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OBRA 1990 AND THE DAC PROXY TAX

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- Stock versus mutual reactions and response
- Impact on
  - Mergers and acquisitions
  - Reinsurance
  - *Consolidation*
- Product changes – new and in force
- Small company problems and opportunities
- New categories of specified insurance contracts
- Impact on Canadian companies

MR. KENNETH A. LASORELLA: Steve Sedlak is a vice president and corporate actuary with Nationwide Life. He's been there for 22 years. He's done a lot of valuation actuary work and tax actuarial work. As a matter of fact, he was on an Academy committee on life insurance, an ACLI 807 task force as well, and an ACLI ad hoc committee on HIV. He's going to give a brief description of the Omnibus Budget Reconciliation Act (OBRA) 1990 and discuss some of the act's effects. So, Steve will introduce the U.S. perspective and give a brief review.

MR. STEPHEN A.J. SEDLAK: *I'll give a quick description of the so-called deferred* acquisition cost (DAC) or pseudo-DAC or proxy DAC that we've been afflicted with (or had inflicted upon us). It applies to any life, annuity or A&H contract – so-called specified contracts, with the exception of pension contracts as defined in Section 818(A), cancelable A&H contracts, flight insurance and foreign contracts. This also applies for contracts in a property and casualty (P&C) company as well as for a life company.

There are three pseudocapitalization rates, if you will, of 1.75% for the annuities and 2.05% for group life. Defining group life is somewhat controversial, and that'll be discussed a little bit more later. The last rate is 7.7% for "other" contracts and it's significant that "other" is also the highest deferral category here. That includes life, universal life, guaranteed renewable (GR) or noncancelable A&H, and everything else.

Any policy that's composed of two of these different categories is going to be called "other," at least that's what the current reading is. So there's no way that you can gain by attempting to turn a life insurance policy into something else, for example, an annuity with a term rider for pseudo-DAC purposes.

The capitalization here is limited to general deductions, and that may actually put a cap on the pseudo-DAC. However, I don't imagine, unless you were to do something fairly massive, that it would really be a factor for most companies. It applies to all premium on specified policies whether at issue or from a 50-year-old policy. It's not really a DAC in that sense of the term. Hence, the name *pseudo.*

Amortization of this DAC is on a nice, simple, straight-line basis over 10 years. Five percent of that happens in the calendar year of receipt of the premium. There's also a small company or, if you will, really more of a small DAC provision. If you have less than $15 million of DAC, the first $5 million of DAC is run off over five years, but this grades off starting at $10 million of DAC and then ending at $15 million.

The pseudo-DAC also applies to reinsurance. Your ceded business counts as a negative premium. This also includes the reserve amounts transferred as if they were premium.

Reductions from ceded reinsurance can only be used to the extent of existing unamortized pseudo-DAC and there's no carryforward. Companies that would do a fairly massive deal this year or last may find themselves actually losing some of this deduction on their ceded business. Unfortunately, the assuming reinsurer would get no reduction for this. Thus we have a situation without symmetrical treatment. Significantly enough, with this exception and perhaps a few others, the reinsurance has mirror treatment so that the pricing of the reinsurance can reflect this treatment between the two parties.

The law also eliminates the capitalization of ceding commissions for both assumption and indemnity reinsurance as long as what you're reinsuring consists of specified contracts. So, if you're not reinsuring nonspecified contracts such as cancelable A&H or flight insurance, you will not have to go through the agony that was inflicted by the Colonial American Life case. However, there is some capitalization on these blocks, at least for assumption reinsurance, that may be coming back. Ed's going to talk about that more. Incidentally, it appears that modified coinsurance reserve adjustments are also going to count as premium for DAC.

Another special little bonus of this thing, which is otherwise negative, repeals the DAC portion of the alternative minimum tax starting with the fourth quarter in 1990. It's great for me; I never knew quite what it meant. Could I have a show of hands? Anybody really know what the DAC part of adjusted current earnings really was supposed to mean? Seeing none, I don't feel quite so lonely here.

Section 809 had absolutely no modification whatsoever. We were virtually the only industry with an increase in tax. I guess as a whole, for all industries in the U.S., except for ours, taxes actually went down a little bit. So, the next time this comes around please let's get together, folks. If you can, influence your companies in any way; we don't need stock mutual splits.

Another portion of the law I'll go over briefly is the disallowance of 20% of the unearned premium reserve on cancelable A&H business. The objective here is to get consistent treatment with what was done to the P&C companies. It also has a six-year phase-in of the existing amount of unearned premium reserve that was in existence at year-end 1990. In a way that's beneficial. They say it's no fresh start, but it's pseudo-DAC, pseudo-fresh-start because six years is a longer period than many blocks of business would actually run off over, especially some credit insurance, unless very long-term policies are being written. So, there's actually a bit of a benefit here.

Now, here are some of the effects and the implications of this little beast. Above all things, and this is common to the 1984 Act as well, it defers a deduction. It doesn't really cause a one-time tax such as an income tax that you never get back. Instead, it defers a deduction, and the real penalty arises because the cash is lost. You've lost the time value of money on the pseudo-DAC, if you will. It works in many ways much like capitalization and amortization of, say, a factory or a lathe or some other capital asset. So, the overall tax isn't increased at all.

The lost interest, on the other hand, is increased. Negative cash flows arise from it. There is an immediate surplus effect from it. Companies that are short on surplus or where surplus is somewhat critical are probably feeling the pain. I'm probably not telling you anything you don't know already there.

Now, the industry is going to have to grow or at least the premium that's subject to the DAC is going to have to grow or the federal revenue is actually going to shrink. Unless total premiums subject to DAC grow something like a little over 10%, there's going to come a time where perhaps the hungry tax monster is going to decide that it wants to come back and get additional tax from us in some other way. So, there may, if nothing else, be an upward pressure on the DAC factors here. Ominously, the House Committee report says amounts capitalized "should in most cases understate actual acquisition expenses." That's kind of ominous.

Statutory effect, I think I mentioned this before, causes surplus use and can be material. There was an industry effort, it may still be ongoing, to attempt to get the DAC set up as an asset, but given all the solvency concerns currently, it might face some really tough sledding. You can, I suppose, use reinsurance, however, to realize that asset.

When it comes to GAAP effects, oddly enough, there are none. GAAP doesn't really recognize the time value of money on this critter. It's a reversal of a timing difference, but the lost investment income, however, is going to start to show up and bleed into your income statement. This is not really any different than what happened under the 1984 Act because here again there were deferrals, unless you had nonreversing situations, such as the fresh start.

