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EMERGING TAX ISSUES

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Panelists: AUGUST C. CHOW
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Recorder: PHILIP J. BIELUCH

- Overview of latest developments on:
  - IRC Section 7702
  - IRC Section 848
  - Market value adjusted contracts
  - Companies in rehabilitation
  - Canadian issues including
    - Part I income tax
    - Part IV capital tax

MR. PHILIP J. BIELUCH: Steve Hooe is branch chief of financial institutions and products of the Internal Revenue Service (IRS). Steven's group watches over life insurance taxation and casualty taxation at the IRS. Mike Cogswell is an attorney and vice president and senior counsel of Merrill Lynch Life Insurance Group. August Chow is a principal at William M. Mercer, Limited in Canada. He's going to talk about the Canadian issues. He is working on a paper on Deferred Income Tax in Canada. And, finally, we have Tom Gick; Tom is a partner at Sutherland, Asbill and Brennan in Washington.

The first thing we're going to talk about are three revenue rulings just published. They are on minor issues and one concerns annuities. Steve will talk about these rulings.

MR. STEPHEN HOOE: Well, the first two rulings really dealt with company tax issues and I'm just going to touch on those briefly. The first ruling basically authorizes a property and casualty insurance company to do the same thing that the regulations have authorized life insurance companies to do for years, that is provide insurance on your own employees. You don't have to go out and buy your insurance on your employees from your competitors. I doubt that this answer is a surprise to many folks, but the ruling makes it clear.

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The second ruling has probably a little more significance. The ruling makes it clear that a parent company can purchase insurance for its employees from its wholly owned subsidiary. Basically, a subsidiary can insure a parent's employees; that is, the transaction will not run afoul of the captive insurance analysis that the IRS has espoused for a number of years. The ruling also states that the service will not follow the Gulf Oil decision to the extent that the decision indicated that a parent could not purchase insurance on its employees from its captive.

The third ruling is the one that's probably of most interest here. It deals with an exchange of a deferred annuity issued by Company A for another annuity contract issued by Company B where the contract holder immediately annuitizes the second contract. The issue is basically whether the contract holder can escape the 10% premature withdrawal penalty on the distributions from the second contract. The issue ultimately comes down to whether the amounts received under the contract issued by Company B fall within the immediate annuity exception of Section 72(g). The ruling concludes that the second contract does not qualify as an immediate annuity because the purchase date of the second contract relates back to the date of acquisition of the original contract. Thus, assuming that the original contract was acquired from Company A more than a year prior to the exchange, the contract holder would not have commenced distributions within the 12-month period required to qualify as an immediate annuity.

Support for the ruling is found in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) legislative history. The legislative history states that for purposes of the exception relating to pre-August 14, 1982 investment in the contract, if one did a 1035 exchange, investment in the contract given up was to carry over to the new contract received in the exchange. That is, a contract received in a 1035 exchange is to be treated the same as the exchanged contract – the contract given up. We think it's reasonable to construe the immediate annuity exception in a consistent manner.

MR. THOMAS A. GICK: If I might interrupt for just a moment. Steve, the ruling concludes that the purchase date of the new contract is the purchase date of the original contract. There is a private letter ruling dealing with Section 264(a) and grandfathering thereunder. In that private letter ruling, it was concluded that in a Section 1035 exchange the date of the exchange would be treated as the date of purchase. What are your thoughts on the different treatments with respect to this issue?

MR. HOOE: Well, again, I think the rationale for the published ruling is supported by the particular legislative history under 72(q), particularly the TEFRA legislative history. To the extent that you're going to carry over the pre-August 14, 1982 investment in the contract to the new contract – that is, carry over that attribute – it would seem to make sense that one would carry over the other attributes as well. Indeed, the legislative history does indicate that various attributes do carry over in a 1035 exchange for purposes of the 72(q) penalty. It may be that like elsewhere in the Internal Revenue Code (IRC), the same word does not necessarily carry the same meaning.

MR. GICK: Then there is a possibility that you might rethink the private letter ruling I previously mentioned?

MR. HOOE: I'd be happy to entertain a ruling request.

MR. GICK: We are going to talk about several topics concerning reasonable mortality charges. The first one that we are going to talk about is the recent issues that have come up with respect to using 100% of 1980 Commissioners Standard Ordinary (CSO) for Section 7702 calculation purposes. But before doing that, a little background may be helpful. Back in 1984, when Section 7702 was enacted under DEFRA, the mortality charges that could be taken into account for Section 7702 purposes were the charges specified in the contract. Due to some perceived abuses and maybe some real abuses, there was a change made in 1988 to this provision by Congress. Specifically, Congress adopted the reasonable mortality charge provision. The statutory language under the provision provides that the charges that can be taken into account for Section 7702 purposes are reasonable mortality charges which meet the requirements prescribed, if any, by regulations and which except as provided in those regulations do not exceed the commissioners' standard tables as defined in Section 807(d) which deals with the mortality tables that can be used in computing reserves for federal income tax purposes.

After the enactment of this provision, Revenue Notice 88-128 was issued which established several safe harbors. One safe harbor that the notice established was that 100% of 1980 CSO would be treated as a reasonable mortality charge regardless of what your actual charges were under the contract. The notice left open, however, a question of whether mortality charges less than 1980 CSO might ultimately be adopted in the final or proposed regulations. The proposed regulations which came out in July 1991 also adopted this safe harbor. Discussions ensued, however, after the notice, and regulations were issued between the life insurance industry and the IRS to determine whether 100% of 1980 CSO was correct. The IRS had a couple of concerns about using 100% of 1980 CSO.

