accident deferred and uncollected premium issue to group life. In the late 1970s, the Supreme Court said you've got a reserve for deferred and uncollected in the case of ordinary life. Some companies had taken the position that was a proper thing to do, not just for ordinary life, but also in group life. The tax court decided not to follow the claims court, which had held in favor of the government on a related case, and ruled in favor of the taxpayer, and said you were allowed to use the annual premium assumption in group life. Finally, the Phoenix case involves an expense allocation. This takes you back to 1959 act in allocations between investment and underwriting. The company had taken the position that a portion of its agents' commissions should be allocated to investments on one of two theories: either that those costs were responsible for bringing onto the books a group of policies from which the company earned both premium and investment income or, the alternative theory, that the agents were involved in the policy loan aspect of the policies and that some portion should be allocated to take into account their policy loan-related activities. The court was more impressed by the latter theory than the former theory. It ruled in favor of the taxpayer, allowed 13% allocation, and chose not to follow or distinguish adverse precedent in the Eighth Circuit and in the claims court. We're waiting, obviously, to hear whether the government's going to appeal any issues in that case and, if so, which issues.

The little wrinkle at the end, I want to say, the 953 Regulations I mentioned before, about distinguishing between investment income and premium income and home company activities and nonhome company activities contain a provision that requires an allocation of policy acquisition expenses, including commissions to investments. So the government ought to chew on that regulation when we look at it on appeal.

MR. BRIAN D. FORMAN: Can you give us any background as to why, on the DAC tax, if they were trying to capture acquisition costs, why didn't they use first-year premiums instead of all premiums?

MR. JONES: There was a lot of consideration given to first-year premiums when they were considering the DAC tax. And I think that was obviously something that had been proposed. Congress was aware of the fact that there would be a correlation between first-year premium and the actual acquisition expenses. But I think there was some concern about the possibility if you just use first-year premiums to get around the DAC provisions. That seemed to be some of the undercurrent that kept coming out. They were really looking to see whether you could get around the provision if you had first-year premium as the tax basis. There was a lot of concern about that. I think that was probably the principal reason.

MR. FORMAN: Is it clear that on cancelable types of A&H contracts, there is no DAC tax?

MR. JONES: It is clear on cancelable types of A&H that there's no DAC tax. But there is a haircut for advance premiums and unearned premiums. There is a 20% reduction, similar to the reduction that was imposed in the 1986 act for property/casualty companies. And that haircut is, in effect, taking the place of the DAC tax.

MR. FORMAN: As far as the foreign reinsurers are concerned, if you have a treaty, say with an intermediary, and the intermediary is a U.S. company filing a tax return, you pay your premiums to them, but the companies involved are foreign companies, is it clear what happens in the DAC tax situation?

MR. CLARK: Is the intermediary an insurance company or simply a broker that's handling the funds?

MR. FORMAN: Let's say it's a broker that's handling the funds, but you're writing the check to that person.

MR. CLARK: I think the contract is with the foreign reinsurance company, not the intermediary. The intermediary is acting as an agent, not as an insurer/reinsurer.

MR. JONES: One thing in this area that we didn't point out specifically are some of the other burdens that are involved here. Just trying to identify who pays tax in the U.S. or is subject to tax in the U.S. is more of an effort than you might expect just to see whether you can get a credit. That alone is going to be somewhat burdensome under this act.

MR. GEOFFREY I. GUY: My view is that stock and mutual debate last year did the life insurance industry a lot of harm when it came to the eventual outcome of the tax legislation. Do any of you see any light at the end of that particular tunnel? Do any of you have any comments as to whether we might see a favorable outcome to that particular debate?

MR. SCHREINER: The ACLI has, for a number of years, attempted to provide a forum for the mutual companies and the stock companies to come together and resolve their differences. In fact, a negotiating team that helped the Egyptians and the Israelis get together was hired. They were unsuccessful in this area. But the effort continues. I think the industry has a clear understanding that as long as it's split, there's a certain weakness perceived by Capitol Hill about the industry and the industry certainly is regarded as a target. Recently, committees have been set up and we're working on an attempt to gather, with the cooperation of the companies, data on income taxes. And this effort will continue. As to what the final outcome will be, the individual companies will have to make that decision for themselves; the ACLI can only provide the forum.