The pseudo-DAC is very much like a premium tax. The best way to look at it, because it's linked directly to the premium via the time value of money that's lost on the pseudo-DAC, is as if it was a premium tax. One thing that's very important here when you start to reflect it in your pricing or in your valuation studies or whatever you're going to do with this critter, is that it's not a deductible premium tax. So, you'll have to gross these numbers up in order to actually get even, if you will, because whatever you charge will probably create tax, unless you're in a fairly unusual situation.

To get a 14% after-tax rate of return (I don't know if anybody actually gets that, but you might want to try) for annuities, this will translate into 26 basis points of premium tax, which you'd have to gross up. For group life that's 31 basis points, and for our favorite "other" category, which includes universal life and a few other things that are near and dear to our hearts, that's 1.16%, and then you'd have to gross that

up. So, you're really talking about something more like about 1.75% when you get all done with that. That's a fairly tough tax.

Now, for reinsurance effects. This will affect all reinsurance transactions, not just those with ceding commissions. This applies to everything. This can be important in experience refund provisions as well. You have with reinsurance, as I've mentioned, the ability to possibly get back some lost surplus. The pseudo-DAC should be a consideration in any treaty, just like the 1984 Act, just like any other tax issues. Because the assuming company is going to get a pseudo-DAC tax, and the ceding company is going to get somewhat of a pseudo-DAC deduction, you should recognize that fact.

Incidentally, there's a slight potential problem when there's not a mirror treatment. That's when you get a spillover where the negative premium, if you will, in the case of the ceding company, is larger than the DAC that it would normally set up in the current year. In that case it spills back and reduces previously set-up DAC amounts that are really going to run off over a shorter period of time. Meanwhile, the reinsurer gets to set the same DAC up, and it's going to run off over the full 10-year period. Slightly different, slightly asymmetric.

A word about double count. This has been a concern, especially in view of the fact that increasing the DAC tax has been discussed. The estimate was $8 billion from the life industry over five years from the current law. Actually, the estimate that was being bandied around was more like $16 billion. But, Congress generously gave us a mere $8 billion. I like it. They're generous that way, just like they're good at simplifying the taxes when they say they're going to simplify them.

Pricing. I think given current margins the pricing effects can be quite material. The premium tax equivalent numbers that I read to you can be awfully steep, especially when they're on products that are margined to return, say, 5% of premium on a present value basis, and the company is going to get hit for nearly 2% of it. That's a lot of profit to lose. So you really have to reflect this stuff for pricing.

Hopefully, the 1984 and subsequent acts, up until OBRA 1990, will also be in your pricing. Those tend to be even more significant. I can give you a few numbers here, and these are for some sample products, universal life (UL) and a single premium deferred annuity (SPDA). For universal life, and this is to get a 14% after-tax rate of return, the 1984 Act came out to cost 172 basis points of spread. The reason I'm saying that is a lot of these products don't have a provision in them where you can change your premium loading, either for marketing reasons or for the product design. So, that is fairly steep. OBRA 1990 costs 53 basis points, at least for the product that we're talking about. One of the reasons that this was so large is that this universal life product was assumed to be carrying statutory reserves at the full accumulated fund value, not at a Commissioners Reserve Valuation Method (CRVM) reserve level. The 172 basis points would drop, I think, considerably if you were actually reserving it at the very low level. I did it this way to just dramatize things, but I want to make it clear it can be better than that. I rather wish that I'd had time to give you the number for something that was holding CRVM reserves, but this is an OBRA 1990 discussion.

The individual annuity, the SPDA, was 16 basis points to account for the 1984 Act and subsequent, and the OBRA 1990 effect is seven basis points. So, it's a lot lighter on that product when there is a charge for the tax using basis point spread. On the other hand, the product is margined a lot more narrowly, and basically the result is interest spread on these products.

For valuations, appraisals and whatever else, I think things can be influenced very materially with this tax. Unlike the situation on pricing where you can pretty much say that it's very unconservative not to recognize the OBRA 90 tax, you're going to probably find it's awfully hard to tell whether it's conservative or not in valuations. The reason for that is you're starting at some point in the future, after a lot of this DAC, if you will, has built up under the product. Now you're going to get what I would call a fresh-start effect where amounts of pseudo-DAC will be running off. In the case of the 1984 Act, reserve differentials from statutory versus tax that are going to run off. They're going to look a lot like surrender charges because whenever there is a surrender under these products in your valuation, you will get a release of that statutory to tax reserve difference effectively into your statutory income. So, the bottom line here is that I don't know of a really simple way to wave a hand over a valuation or an appraisal and say it's always conservative in regard to these DAC taxes.

Some trends. The tax reserves seem to be approaching cash values, and this is really more of a 1984 Act problem. It's due to the fact, in many regards, that the so-called appropriate federal interest rate is so far above the valuation rate now that it just smashes permanent policy reserves for taxes, down towards the cash value floor. This, I understand, at one time was a goal of the Treasury, and it really thought cash value was a better number than statutory reserves, because insurers could manipulate statutory reserves. The whole thrust is a deferral of reserve reductions here.

The Congress and Treasury seem to be trying to circle around toward some kind of definition of economic income that they feel comfortable with, and this, at least, is sort of going toward GAAP principles. I don't know that the execution has done all that well. You could certainly argue that in many ways it is flawed, but the concept is to get an economic income that sort of looks like other industries, where acquired assets must be capitalized and then written down over time.

The next trend and the last one that I'm going to deal with, is the attempt to treat life and P&C insurance companies the same way. You see it with the unearned premium, trying to get asymmetry there, and, unfortunately, when they use asymmetry, as in the case of the appropriate federal interest rate, they sometimes hit you over the head with it, and they always seem to err on the side of more taxation. I just don't understand that.

MR. LASORELLA: Our next speaker is Ed Robbins. Ed Robbins is a principal with KPMG Peat Marwick in Chicago, even though he's on the road probably 85% of the time. He has spent eight years with Peat Marwick, and prior to that, 11 years with Pan American Life. He was a VP and actuary for international operations. He dealt with financial affairs of 10 different countries. He's going to discuss some insights regarding company reaction to DAC tax.