MR. HOOE: Basically, using data for Universal Life policies where the information was available, we attempted to determine what companies were currently imposing as mortality charges on their contracts. Generally, we found that the charges were considerably less than the 1980 CSO amounts.

Also, the premise of the safe harbor in the proposed regulations is that 100% of 1980 CSO is necessary in order to avoid setting up a conflict between 7702 and state nonforfeiture laws. That is, industry representatives told the IRS that the standard nonforfeiture law requires insurance companies to compute nonforfeiture values using 100% of 1980 CSO and the interest rate stated in the contract. Subsequently we became aware that that may not be the case.

MR. BIELUCH: Specifically, the IRS became aware of Actuarial Guideline XII, which is published in the *Financial Examiners' Handbook of the NAIC*. The guideline establishes minimum cash values in a contract. Starting with the 1980 amendments, standard nonforfeiture values are to be calculated. Minimum cash values are no longer required to be based on the interest rate in the contract, but instead are based upon the maximum nonforfeiture interest rate. This is discussed as one option. But it's also noted that not all states follow this interpretation of Actuarial Guideline XII. The IRS, in fact, did a survey of the commissioners on this question.

MR. HOOE: Yes, we did survey the states. We found 36 states followed Actuarial Guideline XII, that is, they did not look to the interest rate specified in the policy as the basis for computing the minimum cash value.

MR. BIELUCH: About how many other states responded that they did not?

MR. HOOE: Eight.

MR. BIELUCH: It is our understanding that the NAIC is currently looking at changing Actuarial Guideline XII.

MR. HOOE: Yes, we understand that Actuarial Guideline XII may be repealed. What is not clear to me is whether the Standard Nonforfeiture Law is being changed. Because if you look at paragraph – I think it's 5(c)(9)of the Standard Nonforfeiture Law, it indicates that minimum cash values are to be determined using the 1980 CSO and the nonforfeiture interest rate. The nonforfeiture interest rate is a defined term in paragraph 5(c)(9). Actuarial Guideline XII appears to be doing nothing more than simply restating what is explicit on the face of the Standard Nonforfeiture Law.

MR. BIELUCH: The next area we are going to go into is multilife contracts. Tom Gick will again provide the background.

MR. GICK: The proposed regulations on reasonable mortality charges that came out back in July 1991 provided a safe harbor which allowed 100% of 1980 CSO to be used in doing Section 7702 computations so long as a lesser charge was not specified in the contract. Specifically excepted from that safe harbor, however, were multilife contracts, contracts that insure more than one life. It should also be noted that multilife contracts were not specifically addressed in Notice 88-128, and Section 7702, for the most part, seems to talk in terms of single-life mechanics as opposed to joint-life mechanics. As a result of all this exception, the rule in the proposed regulations, that second-to-die or multilife contracts are subject to for determining reasonable mortality charges, is that you can use mortality charges the insurance company actually expects to impose, taking into account any relevant characteristics of the insured of which the company is aware. In addition, you must also take into account the likelihood of surrender. It is my understanding that the likelihood of surrender was specifically aimed at second-to-die contracts. Steve can perhaps elaborate on this a bit more, but the IRS was concerned that in second-to-die contracts, because mortality charges in some of these contracts are lower while both lives are being insured, that the contract operates very much like a deferred annuity and, as a result, multilife contracts should perhaps not get life insurance contract treatment. Rather, they should be treated more like annuity contracts. Steve, is that a fair characterization of where the IRS stands on this point?

MR. HOOE: In light of 7702A(c)(6), we recognize that second-to-die or multilife contracts may be entitled to treatment as life insurance contracts. That does not indicate, though, how a multilife contract qualifies under 7702. There are numerous difficulties involved in the qualification of these contracts. By taking into account the likelihood of surrender, the proposed regulation was attempting to police the second-to-die area. The premise underlying 7702 is that there is going to be a sufficient amount of risk between the cash value and death benefits under a life insurance

contract. As a result of the presence of the risk, the contract will impose meaningful mortality charges. These charges, in effect, reduce the internal rates of return under the contract in a way that the IRS or Congress can be assured that the purchaser is buying life insurance for traditional life insurance reasons as opposed to simply purchasing an investment contract. In the case of a second-to-die contract, mortality charges are very low while both insurers remain alive. It begins to look like an attractive investment vehicle. We're to prevent the use of second-to-die contracts as tax-deferred investment contracts while at the same time recognizing that second-to-die contracts historically have served a legitimate estate tax-planning purpose.

MR. GICK: On that, Steve, the industry, through the American Council of Life Insurance (ACLI), has made a recommendation to try to resolve this perceived problem. Specifically, it has been suggested that upon surrender, a second-to-die contract would be treated as a modified endowment contract. Your thoughts on the ACLI's proposal?

MR. HOOE: Well, the premise to the industry's proposal is that if you look at the lapse rates for second-to-die contracts, it's a relatively small number. That is, the industry states that most second-to-die contracts are being held until the death of the second person and thus are being used primarily for estate tax-planning reasons. While that may be true, we are concerned as to how second-to-die contracts might be used in the future. Moreover, in connection with the industry's proposal to invoke 7702A(c)(6) to treat second-to-die contracts as Modified Endowment Contracts upon surrender, one would wonder as to just how much the IRS would pick up under the proposal. I mean, upon surrender, if you surrendered it early, you always have income on the contract under Section 72(e). I'm not sure that the IRS would gain very much upon a partial or a reduction in benefits pursuant to (c)(6).

Another proposal that one might want to consider is whether it would be appropriate to exercise the Section 72(e)(5)(C) regulatory authority such that distributions from second-to-die contracts during life would be subject to the annuity withdrawal rules. That would also seem to be one way of addressing the problem.

