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IMPACT OF TAX CHANGES

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Panelists will review recent and proposed regulations in the U.S. on the taxation of corporate-owned life insurance (COLI) and annuities, as well as Canadian developments with respect to the taxation of life insurance companies.

MR. CHARLES D. FRIEDSTAT: I'm associated with KPMG Peat Marwick LLP in the Chicago office. We're deviating a little bit from the subject matter as described in the preliminary program. We're going to start out by talking about U.S. tax developments. Ed Robbins will start out by talking about some developments in the area of life insurance company taxation in the U.S. with emphasis on reserves and changes in reserve methods. Ed is a principal of KPMG Peat Marwick LLP in Chicago.

Then we'll move on to U.S. product taxation issues, and Hugh McCormick will be the speaker. Hugh is a partner with LeBoeuf Lamb Leiby & MacRae, LLP in New York City. He'll be talking about a number of things in the product taxation area; among them are the recent developments in COLI and some developments in the area of banks and certificate of deposit (CD) annuities.

Julian Dukacz will give us a summary of recent Canadian income tax developments. Julian is the vice president of taxation with Sun Life in Canada.

MR. EDWARD L. ROBBINS: My presentation will try to make sense out of all the statutory and tax reserve concepts that have been heading your way in the past year. The year 1995 has been a rather busy year in the U.S. for developments in the tax reserve area, basically forced upon us by two things: a series of new National Association of Insurance Commissioners (NAIC) guidelines and regulations and some Treasury Department activity, both of which have fairly major impacts or potential impacts on tax reserves in your company. My presentation deals only with company taxation implications of these events.

The first area is NAIC activity. What I'd like to do, rather than go into the excruciating details of the new statutory reserve requirements under the new regulations and guidelines, is talk around the edges, basically as to how each of these guidelines or regulations affect or may affect tax reserves. There are really three major guidelines or regulations that I'd like to speak to. One is Guideline XXXII, formerly referred to as HHH, on immediate payment of claims. The second is Guideline XXX, now the "Valuation of Life Insurance Policies Model Regulation." It used to be called XXX and some people now call it Regulation 830, because it's on page 830 of the NAIC's "Model Laws, Regulations and Guidelines." Last, I want to hit Guideline GGG, now Guideline

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XXXIII, which deals with commissioner's annuity reserve valuation method (CARVM) methodology for annuities. I'll be dealing mainly with these three promulgations from the NAIC.

Guideline XXXII, which deals with reserves for the immediate payment of claims, is somewhat old news now. It was required as of December 31, 1994 for statutory reserving purposes. The only real major tax question to my knowledge that still exists is how you deal with pre-1994 issues. There were three theories as to how you could possibly deal with them. The first theory was that guideline HHH was a new definition of CRVM for life insurance companies. Therefore, you didn't do a thing with your pre-1994 issues. The other two theories deal with the fact that, statutorily, companies are permitted to raise reserves for their pre-1994 issues for immediate payment of claims (IPC) 20% per year. In other words, you'd have to put up 20% of the IPC reserve in 1994 on those pre-1994 issues, 40% as of December 31, 1995, and so forth, until as of December 31, 1998, when you had 100% of your business on IPC.

The two alternatives under the ten-year spread theory are:

- All ten-year spreadable from January 1, 1995 on, that is, a ten-year spreadable event under Section 807(f).
- Each 20% increment causes a like increment in tax reserves which is a "sub" ten-year spreadable event.

Under the latter, you'd get effectively a 15-year spread, which is not a terribly attractive result. We're faced with the two competing theories, one being ten-year spreads from December 31, 1994 on or do nothing with your prior-to-1994 issues.

Let's go to Regulation 830, which is the most interesting of the issues. We now have the unusual situation where the NAIC passed this regulation back in March. It's effective for tax purposes beginning with 1995 issues, but no state has enacted this regulation. We're going to leave New York aside for the moment. New York has its own parallel regulation. Other than that, no state has adopted it and no state is expected to adopt it until 1997, at the earliest. Of course, that could change at any moment. What we now have is XXX for tax purposes for 1995 issues, while statutory is based on old CRVM. The NAIC has basically labored long and hard for six years to come out with what's, in effect, a revenue ruling, at least for the moment.

The first thing that I want to make clear is that under Regulation 830, for all practical purposes from the Life and Health Actuarial Task Force perspective, it is CRVM. The regulation defines CRVM. It's CRVM with respect to policies covered by the regulation, which means policies going forward from the effective date of enactment by any state. A regulation, unlike a guideline, has to be enacted state by state; once a guideline is passed by the NAIC, states can generally opt out if they want, although generally they follow it. Regulation 830 looks, for all practical purposes, like a new definition of CRVM for tax purposes beginning with 1995 issues.

To clear up a lot of misunderstanding, tax basis interest is a 26-state prevailing concept. Tax basis mortality is a 26-state prevailing concept. Tax-reserve method (for example,

CRVM) is not a 26-state prevailing concept. Tax-reserve method is what the NAIC deems it to be on the date of issue of the contract.

I'd like to hit a few items in the details of Regulation 830 that might have some major tax implications. First, and Brian Kavanagh referred to this in an article he wrote, what will the IRS consider to be true CRVM versus requirements in that regulation that the IRS might consider to be above and beyond CRVM? That could be a problem. For example, each renewal segment is net level, as opposed to spreading the CRVM allowance through the entire benefit period. Brian mentioned this in an article, and there are other things in the regulation that could give us some problems. However, it is CRVM according to the model regulation. The unusual cash value requirements and other pieces and bits through the regulation could also be troublesome.