MR. EDWARD L. ROBBINS: Let me frame the issue of new categories of specified insurance contracts. In the Code the DAC tax is contained in Section 848. That section has a subsection called 848(h), which allows Treasury to specify new categories out of the original three that Steve Sedlak mentioned. When it does carve out those categories it can assign a new percentage capitalization to them. The actual impact on taxes using the real numbers would have to be a lot less than using the DAC tax, and looking at it that way, there are very few cases for most companies where this would be true. One notable exception is Federal Employees' Group Life Insurance (FEGLI). There are huge premiums, huge claims and expenses, very little profit. The DAC tax really puts a damper on FEGLI, and the FEGLI staff at one time was trying to exercise an initiative to get a new category of DAC tax capitalization rates on FEGLI. But there's one additional nasty problem when carving out a new set of specified insurance contracts, and that is that the carve-out has to be revenue neutral. What that means is when carving out a new category at a lower rate, some other rates simply have to be raised. As you might figure out, Treasury doesn't want to touch this with a 10-foot pole. It's probably an academic issue. Other companies have been at the door trying to get various categories of specified insurance contracts created, but it looks highly unlikely that Treasury's going to do anything about it.

Let's turn to stock versus mutual company reactions and responses. Late last spring we did a survey for a client, and we got 24 reactions. The survey basically asked companies what they were doing in response to the DAC tax. Our client, rightfully or not, naively or not, felt that by May 1991 every company would have made up its mind, and that sampling a handful of companies would give us solid answers. Right? Wrong. We got 24 responses out of 30 requests. The trouble with this kind of survey is that unless you get huge numbers of responses, you end up with many small buckets of responses with very little credibility in each little cubbyhole of responses. This is the kind of environment that you break your dimensions into. There is mutual versus stock. There is the policy of the company with respect to existing versus new business, and the breakdown by line. Some companies aren't in certain lines of business. And there is the category of the response. By category of response we can include the following: "We don't have the product line in force"; "No decision yet" (which actually constituted a plurality); "Positively decided to take no action at this time." And then there are the various types of action where action was being taken. Well, having selected 30 companies and gotten 24 responses, even though we found that there wasn't a lot of credibility associated with the statistics of the responses, we were able to get general impressions about where the industry might be going. But probably more important than that, we got a lot of good insights and good editorializing on the part of the respondents, and we thought this was immensely valuable. I thought I might share some of that with you.

Basically, we found no reason at all to differentiate mutuals versus stocks on the responses. We couldn't get any meaningful information out of that issue. Additionally, as you would expect, there was a greater tendency to factor the DAC tax into new products than into existing blocks for all the reasons that you might think, and this, of course, included existing blocks where there are nonguaranteed elements or dividends on the product. Companies did not want to monkey with their existing to the extent that they would with new products. There was also another problem. It's very difficult to tell, with the interest rates dropping as they are, what the credited

interest rate drop is due to. Is it attributable to the drop in the earned rates or is it due to the DAC tax? It's difficult to tell. It can be for a lot of reasons.

Let's talk about items specific to product lines. Interest-sensitive lines were adjusted more often and sooner than participating permanent products, for the reasons that it's much easier to change a credited interest rate than a dividend scale. Individual health was a real problem with respect to existing lines. Putting the noncancelable issue aside where you cannot change premiums, a lot of states have minimum loss ratio requirements, and they don't factor taxes into the loss ratio standards. It's very difficult to convince a state insurance department that the DAC tax is not a tax. On existing blocks of annuity and universal life business, we found that slightly over half had decided on repricing of some sort, and on UL the predominant form of adjustment was a reduction in the crediting rate. If there was one single item being adjusted, it was the crediting rate, not the cost of insurance (COI) charge. With respect to expense charges, companies were pretty much charging their guaranteed loads.

Let's talk about certain interesting editorializing items, beyond the mere numbers, that came out of our survey discussions. Let me talk about dividend scale changes first. As Steve mentioned, the DAC tax can be thought of as a nondeductible premium tax that can then be grossed up into a premium tax equivalent of some kind and the dividend reduced for it. Other companies have embarked on a general total repricing post-tax, that approach really applies only to new business, where you can change premiums, cash values and dividends; that is, completely reprice. Still other companies employed a rather interesting approach. They basically tried to replicate offset, the statutory loss that the DAC tax was giving them, trying to take, for example, in a particular year, 95% of 7.7% times 34% minus the amortization that was coming in that particular year to try to, dollar-for-dollar, offset the statutory loss due to the DAC tax. It becomes rather complicated to use that approach.

As most of you know, the DAC tax amortization is a locked-in, straight line schedule over five or ten years, depending on the size of the capitalization, but individual policies really don't persist permanently. They undergo a phenomenum called survivorship. So, for example the first-year premium is paid and a thousand policies are in force and three years later, 800 policies are in force. The amortizations are coming in at that time from those 1,000 first year policies. So, what can happen? Actuaries understand the concept of $(1 + i)/p_x$, a very, shall we say, powerful accumulation factor.

You can actually end up years after issue with a net benefit from the DAC tax because of the effect of survivorship, and that becomes even more powerful when talking about policies reaching the premium vanish point. Now a whole bunch of very powerful amortizations can be coming through in the future, so what do you do? You've got all kinds of incidence problems like this with that offset solution. An additional problem that you have, of course, is that in the first and second year it's difficult to completely offset the statutory loss due to the DAC tax. Many companies have a zero first year dividend or a very small one. So, there is that type of incidence problem to worry about.

Let me just talk for a moment about this whole area of deferred taxes on the statutory statement. As many of you know, back under the 1959 Act, pre-1984, there were a lot of deep discount bonds, market discount bonds that companies held in their portfolios. That was basically a deferred tax liability. It was going to be a huge tax payable at redemption or maturity of those bonds. Additionally, there were the 818(C) adjustments that also amounted conceptually, in effect, to a deferred tax liability. Those have all gone away, and now we end up with embedded deferred tax assets in our statutory statements typically. What am I talking about? I'm talking about the applicable federal interest rates, tax reserves way below statutory reserves as a result, and we're talking about the DAC tax. Those are all giving us, if you will, an embedded asset. If you stopped writing business and stopped collecting premiums today, you would end up with a whole bunch of future tax deductions going off into the future, and which have a value. There have been initiatives, all unofficial as far as I know, to try to get something established in this manner on the statutory balance sheet. It has fallen on and probably will continue to fall on deaf ears, but it is getting an audience in NAIC circles.

Let's turn to some GAAP accounting issues. For companies that currently do GAAP accounting, and Steve referred to this for a moment, there is only an insidious effect of the DAC tax on GAAP income statements. In other words, you can set up a deferred tax for the cash payout on the DAC tax, so you end up with an insidious loss of investment income over time on GAAP income statements.