MR. BIELUCH: I think we're going to move from that to another reasonable mortality regulation area, substandard. I will start with a little history. The reason we have a reasonable mortality regulation requirement in the Code Section of 7702 is that there was some single premium being sold back in the mid-to-late 1980s that everybody called substandard and used 1,400% of the 1980 CSO in the development of guideline single premiums. With this backdrop the question that comes is, "What is an objective definition of substandard? Is guaranteed issue by itself an okay definition of substandard? Is extended term an okay definition of a substandard? Does this make a standard policy substandard?"

Certainly the substandard mortality charges, without being specifically referenced in Revenue Notice 88-128, are subject to the interim rule of not being materially different from what is actually expected to be charged. Flat extras on participating whole life or table ratings on participating whole life at nonparticipating flat extras added to a dividend mortality. There are four methods that have been proposed for charging for substandards that ought to be allowed under the final reasonable mortality regulations. These are the (1) flat extra approach, be it a temporary flat

extra or be it a permanent flat extra; (2) the multiplicative approach – this is where a percentage of the 1980 CSO table is used for purpose of the guideline premium calculations typically; (3) an additive approach where the table rating on the substandard, the current cost, is added to the 100% of 1980 CSO; and (4) age rating. I was wondering, Steve, if you have any comments on these different approaches.

MR. HOOE: One general comment first. If you look at the proposed reasonable mortality regulations and the definition of substandard risk, it was a very general definition. If we establish safe harbors for substandards, it may be necessary to consider how to tighten that definition.

With regard to the various methods, we probably have the most problem with the multiplicative or percentage extra approach because the approach permits multiples of the margins in the 1980 CSO table. We are aware that there is a significant margin between the basic table, the table that was constructed based on the raw data that was developed, and what is out there now as the 1980 CSO table. We have less concern with the flat extras.

With regard to age rating, we have some concern whether age ratings give rise to reasonable mortality charges throughout the duration, the entire duration of the contract. It may be appropriate -- in the case of the female being moved to a male schedule of mortality charges – to go back a number of years. That would establish the relationship between the number of male deaths and female deaths as of a particular point in time. However, it is questionable whether that relationship continues over the entire duration of the policy. While I am not an actuary, it seems to me that the ratio of males dying to females dying will vary considerably as one moves out over the entire duration of the contract.

MR. BIELUCH: Moving along, another hot issue is whether a term rider on the base insured in the contract is a qualified additional benefit. There is one private letter ruling out, 9106050, that actually defined it as qualified additional benefit (QAB) and not an integrated death benefit. For example, if you have $100,000 of whole life on an insured and you have a $200,000 other insured rider issued on the same insured, this private letter ruling would not allow you to use a $300,000 death benefit for purposes of the corridor on the guideline premium test, but would say that you had a $200,000 QAB and a $100,000 base insurance coverage. It would also arguably change the definition of what is used in calculating the guideline premiums for $200,000 of insurance from the cost of the death benefit on reasonable mortality basis to the charges actually expected to be imposed.

Two issues do come up in this area. One issue that is actually expected to be imposed was part of 1988 Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and may require current mortality charges on that piece. And the other one is there is arguably a requirement in Section 7702 that QAB charges not increase. It's a question of with an increasing mortality rate, what would happen with an increasing mortality charge in this situation?

The other area where this becomes very important is on integrated whole life participating contracts that have target term or some term fill-in calculations, because if you treat it as a QAB, then under certain calculations or options, it may look like you get a

different seven-pay premium. You do have to adjust it then for decreases in this term rider death benefit in the first seven years, lowering your seven pay premium if it is a QAB.

Let me also point out the famous Jackson National Amendment that was referred to here earlier by code section that requires decreases over the entire lifetime of the contract to be taken into account for purposes of reducing the seven pay, so that a second-to-die integrate whole-life contract that actually has a target term reduced to zero by the end of the duration of the contract may get no additional seven pay premium from this target term.

MR. HOOE: I have two basic comments. First, I think the letter ruling is consistent with the TEFRA legislative history. The TEFRA legislative history indicated that a family term rider included a term rider on the primary or base insured. In fairness, though, I would point out that the ACLI has asked us to reconsider the issue and that we continue to think about it. At this point I guess I tend to be skeptical of the industry's arguments. I still see the TEFRA legislative history and under the literal language of that legislative history a term rider on the primary insured is a QAB.

Phil, I agree that to the extent you pointed out that under Section 7702(e)(1)(a), which indicates that neither death benefits nor QABs can increase, that in the case of a QAB what one may be talking about is the charge for the QAB. Under subsection (f) of 7702, the benefit itself is not a future benefit for the purposes of 7702. Rather, it is the charge for the benefit that is considered the future benefit. And that may well be true for purposes of applying the computational rule in Section 7702A.

MR. BIELUCH: I think, now that we've learned all the ways you can fail, we're now going to move on to the treatment of failed contracts.

MR. GICK: It is my understanding that the treatment of failed contracts has been discussed extensively in previous Society of Actuary meetings and I will not go into a great deal of detail. Suffice it to say that there is a method to correct failed contracts. There is a method that is actually set forth in the code and then there is a method that is not in the IRC, but a company with failed contracts can avail itself of this method too. The one that is in the code is a waiver request and actually under either method you will be required to file a waiver request. If you can demonstrate that you had your contract fail because you had a reasonable error and you are taking reasonable steps to correct that error, the IRS, to date, has issued waivers of such a failure with -- and this is important -- no toll charge.