There are other GAAP results that I want to bring to your attention, or possible GAAP results, depending on how you GAAP, and they have to deal with SFAS 97. Let's say there is a product that's not quite recoverable. The amortization ratio might be 110%. So there is a recoverability problem and you have to "haircut" your capitalization a little bit, absent the DAC tax. Now all of a sudden the DAC tax hits, and you cut the crediting rate 30 or 40 basis points, and you retest recoverability pretax. Basically GAAP accounting at the product line level is a pretax concept. Now all of a sudden this product looks speciously recoverable, even though after taxes it's in the same place that it was before. Is that right? Well, to paraphrase the quote, "I am what I am," SFAS 97 "is what it is." That's what it says to do.

The other anomaly I want to bring to your attention is, let's say a block of UL business was issued in 1985, and in 1991 you want to drop the crediting rate and increase the spreads. All of a sudden the effect of this is going to defer the average profit. The weighted average profit is going to be in the later durations, which means that the amortization's going to take place later than before, on the average. The DAC asset is going to pop upward. You're going to incur specious income, an actual infusion to GAAP income in the statement in the year of the crediting rate drop if you follow SFAS 97 literally. Nobody's perfect. The SFAS 97 writers were smart people, but they weren't perfect. I don't think they anticipated this. Pretax GAAP accounting does have some problems. There have been some solutions suggested. SFAS 97 doesn't permit any of them. I really am not sure what's appropriate there.

One other insight is probably worth mentioning. Take a company that's small enough to be subject to the five-year amortization schedule on most of its business and on the 10-year amortization schedule on some of its business. As Steve mentioned, the first $5 million is subject to a five-year amortization, and there is a 10-year

amortization on all the rest, and it phases out between $10 million and $15 million of capitalization. So, for example, if there is an $11 million capitalization, the five-year phaseout is on the first $4 million. At $12 million of capitalization, the five-year amortization is on the first $3 million. Anyway, how do you price? Do you use five-year or ten-year or some combination when you do your pricing? Well, seeing the mood that Congress is in, I would advise you to use 10 years, probably the better part of valor.

On a topic that's very strongly related to DAC tax, 1035 exchanges, I want to mention that we're finally beginning to see companies that are no longer quite as enthusiastic as they were on internal, redating exchanges. Why is that the case? Well, in recent years Congress has made internal exchanges very unattractive in certain ways. Remember that big rush of internal exchanges in the mid-1980s? Well, I don't know if that would have happened today. Take a look at the disadvantages now. There is a higher tax reserve valuation rate for a pre-1988 issue exchanged after 1987, than the tax reserve valuation rate that it would have had. An original 1987 issue jumps from a 5.5% valuation rate to 8.42% if you rebate it to 1991. That's a whale of a difference. It was either Walter Harris or Gary Geisler of the IRS who basically indicated that they were inclined towards DAC taxing the rollover on an internal exchange. That's an expensive proposition. So, you want to be careful about that.

And then, of course, there are the policyholder taxation issues ungrandfathering under Section 7702. Talking about generations of policies, pre-1984 policies, there were not many limits on pre-1984. TEFRA had a few limitations. For issues of 1985 through 1988 there is a strict definition of life insurance, but there was no limitation on the mortality charges that could be used for computational limits other than the mortality charge as specified in the contract. For such reasonable mortality charge limits, October 20, 1988 was the cutoff there. When converting an old policy, it's in the law that a 1035 exchange actually comprises a new policy for 7702 purposes. So, you're into all these more restrictive features when you internally exchange. Additionally, and, I should put a question mark behind this item, there is the question of ungrandfathering under Section 7702(A). An exchange of contracts under 7702(A) is a material change. It starts a new seven-year testing period for modified endowment testing. I wasn't really able to tell whether it ungrandfathers a policy. It looks like it does. It might. I wouldn't take the chance that it doesn't.

Changing subjects for a moment, have we seen shifts from individual life to group life to take advantage of the lower DAC tax category? We're talking 7.7% down to 2.05%. We've seen nothing en masse in terms of changes of product design. What we have seen to some extent, or heard, is a lot of talk about possibly doing it and companies that have basically shifted the location in their annual statements from the individual column to the group column on borderline-type products.

We also have not seen a rush from noncancelable policies to cancelable policies. This really took up quite a bit of conversation when OBRA 1990 was first passed; whether companies would take advantage of these kinds of opportunities if they were, in fact, opportunities. The problem with switching from noncancelable to cancelable is that there is kind of a quid pro quo going. You get rid of the DAC tax, but you incur a 20% haircut on the unearned premium reserve beginning on 1/1/91,

and you also risk the loss of the active life reserve as a deduction. So, you have to put the arithmetic to it to see how it really comes out. If there is an age-banded, noncancelable policy where the reserves don't really move along to a great extent, the active life reserves don't really build up on it, maybe you're not giving up very much, and if your premiums are monthly, you're not giving up much unearned premium. You'd have to put the arithmetic to it with respect to any policy you're speaking of.

I want to bring your attention to one particular private letter ruling that came out in 1988, and a subsequent revenue ruling, 89-43, that came out in 1989, that deals with a group nursing home product. Let me give you the fact pattern. It was a group nursing home product on a professional association. Premiums were entry-age based, contemplated level, guaranteed renewable type, and if a person quit or if the master policy was terminated, there was the right of conversion at the original age of entry. The private letter ruling back in 1988 held that this was noncancelable for purposes of active life reserves, for purposes of 807. The revenue ruling one year later reiterated this. The difference between a private letter ruling (PLR) and a revenue ruling is that a PLR cannot be used as a precedent. It applies to that company specifically. But the revenue ruling is law. I'm sure the company was very happy to find out that it had noncancelable insurance back in 1988. I'm not so sure with the DAC tax that it is so happy about that decision today. The old double-edged sword.

Let's turn for a moment to the special problems involving small life companies. For a company in a corporate group that has less than $500 million of tax basis admitted assets at the end of the tax year, there is a 13.6% effective marginal rate on the first $3 million of tentative life insurance company taxable income (LICTI). On the next $12 million, there is a 39.1% marginal rate which brings you basically to the 34% on the aggregate first $15 million. Well, the DAC tax is giving some horrible problems to small companies. They're being pushed into that 39.1% phase-out corridor. A company that was a $3 million company before might now be up to $5 million, so now it is being taxed at a high marginal rate of 39.1%.

Table 1 is a rather simplistic statutory income projection, if you will. Premium income increases at 10% a year. The operating gain on the line of business, that is excluding interest on surplus, increases at 10% a year. This is a small company. Surplus at the beginning of the year is $20 million. Rows 3 through 8 are basically pure out-and-out calculations, recursive calculations of a Lotus worksheet, investment income on surplus at 8%, federal income tax, excluding the DAC tax, the net contribution to surplus, and an ending surplus line that builds, and you'll notice this chart represents a company before the DAC tax. What if the DAC tax had never arisen? Starting with 1990, going through 1996, this company starts out at about a 25.44% effective tax rate. Now, effective tax rate is a different term from marginal tax rate. The effective tax rate is simply the incurred federal income tax, divided by the pretax gain from operations. That's what boards of directors and senior management people key in on. It's one of those things they get concerned about when those effective tax rates go up to 70% and 80% and 90%, which can happen in some DAC tax scenarios. Anyway, without the DAC tax there is a 25% effective tax rate in 1991, gradually moving to 27%, to 28%, to 29%, up to 32%, as the company's tentative LICTI climbs towards $15 million. LICTI goes from $5 million towards $11 million during the time horizon of this chart. So, it's basically being taxed at 13.6% of its first $3 million, and 39.1% of any excess in this situation.

TABLE 1
Financial Effects of Proxy DAC Tax
Illustration No. 5: Statutory, Small Company – No DAC Tax
(All Figures in Millions)

Description	1990	1991	1992	1993	1994	1995	1996	Remarks
1. Premium income	30.0	33.0	36.3	39.9	43.9	48.3	53.1	Rate of growth 10%
2. Operating gain on LOB	4.0	4.4	4.8	5.3	5.9	6.4	7.1	Rate of growth 10%
3. Surplus, beginning of year	20.0	24.2	28.8	33.9	39.6	45.8	52.8	Row 7, prior year
4. Investment income on surplus	1.6	1.9	2.3	2.7	3.2	3.7	4.2	Assumes 8%
5. Federal income tax (excl. DAC tax)	1.4	1.7	2.0	2.4	2.8	3.2	3.7	(Row 2 + Row 4) times sliding scale
6. Net contribution to SPLS	4.2	4.6	5.1	5.7	6.3	6.9	7.7	Row 2 + Row 4 – Row 5
7. Ending surplus	24.2	28.8	33.9	39.6	45.8	52.8	60.4	Row 3 + Row 6
8. FIT/statutory income	25.44%	27.02%	28.39%	29.58%	30.62%	31.53%	32.33%	(Row 5)/(Rows 2+4)

Assumes:
- Regular tax
- No NOL carryforwards
- All individual life insurance
- No other statutory/tax reconciling items

Before we go into the effect of the DAC tax, this is just a quick rundown of certain simplifying assumptions that I made. There is a regular tax in all years, no alternative minimum tax (AMT), and no net operating loss carryforwards. It's all individual life insurance. In other words, it's in the 7.7% group of specified insurance contracts, and there are no other statutory to tax reconciling items. I'm assuming that reserves equal statutory reserves, and other such fantasies.

Table 2 shows the effect of the DAC tax. You'll notice that the 1991 effective tax rate has jumped to 40%, from about, somewhere in the mid-1920s, and, by the way, the ratio of the surplus or the operating gain to the amount of premium income is key. If the operating gain and the investment income on surplus is a very tiny amount, you could dwarf it by the multiplier you have to put on your premiums. One other statement we can make about this table is the issue Steve Sedlak mentioned. If the industry's premiums don't grow, eventually the revenue from this source is going to dry up because you end up with timing difference income only. If instead of 10%-a-year premium growth here, the premiums were flat, then you would no longer end up with a DAC tax in 1996. The amortizations would equal the current capitalization, and as you notice here, the effective tax rate declines from 40% in 1991 down towards 35% in 1996. The message here is that a lot of small companies are just beginning to realize what a horrible shock this DAC tax is, and they're getting awfully concerned about it; the question is, what can you do about it? Well, that leads us to the subject of reinsurance.

There are some things that can be done. You can cede away business, of course, and take the deemed tax reserve on the ceding away of existing business as a negative against the current DAC-taxable base. Of course, you've got to be careful that it doesn't eat up the DAC tax asset that's already been created; otherwise you'll never get it back.

Let me give you another idea that's been suggested. For a company that's close to $500 million of assets, and it's near to losing the small company deduction entirely, let's say the company has $400 million today, and by 1993 it will have over $500 million, what it might decide to do is give away some of the business. If it's in the phase-out at 39.1%, it gets a deduction at 39.1% marginal rate when it cedes the business out, and it takes it back in when it gets over $500 million, at 34%. So, now it becomes more than a timing difference. It becomes a permanent difference. There is some arbitrage like this to be had using reinsurance techniques that small companies might wish to take advantage of. It all depends on the situation you might find yourself in. Steve again mentioned Colonial American. On a general reinsurance topic, the Colonial American case basically required a company to capitalize the deemed ceding commission on indemnity insurance. The ceding commission is equal to the tax reserve minus the assets transferred. That went away as of reinsurance acquisitions, if you will, as of September 30, 1990. We again have mirror image effects from reinsurance with respect to that kind of capitalization.

We do have a couple of things that have fallen through the cracks. For example, let's say a small company with a five-year amortization cedes reinsurance to a company. The assuming company's got to take it in on a 10-year amortization basis. The question arose, can the small company use the 10-year amortization basis on that negative portfolio, the ceded portfolio, which would help? And the answer appears to

TABLE 2
Financial Effects of Proxy DAC Tax
Illustration No. 6: Statutory, Small Company – DAC Tax
(All Figures in Millions)

Description	1990	1991	1992	1993	1994	1995	1996	Remarks
1. Premium income	30.0	33.0	36.3	39.9	43.9	48.3	53.1	Rate of growth 10%
2. Operating gain on LOB	4.0	4.4	4.8	5.3	5.9	6.4	7.1	Rate of growth 10%
3. Surplus, beginning of year	20.0	24.0	27.7	32.1	37.0	42.7	49.1	Row 7, prior year
4. Investment income on surplus	1.6	1.9	2.2	2.6	3.0	3.4	3.9	Assumes 8%
5. Federal income tax (incl. DAC tax)	1.6	2.6	2.7	2.9	3.2	3.5	3.9	(Row 2 + Row 4 + DAC base) times sliding scale
6. Net contribution to SPLS	4.0	3.8	4.3	4.9	5.6	6.4	7.1	Row 2 + Row 4 - Row 5
7. Ending surplus	24.0	27.7	32.1	37.0	42.7	49.1	56.2	Row 3 + Row 6
8. FIT/statutory income	29.07%	40.43%	38.74%	37.26%	35.95%	35.03%	35.12%	(Row 5)/(Rows 2+4)

Assumes:
- Regular tax
- No NOL carryforwards
- All individual life insurance
- No other statutory/tax reconciling items
- Five-year amortization period

DAC Tax Calculations (figs. in 1,000s)

	1990	1991	1992	1993	1994	1995	1996	
Net capitalization	0.578	2.541	2.795	3.075	3.382	3.720	4.092	
Tax base	0.520	2.171	1.892	1.584	1.246	0.932	0.835	
DAC tax	0.203	0.849	0.740	0.620	0.487	0.364	0.326	

be, no, it can't. The concept in the law appears to be that you have to get to net premiums from the ceding company's point of view and deal with that net. So, again you have an asymmetric situation on your hands.