Well, what happens if your error is not reasonable? There is provision in the Code to correct this type of error, but the IRS will allow contracts which have unreasonable errors to be corrected as well. Here, however, and this is the big difference from reasonable errors, the IRS is going to exact a charge from the companies for this failure. That toll charge is 28% of the income on the contract plus interest and plus the possibility of penalties. One penalty that might be assessed is failure to report. I would also point out that the failure to report penalty can reach as much as $15,000 per contract if it stays out of compliance long enough.

Perhaps we should talk a bit about what is a reasonable and an unreasonable error. An unreasonable error -- and Steve, if I misstate this, please correct me -- an unreasonable error is one in which your contract fails because you did not take into account the plain language of the statute or the legislative history. You disregarded such plain language in doing your 7702 calculation. A reasonable error is one where there is an ambiguity in the statute or the legislative history and the IRS does not agree with your interpretation, but agrees that, yes, you could have reasonably interpreted the statute to work that way. Typical reasonable errors that have been granted waivers to date are clerical and mathematical errors, human-type errors, in doing computations.

An example of an unreasonable error, the example Steve Hooe constantly gives to me, is one in which a company in calculating guideline single premiums takes into account increasing death benefits which is clearly violative of Section 7702. Is that fair?

MR. HOOE: I think you're being fair. I mean, what we're really looking for is for the taxpayers to demonstrate that they reviewed the statute and put in place a system designed to ensure at least minimal compliance with the requirements of Section 7702. To the extent the rules were clear on the face of the statute, companies should establish a procedure to ensure that they comply with those rules. Having done that, if you can come in and demonstrate to us that you have that system in place and someone made a human error, then we have granted waivers with respect to those errors.

Not only that, but as Tom pointed out, there are a lot of unanswered questions under 7702. If a company can come in and demonstrate that an ambiguity exists as to what is the correct rule, the fact that we don't agree with your interpretation will not preclude the granting of a waiver. If we recognize your interpretation of the statute was reasonable, then in the absence of regulations or further guidance from the service, we may grant a waiver.

But where a company comes in with an error that violates a rule that is clear on the face of the statute and, for example, taking increasing death benefits in computing the guideline single, then it is hard to say that that company has really read and thought about compliance with Section 7702. At that point we're looking at an unreasonable error and it becomes a choice as to what is in the best interest of the system taking into account the company's interest as far as its relations with its policyholders and the IRS's interest in collecting the tax that's due to the United States. It does not involve the imposition of a penalty. This is just a question of the tax that's due to the United States from the policyholders. The company, for public relations reasons, may choose to pay it in lieu of having its policyholders pay it. The IRS may be interested in collecting the tax from the company as opposed to having to pursue a thousand individuals across the country. But it's not a penalty for an unreasonable error, it is simply the collection of tax with respect to an amount that is due and owing to the U.S.

MR. GICK: One other item that we should point out is whether you get a waiver because you had a reasonable error or if you pay a toll charge because your error is

unreasonable; in either case does the IRS require that your policyholders be informed that there was such an error. That might be good news.

However, if there is anything that I can leave you with about failed contracts, it is that it might be a good idea to start taking Section 7702 compliance seriously. The reason why I say this is that until now there have been no Section 7702 audits. Recently, however, the IRS announced that it will begin auditing for Section 7702 compliance. You might ask, "How is the IRS going to go about doing that?" First, the IRS recently received from the ACLI a Lotus spreadsheet which sets forth Section 7702 calculations for guideline and cash value accumulation test products.

The IRS might be able to check your systems with that program. But before that, there are certain things that the IRS has indicated it could do. Indeed, it is really rather easy for the IRS to check 7702 compliance. Specially, the IRS has indicated that they will ask a couple of simple questions. The first question will be, "Do you have a 7702 compliance system in effect?" If you answer no, well, you can guess what is going to happen. If you answer yes, there is going to be another question. The next question is going to be, "Has that compliance system discovered any 7702 failures to date?" If you answer no, fine. If you answer yes, I think the question is going to come, "Well, how come you haven't gone in and asked for Section 7702(f)-(8) relief?" The IRS will tell you, and I think that they're correct on this, that the only way you can correct the error is to go in and get a waiver from the IRS.

There is one more question that the IRS might have up its sleeve even if you answer all of the above-mentioned questions correctly. The IRS has received a number of waiver requests. Some of these waiver requests have dealt with inherent errors in certain purchased software. The IRS knows what these systems are and they could very simply ask, "Do you have System X? Do you have System Y? Do you have System Z? We understand that there is an error with this system. Have you discovered it? What are you going to do about it?" This is something that you may want to start thinking about – hopefully everybody is thinking about it already.

One last item – there was a ruling issued earlier this year which indicated that – again, this dealt with purchased software – that perhaps any error in purchased software may not be a reasonable error, at least that's the way some people are interpreting the rulings. Mike Cogswell has a couple of thoughts on that ruling.

MR. MICHAEL P. COGSWELL: One thing about this ruling from a company standpoint, Tom, is the company's gone out and purchased a software package that they believe complied with 7702. If you read the ruling, the ruling is 9202008, there were human and clerical errors and they granted waivers for those, but there was an inherent structural design in the software for which no waiver was granted.

MR. GICK: The inherent design flaw in the system, according to the ruling, did not take unscheduled premium payments into account.

MR. COGSWELL: It sure leaves a company in a position that they are either going to apply for the administrative relief under 9117 and pay the tax that is due or they are going to seek redress against the vendor depending upon the terms of that software

agreement. It appears to me that what the IRS is saying is they're not going to be the guarantor of the performance of the software package.