But let's talk about Colonial American again and the fact that the big asymmetry of Colonial American has gone away. That window appears about to close. HR-3035, via a proposed new Section 197 in the Code, is going to contain rules for amortization of intangibles. It's also going to apply to assumption reinsurance, that is, deemed ceding commissions on assumption reinsurance. It's also going to apply to goodwill. It's going to apply to the value of in-force under a company acquisition where a 338 election is made. The question is, what are consulting actuaries going to have to do anymore in this area? I don't know. When you've specified that there's no difference between goodwill and the value of in-force, and the deemed ceding commission is the tax reserve minus the assets transferred, and you've specified the useful life which this 14-year amortization period is, and you've made it straight line, there's not a whole lot for actuaries to do, is there?

MR. LASORELLA: What about expert, straight-line amortization?

MR. ROBBINS: The bill is designed to be revenue neutral, and that's a bit fictional because whenever there is a revenue-neutral bill there are typically going to be some industries that are winners and some that are losers. I suspect which one the insurance business is. Fourteen years is a very long time compared to most useful life calculations in the industry. The bill is supposed to be revenue neutral, and Dan Rostenkowsky has basically said that any changes to it are also supposed to be revenue neutral within the four corners of the current bill. That was his language. And what that means is that congressmen should not look at this as a "cash cow" to try to extract more revenue from it or less. They can make changes, but every change has to be proven to be revenue neutral.

Just a few comments about the bill. The General Accounting Office (GAO) is in support of it, although the GAO would actually like to establish class lives for different types of intangibles; for example, a class life different on goodwill from value of in-force. I want to mention that the bill wraps around the DAC tax. Let's say \$100 of tax reserves are transferred, \$90 of assets are transferred, so there is a \$10 deemed ceding commission. The \$7.70 becomes the DAC tax on that transfer, and, therefore, \$2.30 becomes the 14-year amortizable amount under this bill, summing up to the whole \$10 deemed ceding commission. At least they were that sympathetic, but there is a perceived inequity in that. I don't know if any of you were in on the initial inside track when the DAC tax was being formulated back in OBRA 1990, but the concept was that it was going to be much too difficult to have a high/low DAC tax scale. So, they agreed on the level \$7.70 as a level percentage of premiums. Now, the high/low DAC tax scale would have stood us in very good stead on this \$90/\$100 example. What happens is the \$100 of tax reserve is transferred, \$90 of assets, \$10 deemed ceding commission. You pay the DAC tax on the \$7.70. You get the \$2.30 capitalization. And then you continue to have future DAC capitalizations as that business runs off, future premium subject to future capitalization. Many companies view that as an inequity, and from an economic viewpoint, what that's going to do is raise that \$90 maybe to \$94. Well, if there is a \$94 asset transfer on a \$100 deemed tax reserve transfer, the DAC tax kind of eats up the

whole thing, doesn't it? And you don't get a negative, you don't get a benefit. You can't set up a capitalized liability under House Resolution 3035, according to my understanding. And just as an aside, there is no correlative effect where the ceding party would establish an amortizing tax basis liability, of course. It's only the assuming party that incurs this capitalization. That's all very much in line with Steve's comments about Congress continually seeking additional timing difference revenue. So, we've touched on many subjects: company pricing reactions to the DAC tax, the effect on small companies, some reinsurance implications, and the new intangibles bill from the Ways and Means Committee.

MR. LASORELLA: Our next speaker is Larry Rae. Larry Rae has been with Confederation Life for 18 years. He is an assistant vice president, corporate actuarial. He has responsibility for the valuation of individual insurance products, Canadian and U.S., and until last year he was responsible for taxation and compliance. He's been on a subcommittee with the Canadian Life & Health Insurance Association on U.S. taxation. We thought that it would be good to have the Canadian perspective covered as well since we're in Canada. You've had a review or a summary of the DAC tax, as well as some of the U.S. implications from a U.S. perspective. Now let's see if anything is different regarding the Canadian perspective.

MR. LAWRENCE J. RAE: Although U.S. tax law is structured to have foreign life insurance companies taxed in a manner that is consistent with that of domestic companies, there are still a number of significant differences in the overall tax picture. In addition, the methods used in an attempt to produce a level playing field have not always been satisfactory. This session is primarily geared towards OBRA 1990 and the DAC proxy tax. For better or for worse, the impact of this law on foreign insurance companies is essentially the same as that for domestic insurers. So, I'll touch briefly on this subject later. I'd like to give you a little bit of an idea of the tax environment for Canadian companies in the United States. There are three key areas I would like to discuss: Section 842 issues, branch profit tax, and the alternative minimum tax.

As far as Section 842 is concerned, in order to give you an understanding of the tax treatment, I'd like to digress slightly for a quick review of the regulatory environment. Canadian companies file a different annual statement with the NAIC, the so-called Form 1A. This return includes neither a balance sheet nor an income statement but instead includes a presentation of assets and liabilities and a statement of operations. There is no surplus account. Foreign insurers must maintain sufficient assets and trusts in the United States to satisfy its obligations to its policyholders and creditors. The rationale is that global surplus of the company is available to all clients and, therefore, does not need to be invested in any specific jurisdiction. This is not an unreasonable position. The Canadian regulators recognize this in the Canadian annual statement by avoiding double counting of surplus through the use of a reserve for foreign jurisdictions. This reserve is a surplus appropriation that sets reserves on U.S. policies to the NAIC level before free surplus is determined. Why is this important? Section 842A of the Internal Revenue Code taxes foreign insurance companies as though they were domestic companies on income effectively connected with the conduct of any trade or business in the United States. This business has always been viewed as being comprised of the liabilities shown in the NAIC return and the assets held in the trust.