MR. HOOE: I think that is the teaching of the ruling. You should not come away from or view the ruling as saying all software errors are per se unreasonable. That's not the message of the ruling. Basically, we are going to look at the nature of the error in the software package and determine whether that error was a reasonable error. I mean, if your software package takes increasing death benefits into account, we probably are going to say that the error is unreasonable. But, as to other types of errors, it's really incumbent upon the taxpayer to come forward and identify the error and demonstrate that it was a reasonable error. However, we also have read the vendor's disclaimers of any implied or express warranties of fitness of software for particular purposes. If the vendor is unwilling to guarantee his software, the government will not guarantee it either.

MR. COGSWELL: But, Tom, it seems to me that one of the things a company could do to try and help its case along is to adequately test the software on a number of different scenarios when the package is received and build a case that if, in fact, there's something that's discovered down the road, at least you've done the due diligence to set up your case if you have to go in and ask for a ruling.

MR. GICK: I think, again, the IRS would say that all those things are helpful. I might add, however, that you may discover that going back and trying to determine what happened in 1984 or 1985 -- seven, eight years ago -- under your computer system that you have modified several times since then, to figure out exactly what might have caused this glitch may be more expensive than the toll charge.

MR. HOOE: I would agree that it is incumbent upon a taxpayer who purchases a software package to test that software to be sure that it does comply with 7702, at least those rules which are clear on the face of the statute. If someone comes forward with a software package that's in clear violation of one of the computational rules, but they say, "We tested the software," we're going to be somewhat skeptical. But I think the way that you deal with software errors in a waiver is to show that you purchased the software, tested it, and the type of error is not the type of error that would be discovered with any sort of reasonable amount of testing. If a company can demonstrate this, then it may well have a case that is appropriate for waiver.

MR. COGSWELL: All of us, I think, are anxiously awaiting the final regulations on Deferred Acquisition Cost (DAC). I do want to highlight a couple of areas where the industry has voiced concerns, particularly through the ACLI, and that concerns the group contract area or if group contracts are able to qualify for a reduced capitalization rate. One of the issues that's in the proposed regulations is what is the basis on which premiums are determined on a group basis? The proposed regulations take the position that you need to satisfy two tests, one is the identical premium test wherein the insurer charges the same premium or differs the premium only on the basis of gender, smoking status, or age. The other test is really the eligibility test and that requires that the insurer not deny or limit coverage to any member of the group. There is an exception for group term products, those without a cash value. They can deny or limit coverage on the basis of a simple medical questionnaire. There's

another exception for group term or group products that had underwriting, but that expires at the end of the year.

Now the industry has been concerned here, because it doesn't seem to address group cash value products and they've expressed concern about the need to guard against antiselection, so they need some limited underwriting. It's been suggested that the IRS's concern is they want to avoid any sort of bundling of individual contracts to achieve a group DAC tax rate. So there's this tension. There's been a number of discussion papers back and forth on this issue and we're anxiously awaiting to see what the final regulations say about that.

The other issue really deals with internal exchanges. Again, the proposed regulations don't seem to give any relief with respect to intracompany exchanges. I'm led to believe there are different practices. Some companies don't pay any commission or sales charge to their field force for selling these products. I've been told that there are some companies that do, but the concern the industry has raised is you're really hitting the same premium twice, where it's just a rollover, an upgrade, or an internal exchange. You're hitting the same premium with a second DAC charge.

MR. HOOE: First, with respect to the group life insurance, the intent underlying the proposed regulations was largely to codify what we thought was this current practice in the industry. When we received the comments saying that nothing currently sold as group insurance would qualify as group insurance under the proposed regulations, we realized what a great job we had done. That being the case, I think that we have to revisit the definition of group and the limitations on the underwriting requirements. While we do have concerns as far as the bundling of individual contracts or the migration of individual cash value contracts into the group category for purposes of 848, we certainly did not intend to come up with a federal definition of group that was totally foreign to what the industry has viewed as traditional group contracts over the years.

With regard to the intracompany exchanges, there is a problem. I mean, we are aware of some companies paying reduced commissions on intracompany exchanges. Certainly if you pay any commission or if you have acquisition costs and you're currently deducting those acquisition costs, then it's appropriate that the exchange be subject to Section 848, which is by its nature a proxy for acquisition costs. Because it's a proxy, it works as fairly as any other proxy works, that is, some people will benefit and some people will have the detriment of the proxy.

I obviously can't tell you how the final regulations are going to come out on either issue. I would anticipate that there would be some revision in the final regulations with respect to both issues.

MR. COGSWELL: Any chance they're going to be out before year end?

MR. HOOE: They're on the business plan to get out before the year end and we expect to meet the deadline.

MR. BIELUCH: That's this year end, right?

MR. HOOE: Yes, unlike the 7702 regulations which I have promised for a number of years, the final regulations should be out before the end of this year.

MR. BIELUCH: The next area we want to talk about is market value adjusted annuities. There was a provision contained in HR11 to change the tax treatment of these annuities. There have been past panels at the Society that have discussed this tax problem which is due to the fact that separate account market value adjusted annuities for tax purposes have the assets at amortized cost and liabilities at a proxy for amortized cost or the present value benefits of the applicable federal interest rate, but never less than the statutory reserve. The problem that the HR11 provisions were attempting to address was that with an increase in interest rates, the reserve on a statutory basis would spike down establishing a new floor for the tax reserves -- while the assets would be at amortized cost creating a very high gain in the year of spike upwards in interest rate. We've done some projection showing that the gains on a tax basis can be upwards to 20% on a long duration market value adjusted annuity. Certainly the way to move the assets to market from a tax point of view is to sell the assets and buy new ones. Unfortunately it would be terrible if the Federal Tax Code encouraged the transaction costs or market disruption of selling assets just to achieve a tax result.

It's our understanding, though, that this bill has been reported to the White House, but it was reported so that the President would not have to consider vetoing it or pocket vetoing it prior to the election with the hope that maybe he would consider signing it. I guess Fred Goldberg has announced that the President will veto that bill.

Also contained in the bill was a provision concerning acceleration of death benefits, tax treatment. Steve, is it your business plan for this year? Would you discuss it?

MR. HOOE: The business plan also calls for providing guidance concerning accelerated death benefits. The guidance likely will deal with what happens to a contract when you add an accelerated death benefit rider to the contract. That is, what is its impact on grandfathering. In addition, guidance likely will be provided concerning how a contract with an accelerated death benefit demonstrates compliance with the 7702 requirements for life insurance. Again, it is on the business plan to be out by the end of the year. We would intend to make that deadline also.

MR. BIELUCH: Now Mike will talk about companies in rehabilitation revenue rulings.

MR. COGSWELL: There are three rulings that I want to discuss.

The first deals with the serially funded exchange. In certain rehabilitation proceedings, the policyholder may not be able to either withdraw, as a withdrawal from the policy, all of the cash value, or, in the course of a 1035 exchange, be able to assign the whole cash value to a new company. But that amount that's retained in the policy may be available for subsequent distribution. The IRS, in rendering ruling 9243 has issued a ruling that in the course of an exchange, if a policyholder assigns an annuity contract to a different company and is issued in exchange a new contract, the company in rehabilitation is obligated to send any remaining amounts to the new carrier. That would be treated as a valid 1035 exchange even though the full amount

isn't sent over at the time the new contract is issued. It also indicated that in the case of a life contract, a similar rule would apply there.

One thing we've been hearing rumors of is that certain companies have been taking the position that a code section which prohibits assignments of pension plan contracts may prohibit them from effectively assigning residual balance in the contract to the new carrier. Steve, do you have any thoughts on that?

MR. HOOE: I think that, at least tentatively, one should be able to do it. That's a tentative inclusion. I would urge anyone who's faced with the issue to submit a ruling request and we'd be happy to address the issue in a ruling request. The IRS did issue a ruling in 1990 that a trustee to trustee assignment was not a realization event. While the 1992 ruling uses the Section 1035 mechanism to allow one to take the money in cash but presumably invest it in a new plan with a new trustee within 60 days, it would seem that that transaction would fall within the spirit of the ruling if not within the literal letter.

MR. COGSWELL: The ruling you were just discussing is ruling 9002044. This ruling is very helpful to the industry in that it gives us a mechanism where policyholders can actually touch the cash and still complete a 1035 exchange. As most of you know in the past, if the proceeds of a surrendered policy were actually paid to the policyholder and they took that surrender check and gave it to a new company in issuance of a new contract, the IRS has taken a position that that's not a valid 1035 exchange. With respect to troubled companies, however, Revenue Procedure 9244 will allow that exchange to happen if certain conditions are met: the old policy which is being surrendered is issued by a company in rehabilitation or a similar proceeding, the taxpayer must withdraw 100% of the value of the contract or if a lesser amount is only available as a result of the proceedings the taxpayer must take the maximum amount to which he or she would be entitled under those proceedings. The exchange would otherwise qualify as a 1035 exchange or under ruling 9024 as essentially a direct trustee to trustee transfer in the case of 403(b) annuity contracts.

Finally, the policyholder must invest the cash in a new contract issued by a different company within 60 days following the receipt of the cash or if later by September 13, 1992. Now if the distribution is restricted, the policyholder must also assign rights to any future distributions to the new carrier. There is also a requirement that an information statement be attached to the policyholder's return and that certain information be provided to the new carrier regarding investment in the contract and the amount of cash distributed.

This ruling has raised a couple of issues concerning if you have a rehabilitation proceeding where the policyholder is given an option that he can either take, for example, 55% of the cash value of the contract now and be subject to a massive surrender charge or take a reduced amount but be able to get the full cash value, say, over a period of 10 years. What is the maximum amount to which the policyholder is entitled for purposes of this ruling? I think the ruling doesn't answer that at this point.

Another issue is let's assume a policyholder had a life contract, had a withdrawal from the contract and had received the cash, and he or she applied for underwriting to a new carrier and in the course of that application gave the proceeds of the

withdrawal to the new carrier. If the policyholder is rejected in the course of the underwriting process and the 60-day period has elapsed, I think they're stuck. I think they're going to have a gain there. Any other comments or thoughts you would have on these rulings?

MR. HOOE: With regard to your first point, I think the spirit of the ruling was to provide aid and comfort to policyholders. In your example, the policyholders could withdraw 55% of the surrender value of the policy subject to a massive surrender charge or draw a lesser amount over a series of years. The published ruling literally says that one must take the maximum amount out that one is entitled to receive. However, I can see the argument that where what one is entitled to carries with it a massive surrender charge, that it's not much comfort to policyholders to say that the only way you get the tax benefit is to subject yourself to that surrender charge. If anyone finds themself in that situation, I would urge them to come in for a ruling request, because I think that we would receive the ruling request with a fair amount of empathy.

As to the second point, I agree. I think if you don't reinvest within 60 days, I don't know how you're protected.

MR. COGSWELL: I think the teaching there probably, Steve, is that policyholders are just to sign the contract and not take sums out so they're not walking into that situation.

MR. HOOE: I think if you want to be safe, that's the way to do it.

MR. COGSWELL: The final ruling is Revenue Procedure 92-5-7 where the IRS announced that the modification restructuring of life annuity or endowment contracts in the course of a rehabilitation will not cause loss of grandfathering for a number of code sections, nor will it start a new testing period for 264, 7702, or 7702A. The only other point I would make on this ruling is very often in these rehabilitation proceedings there is an assumption reinsurance transaction that takes place where business is pulled from the troubled carrier into healthy companies. The IRS has issued a number of Private Letter rulings that suggest that the grandfathering is not disturbed by that insurance transaction.