With respect to the remainder of a company's income from sources within the United States, the normal withholding tax under Section 881 is payable, the rate for Canadian companies being 15% by treaty. Since foreign insurers are not required to maintain a surplus account in the United States, there is an apparent tax advantage over domestic firms whose earnings on surplus get into their tax base. In order to correct for this, Section 842B imposes a minimum effectively-connected net investment income on foreign insurers. To the extent that actual effectively-connected net investment income is less than the minimum, then income equal to the deficiency is effectively imputed. The calculation of the minimum effectively-connected net investment income involves the use of two ratios calculated by the Secretary of the Treasury. The first is the ratio of domestic assets to total insurance liabilities. When this ratio is multiplied by the foreign company's total insurance liabilities, the required assets resulting effectively cover an average surplus position. These required assets are then multiplied by the ratio of domestic company net investment income to mean domestic assets. The result is minimum effectively connected income for the company.

There is a ripple effect of these calculations in the tax return. To the extent that there is imputed income, there is a proportionate reduction in the Section 881 tax payable. For a foreign mutual company its equity base in the differential earnings amount calculation is increased by the excess of the required assets, as calculated above, over the trusteed assets.

There are a number of technical and practical problems with the legislation as it now stands. On the technical side there are three problems. There is a two-year lag in the determination of the domestic company yield. The problem here is obvious. One considers what yields were like two years earlier, in any of the tax years since the legislation was introduced in 1987. The second problem is that there is no provision to allow for the credit of a foreign company's actual effectively connected net investment income where it exceeds the minimum in a year such as might occur in a period of increasing asset yields. The third problem is that the domestic net investment income is being calculated on an NAIC basis which typically exceeds its tax basis income.

On the practical side there is a view that the use of domestic company averages is inappropriate and, at worst, discriminatory. If domestic companies were required to use the same approach, the expectation would be that half of them would have income imputed. The likelihood is that companies most adversely affected would be the larger companies that have the lower surplus ratios. The foreign insurers operating in the United States tend to be large companies. In addition to ignoring size in calculating required surplus, the types of business that the company writes in the U.S. are also ignored. So, companies with business requiring relatively less surplus are penalized. On the investment income side, prudent investors taking a lower yield on higher grade assets are penalized by the inclusion of companies in the domestic calculation with significant amounts of junk in their portfolios. Foreign companies also tend to have subsidiary companies in the United States. The investments in these subsidiaries typically have lower yields than other assets and are usually in the trust base. Part of the reason that the yields are lower is that the distributions from the subsidiaries are on an after-tax basis. The operation of Section 842B essentially results in double taxation.

As a result of the problems noted above, the Canadian insurers are currently lobbying for more equitable treatment which more closely approximates the true business profits of each individual company reasonably attributable to its U.S. permanent establishment. Just to give you an idea of the types of ratios that we're looking at, when the Secretary's ratio (this is the asset-to-liability ratio) was first calculated for 1988, it was set at a ratio of 120.5%. Now, that in and of itself isn't necessarily important. I don't know how many of you feel that you've got that kind of surplus coverage, but the real problem was that Treasury goofed. The calculation was wrong. It should have been 117.5%. So, Treasury was approached, and the error was pointed up, but it refused to correct it. What we were looking at was a situation where there was an extra 3% of assets with a domestic yield in the range of 9%. So, 25-30 basis points on the assets were imputed over and above what would normally have been imputed by this section. The rate has been changed for 1989 (they are recalculated every year, by the way), down to 117.2% and for 1990, 116.5%. So, they are dropping. However, the domestic yield in 1989 was 8.7%. In 1990, surprisingly, it had gone up to 8.8%.

The branch profit tax was enacted in 1986 to achieve greater parity between remittance of branch profits and distribution from U.S. subsidiaries to foreign owners. Section 884 taxes the so-called dividend equivalent amount (DEA) at the lesser of 30% or the treaty rate. The DEA is defined as the U.S. branch's effectively connected earnings and profits (E&P), less the increase in U.S. net equity but not to be reduced below zero. If there has been a decrease in U.S. net equity, then the decrease in U.S. net equity is added to earnings and profits as well but is not to exceed the accumulated E&P for prior years, less the accumulated DEA for prior years since 1986. The last adjustment prevents retroactive taxation before the introduction of the tax.

Certain problems arise in the actual implementation. Although earnings and profits intend to measure economic income, the regulations include any imputed income under Section 842B in the calculation of E&P but do not allow an increase in equity, which is simply defined as the U.S. assets minus U.S. liabilities. Further, U.S. assets and liabilities are not calculated based on NAIC values but are a percentage of worldwide totals based on the ratio of U.S. earnings and profits to worldwide earnings and profits. Depending on the relationship of U.S. earnings and profits, which can be anywhere from a negative value to a value exceeding worldwide E&P, the resulting asset and liability values are likely to bear little resemblance to reality.

There are other issues worth noting. First, for mutual companies the impact of the add-on in the differential earnings amount calculation noted earlier artificially decreases a company's earnings by limiting policyholder dividends. Second, the treatment of the transfer of business from a branch operation to a subsidiary in the U.S. produces a tax deferral until the subsidiary pays a dividend or the stock in the subsidiary is sold. Third, there is an element of double taxation in the branch profits tax as well since the tax is applied to distributions made from after-tax income.

Moving to the alternative minimum tax, the first step in calculating the AMT is to identify the applicable financial statement to be used. For Canadian life insurers this would seem to be the NAIC return. As noted earlier, the Form 1A does not have an income statement or a surplus account. Effectively connected book income would be

the pretax net income or loss from operations after reductions for dividends paid to policyholders, which is subject to the special differential earnings adjustment mentioned earlier under Section 842B and further adjusted for gains or losses on distributions of property that are not reported in the NAIC statement. Beyond these adjustments, the calculation of AMT is the same as that for a domestic corporation.

One other issue. There is a branch level interest tax concern currently facing the Canadian companies. This relates to the applicability of Regulation 1.882-5. Since Section 882 generally defines the manner in which most foreign insurance companies are taxed, we feel that there is a problem here since the taxation of the foreign companies, insurance companies, is controlled by Section 842. The calculation in the regulation essentially calculates the amount of deductible interest that is available to the company, and, again, it does it by the use of ratios. It can produce a situation where the deductible interest is less than the actual interest incurred by the company, in which case the company is penalized, or it can actually produce a situation where the amount of interest deductible is higher than the amount that actually is incurred by the company. In the latter case there is a withholding tax on the excess.

Finally, returning to the DAC, I think you can see from the situations that I've described that there's no specific impact on the DAC calculation, but one area that is important is that of the pricing actuaries and how they are bringing tax into their product pricing. You must realize that the effective tax rate, because of some of these changes, is quite volatile. They must be very careful in choosing the method of bringing the DAC adjustment into their calculations.