MR. HOOE: And that continues to be IRS position.

MR. BIELUCH: At this point we're through with the American content. I think it's always helpful to at least hear his opinion, even though we recognize he does not speak for the IRS at these meetings.

MR. HOOE: Yes, that's right, although I forgot to give it at the beginning, let me give you the required disclaimer that I'm required to give since Philip was good enough to remind me with his last remark. Basically, anything that I say represents my personal opinion, has not been cleared with Chief Counsel or anyone else at the IRS, and cannot be relied on as precedent, and with 55 cents buys you coffee in the IRS basement.

MR. AUGUST C. CHOW: When I look at the audience, I wonder how many people in this room are from Canada or are working with Canadian tax laws. With the freedom of information and the free trade between the United States and Canada, I guess there's a possibility that one day there may be some tax cross-fertilization between the two countries. I understand that the IRS and Revenue Canada have already started a process to exchange views on tax administration between the two countries. So maybe one day you may find some of our Canadian tax law getting into the U.S. IRS or vice-versa.

My presentation is to give you a brief summary of the company tax issues emerging in Canada. This is not to say there are no emerging policyholders' tax issues, but my talk deals with company tax issues only.

When I started to prepare my speech a few weeks ago, I went to the Society's *Record* to see what Canadian tax topics had been covered at the Society's meetings in the last few years. I didn't find very much. So before I talk about the emerging tax issues, I thought it might be useful to spend a few minutes to cover some of the recent tax changes that happened in Canada.

I will take you back to 1987. In the 1987 tax reform, the Canadian Federal government reintroduced what is the so-called Investment Income Tax (IIT). The IIT is a tax on the inside buildup of a life insurance policy. The original calculation of the IIT was based on a very complicated actuarial formula which produced little tax revenue to the government. In 1990, the calculation was replaced by a much simplified formula. The IIT calculation is basically equal to the mean tax reserves multiplied by a prescribed interest rate, minus a T5 deduction. The T5 deduction is essentially an amount which has already been taxable to policyholders for those policies which are not exempt under Regulation 306 of the Canadian tax law. Then the IIT is simply the taxable income multiplied by the tax rate of 15%. Certain policies issued prior to 1990 could be partially exempt or fully exempt from the IIT depending on the terms and conditions of the policies. There are specific rules and I won't go into the details of it.

In the 1987 tax reform, there are also substantial changes being made to corporate income tax for life insurance companies. With respect to tax reserves, the most significant change is in the method to calculate the Maximum Tax Actuarial Reserves (MTAR) from one year preliminary term to 1.5 preliminary term basis. There are also changes to other reserve computation, such as Unpaid Claims Reserves (UCR), the Incurred But Not Reported Reserve, the Investment Reserves (IR), Claims Fluctuation Reserves (CFR), and Policyholder Dividend Reserves (PDR). All these changes would, generally, give you a lower reserve deduction.

There's also substantial changes to the calculation of the Canadian Investment Fund (CIF). The CIF is a calculation which determines how much investment income will be subject to tax in Canada for multinational and nonresident companies. The calculation of the CIF is very complex and has been a major concern to the Department of Finance and Revenue Canada.

As I said, the government's always looking for additional tax revenue. Shortly after the tax reform, the Canadian Federal government in 1989 introduced the Large

Corporations Tax (LCT). The tax is imposed on companies' capital in excess of $10 million. Also in 1990, the government extended the Part VI Capital Tax to life insurance industry. The Capital Tax was originally levied only on banks and trust companies, but it was extended to life insurance companies in 1990.

It's interesting to note some of the tax similarities and differences between the United States and Canada. Over the last few years, government in both countries tried to raise additional tax revenues. In the States, the Treasury opted to raise tax based on premium income which is the well known DAC tax. In Canada, the government decided to raise tax based on capital.

Table 1 shows the calculation of the Large Corporation Tax and the Capital Tax. First, the LCT applies to companies where the capital is in excess of $10 million and the CT applies to companies where the capital is in excess of $200 million. Second, the LCT has a flat tax rate of 0.2% and the CT rate is 1% on capital between $100-200 million and 1.25% on excess capital over $300 million. Thirdly, the LCT applies to "financial capital" and "physical capital," while the CT applies only to "financial capital." And finally, the LCT can be offset by the federal surtax, and the CT can be offset by the federal income tax. Essentially, the LCT and the CT are a minimum tax. If a company is not subject to the regular corporate income tax, then the company will be paying the LCT and CT.

TABLE 1
Comparison Between Large Corporations Tax and Capital Tax

	Large Corporation Tax	Capital Tax
1. Exemption level:	$10 million	$200 million
2. Tax rate:	0.2%	1% between $200 and $300 million and 1.25% on excess
3. Tax base:	Physical capital & financial capital	Financial capital only
4. Offset:	Federal surtax	Federal income tax

I have just given you a basic capture of the tax changes from 1987-90. During the last two years, the Federal Department of Finance had been monitoring how effective was the tax reform on the life industry. The government discovered that despite the changes made to the reserves and the CIF corporation, the industry is still paying a very small amount of income tax. Some of the areas currently being studied by Department of Finance are as follows: first, taxation of multinational and nonresident companies. Multinational life insurance companies are domiciled in Canada and write business in and out of Canada. Under the present tax rules, the life insurance industry is the only industry in Canada paying tax on domestic profits. All other corporations in Canada, including other financial institutions such as banks and trust companies, are paying tax on worldwide profits. The Department of Finance is studying whether the Canada-only taxation should be replaced by the worldwide taxation for multinational insurance companies in Canada.