MR. LASORELLA: I just have one other observation, since everybody's picking up on Steve's earlier presentation, about when Steve mentioned 1.75% as being sort of an equivalent type of premium tax that's already grossed up. The pricing actuaries who have basically tested this have run into some other problems. When they tried to actually increase premiums they would end up generating additional commissions as well as commission-related expenses, possibly bonuses, as well as just the additional premium itself generating additional DAC tax. So, it is kind of circular. It's almost an iterative technique that's used to find out what the real impact is.

MR. WILLIAM E. MASTERSON, JR.: I have a question for Ed Robbins. You mentioned the possible use of reinsurance situations for small companies that are using the five-year amortization and being careful when they are right on the borderline, when they have a marginal rate, it was 39%, I believe, that you mentioned. Would the Internal Revenue Service use its ability to reallocate income between the two parties in the reinsurance agreement under Section 845 to take away that arbitrage phenomenon that you described?

MR. ROBBINS: Yes, Bill, I actually had it in my notes to say that, and I didn't say it. It's a very good point. I'm glad you brought it up. Section 845 gives Treasury the authority to recharacterize a treaty or a transaction if there is "a significant tax avoidance effect," with no correlative adjustments on the side of the other party. All this is, of course, subject to 845 types of dangers. Treasury has been somewhat loathe to use 845, but this is all scuttlebutt, what I've heard, and you might be able to add to that, Bill. The concept is it might be an unconstitutional law, and Treasury doesn't really want to invoke it unless it has a truly, really abusive-type situation. So,

it is a little reluctant to use it. Now, I've heard of one area where it has tried to use it, and that was where a company ceded annuity reinsurance to its subsidiary, and I can't do the math in my head right here, but one company had a lot more tax-exempts and dividends received than the other, and instead of cash the Treasury deemed tax-exempt bonds and equities to be moved along with it in order to actually raise the taxes. That was at the agent level. I don't remember what happened at the appellate level or it might have even been thrown out at the agent level. We've seen some attempts to invoke Section 845, although it's very rare.

FROM THE FLOOR: My question is about group universal life as it's commonly sold, which is as an employee-paid benefit, not for the benefit of the corporation but for the benefit of the employee. Has anything definite been said about whether this is group or individual? And, if not, how are most companies treating this?

MR. ROBBINS: Back in late 1990 there was an awful lot of discussion at the ACLI level. That was a point that was taken up, as to whether that was group life, I believe. I think the final resolution, from what I understand, was that the ACLI wrote up many issues with possible answers and then dropped it and decided not to go for helping write the regulation. That's what I understand happened. I know the issue of what was group life was an issue.

MR. FRANK V. BROLL, JR.: A section of the DAC tax says that when there's a rider on a policy, the DAC tax applicable to the base policy applies to the rider. So, an annuity rider that might be attached to a life policy is going to be taxed at 7.7%. Is that correct?

MR. ROBBINS: There's a very complicated bit of legislative history on this, and it was reiterated to me at one time. You could get to the concept that the example cited in the Code of an annuity rider on A&H was the only example that really ascribes to the higher 7.7%.

MR. BROLL: That was the one that was specifically mentioned, wasn't it?

MR. ROBBINS: Yes.

MR. BROLL: I'm just wondering if companies are going to have to drop their annuity riders or if they're going to start adding permanent life coverage to their annuity policies.

MR. ROBBINS: I recall that the final conference report only speaks to that one example, and they don't cite it explicitly as an example. They simply cite it as a situation, as a fact pattern that would get the 7.7%. I believe the Senate report specifies that you go right to the 7.7% when you have combinations of classes, and I think there is a risk that this will be the Service's interpretation. Some people have actually taken a position that it is only that one instance cited in the law that gets that type of treatment. I don't think it's something you can rely on. Anyone with an annuity rider on the universal life policy, for example, might think about doing something else.

PANEL DISCUSSION

MR. LASORELLA: What is group? And what are return premiums? Would someone like to address that? Just give sort of an opinion? There are a lot of administrative issues. There are other administrative problems as well, e.g., capturing data. So, we'd just like some comments from the audience to find out what some of the problems are and how you might be handling them, if someone would like to volunteer.

MR. MASTERSON: Since nobody's volunteered, I presume everybody is waiting for the regulations to come out within the next month on the subject that will answer these things, and we do have it on good authority that the regulations are close to being released from the Internal Revenue Service, and perhaps some of these things will be discussed. I know one of the troubling areas on what group is has to do with a situation where a voluntary employee beneficiary association (VEBA) owns a life insurance policy, and the proceeds of the policy are payable to the VEBA. The question is, does that constitute group insurance or are the proceeds viewed as being partly paid for the benefit of the employer and, therefore, could they deny the employer the deduction for the money that he put into the VEBA? I believe that is one of the topics that will be addressed in the regulations that are coming out, but this does throw into question whether the employer gets a full deduction for the money put into the VEBA.

MR. ROBBINS: There are three hurdles you have to make to get down to the group life capitalization percentage of 2.05%. One is that premiums are to be determined on a group basis, whatever that means; second, that it's basically an association of employment or similar organization; and third, the death benefit has to be payable to the insured or for the benefit of the insured, and I guess the VEBA situation was basically speaking to that last issue. There is an element in the code that credit life, even though it's normally payable to the creditor, would not exclude it from group life treatment.

There's another question as to premium scales; for example, five-year age bands. Are one-year age bands significant in determining whether a coverage is group life? Other issues are commission scales, underwriting practices. If you consider a T account, for those of you who are into accounting, there are debits and credits. The Treasury looks at the debits, and we look at the credits. The debits and credits of any particular fact pattern may be controlling, absent any regulations. You put down all your commission and underwriting, etc., facts in your favor on the credit side, and the Treasury assembles a set of debits, and you see where you come out. I think it may come to that.

MR. LASORELLA: Is there anything similar going on in Canada, similar to the DAC tax?

MR. RAE: I mentioned earlier that the tax authorities are trying to get to something close to true business income. You're probably aware that in the Canadian situation now the move for statutory reporting is through the policy premium method which is similar to GAAP accounting. The tax authorities are looking at this with covetous eyes and have decided that they think this is a great idea for taxation as well, and there have been representations backward and forward on this to move from what is currently the maximum tax actuarial reserve to something else. The tax authorities, of

course, want to move to the policy premium method in full. There has been a position returned to them that we would like to have a cash value floor concept introduced in order to ensure a level playing field with other deposit-taking institutions. There is, however, some sentiment both ways, given that the policy premium method itself actually takes into account expectation of persistency, withdrawal, whatever you want to call it, and that the deficiency reserves for surrenders are, in fact, not necessary. So, obviously the insurance companies are looking for the highest reserves that they can get. So, the process is going to be an interesting one.