Second, as I mentioned earlier, in the 1987 reform, the computation of tax reserves was changed from the one-year preliminary term to the 1.5 preliminary term basis. The Canadian Institute of Actuaries has been studying the Policy Premium Method (PPM) reserves, which will be prescribed for Generally Accepted Accounting Principles (GAAP) and for statutory reporting starting the end of this year. The Department of Finance has indicated that once the PPM reserve is in place, they'll likely adopt the PPM reserves for tax purposes. The government has not given us much detail on what forms of PPM reserve would be. The two issues which need to be addressed are: (1) Should the full amount of PPM reserve be tax deductible? (2) Should the "cash value flow" under the PPM reserve be tax deductible?

There's one other implication if the tax reserve is changed to some kind of PPM reserve. It is likely that the Department of Finance may also want to look at the taxation of policyholders, in particular the exempt test of a life insurance contract.

Last, the Department of Finance is concerned about reinsurance. I'm sure they are aware of the IRC Section 845. Their concern is that companies use reinsurance to shelter taxable income and also to move income to offshore tax haven countries. Currently in Canada, there's no excise tax on insurance ceded to foreign companies not licensed in Canada. In the United States, there is an excise tax if you reinsure with unlicensed companies. I guess the Department of Finance will be looking at different options.

In December 1991, the life insurance industry, in anticipation of further tax changes by the Department of Finance, submitted a lengthy report to the Department of Finance. The main points are summarized as follows: principal of taxation, Canada-only taxation, PPM reserves, reinsurance, and capital tax.

In the submission the industry pointed out that whatever new tax system is used in Canada, the tax regime must be fair, based on the ability to pay, and should remain competitive among the insurance companies and other financial institutions. Some of you are aware that in Canada we have just gone through financial deregulations. Effective in June 1992, we have a new insurance act and new bank act which allows banks and insurance companies to carry out similar types of business activities. Currently, banks and insurance companies are taxed quite differently. There is a concern about the level playing field between the banks and the insurance companies from a tax perspective.

The second point in the report urged that "Canada-only taxation" is the right form of taxation for life insurance companies in Canada. The report, however, suggested further improvements or refinements to the existing CIF.

The third point in the reports recommended that 100% of the PPM reserves with cash value floor should be deductible for tax purposes.

The report also commented on the capital tax that, because it's not based on the ability to pay, the capital tax should be replaced by some other form of taxation, such as a minimum tax based on company book's income. The report further commented that if the capital tax were to stay, some technical changes should be made to the calculation of the capital tax and the large corporation tax.

With all these activities going on, the Department of Finance is pushing hard to look for new ways to raise tax from the life industry. To some surprise the federal government in the February 1992 budget proposed to raise additional short-term tax revenue from the life industry. As you can see from Table 2, it started from $55 million for the fiscal year ended March 1993, up to $105 million for 1997 for a total of $450 million over the next five years.

TABLE 2
1992 Federal Budget

Fiscal Year Ended	Additional Short-Term Tax Revenue from the Life Industry
March 31, 1993	$ 55 million
March 31, 1994	75 million
March 31, 1995	85 million
March 31, 1996	95 million
March 31, 1997	105 million

In order to meet these additional tax revenue targets and to spread the tax more evenly among all the companies, in August 1992 the Department of Finance proposed to increase the CT rate by 0.5% on capital in excess of $10 million. Table 3 compares the current CT rate with that proposed by the Department of Finance and the counter proposal by the Canadian Life and Health Insurance Association (CLHIA) in October 1992. The CLHIA industry proposed that the additional tax should be based on a sliding scale. The far right hand column showed what's being proposed by the CLHIA. You can see that the additional tax is coming out from the middle range of capital, and that the tax rate on capital in excess of $300 million remains at 1.25%. The proposal by the industry is based on the principles that the ultimate tax rate should not be greater than 1.25% because of the competition with other financial institutions, and that the tax should be spread more evenly among small-, medium-, and large-size companies.

TABLE 3
Capital Tax Rate

Capital ($million)	Existing Rules	Finance Proposal (August 1992)	CLHIA Proposal (October 1992)
0 - 10	0.00%	0.00%	0.00%
10 - 50	0.00	0.50	0.50
50 - 100	0.00	0.50	0.875
100 - 200	0.00	0.50	1.10
200 - 300	1.00	1.50	1.25
over 300	1.25	1.75	1.25

With regard to the tax changes we can expect in the near future, I think it's certain that the Department of Finance will be finishing their additional CT rate and the exemption level soon. In 1993, we can expect that the Department of Finance might finally get around to deal with some of the issues they've been working on, such as, the change to the PPM reserve for tax purposes, the minimum tax on the book

income in lieu of capital tax, the issue whether multinational companies should be taxed on worldwide or domestic income, and last but not least, the reinsurance issue which is near and dear to the hearts of many Canadian companies.

Well, I've given you a quick summary of the company tax issues emerging in Canada.

MR. STANTON L. COLE: I want to go back to, I think, the second issue you talked about, Actuarial Guideline XII. The Life and Actuarial Task Force of the NAIC did in fact rescind that earlier this month, so that's subject to their parent committee approving it which should be noncontroversial.

MR. BIELUCH: Yes, I want to point out, too, that in discussing this here with Steve, he actually thought it was very helpful because he and the NAIC have talked for the first time in this area. There has been some cooperation between the two.

MR. COLE: Yes. Of course, it all came about because of the letter that he wrote to the 50 insurance commissioners. Somebody from the NAIC was supposed to call them and tell them about that action.