I want to go to the use of select factors in Regulation 830. Use of select factors is prohibited under Revenue Ruling 92-19. If you're going to use 1980 CSO, you must use it without select factors. Let's assume for the moment that the prohibition of select factors will still be the case if and when 26 or more states adopt Regulation 830. The apparent conclusion that the IRS has reached is that select factors generally give you higher reserves and therefore, under the requirements of Internal Revenue Code (IRC) Section 807(d), you must use the mortality table that produces generally lower reserves if you have a choice among two or more tables or two or more options.

All of a sudden you have some interesting issues that result from the use of select factors for statutory and the use of nonselect factors for tax. For example, do you have different segment lengths for statutory than you might have for tax, because of the use of select factors for statutory and non-select factors for tax? If you don't want to use different segment lengths for tax, you might want to take the position that you can use select factors to define your segments, but not to define your final reserves. I don't know if that's going to work. Another major tax implication involves the treatment of universal life policies with significant guarantees and retroactive persistency bonuses.

Before we get to Guideline GGG (now Guideline XXXIII), I want to go back to the idealistic days of the 1984 Tax Act. In the 1984 Tax Act, we had a situation where Congress had a great opportunity to build Section 807 around the statutory environment at the time. Over the last 11 years, the statutory requirement has really drifted far away from Section 807 in lots of ways, and we're now faced with a confusing situation.

We have the different states enacting this Regulation 830 [Guideline XXX] at different times beginning in 1997 we think. Tax reserves are only a small part of that mess, but as you all know, the regulatory process has become quite fragmented in terms of what some of these very complex regulations mean. Just as an aside, there's a list of pending changes, corrections, etc. to Guideline XXX that the regulators have come out with, so it's going to change again and if it changes twice in a year, I'm not sure what that implies for tax purposes.

Remember the book *In Search of Excellence*, by Tom Peters? One of the attributes of excellence was tolerance of ambiguity. We all now have the opportunity to become really excellent or at least tolerably above average.

I'd like to go on to Guideline XXXIII, formerly proposed Guideline GGG, which defines CARVM for deferred annuities. Without going into excruciating detail on the new requirements of the guidelines, suffice it to say that this will mean an increase in annuity reserves for many companies, and it is effective for tax purposes for 1995 issues. One of the interesting things about Guideline GGG is some arguably gratuitous language in the preamble to it. It speaks to the concept that this is definitely not a new definition of CARVM, but is a clarification of what CARVM was always meant to be. There was an article in the *Financial Reporter* back in December 1994 that implied that the regulators felt that this language would be helpful to companies in justifying an immediate bump-up in pre-1995 reserves. I think somebody was dreaming. That's not the way Treasury works. The service has other ideas on changes in reserve approaches, required or not, on prior year issues.

According to Revenue Ruling 94-74, it appears clear that such an increase with respect to existing in-force business is a ten-year spreadable event. For tax purposes, the way the ten- year spread rules work, it actually would have been a lot more protective of companies for the commissioners to have said that it was a new definition of CARVM. Ten-year spreads of strengthenings are not necessarily a good idea. I want to show you an example of that. Let's say there's no change of tax reserve method on prior-year issues and you have a tax reserve pattern at year-end 1994 through 1999 of 93, 93, 95, 97, 99, and 100. This will result in tax deductions in 1996 through 1999 of 2, 2, 2, and 1. We're assuming that the account value remains at $100 in all years and that those can be looked at as dollars or percentages of the fund (either way), just to keep the clarification simple. If you were to make a change in reserve basis, you'd have to bump up 1995 reserves from 93 to 96. The way it works is in 1995, at the end of the year, your closing reserves are on the old basis, that is, the 93. The opening reserves in January 1996 are on the new basis with a $96 reserve, and that $3 change at midnight basically gets spread over the next ten years. With that spread of $0.30 a year going out for ten years, you have the reserve increase giving you smaller early deductions. When you add those results together, by 1999, you've actually had lower deductions for having strengthened your reserves. It's a terrible answer in this case. You obviously get a better answer here if you don't strengthen prior reserves at all.

There were some things about Guideline GGG which begs the question—is this really what CARVM was always meant to be? For example, there is a requirement that you put up at least 93% of your fund as your reserve, if you have contract language that enables you to buy settlement options at the then-current single-premium immediate annuity (SPIA) rates. If you have that contract language, you have to put up reserves of at least 93% of your fund value. Could it really be construed that CARVM was always meant to be at least 93%? That's what they're saying. And that's only one example of new CARVM requirements.

The guideline was silent on one issue, in particular. That was whether continuous CARVM would be required. The standard valuation law is pretty specific. It talks about ends of contract years. Continuous CARVM suggests that you check your present values at every future moment of time. Guideline GGG is silent on this point. It throws in some ambiguous language. We don't know how the states are going to react to the wording of the guideline. We've heard rumors on both sides of the issue, but the IRS has sent out a technical advice memorandum (TAM) 9452001, on which it is clear. Under TAM 9452001, you had a situation where a company had an annuity product where the

surrender charges reduced at the end of the current contract year, rather than the typical case of the first day of the next contract year. Low and behold, Treasury held for the taxpayer. They said the taxpayer is entitled to the deduction because, under the standard valuation law, you go to the end of the contract year and, in this case, the net surrender value is increased, because the surrender charges are already reduced. But if the surrender charges had been reduced one day later, the deduction would not be there. The old song "What a Difference A Day Makes" applies here.

This is a good transition from regulatory activity to Treasury activity. We've just talked about TAM 9452001. There were also a couple of other recent additional rulings worth mentioning: Revenue Ruling 94-74, changes of reserve method; TAM 9442001, term insurance with convertibility benefits, as to how to define a "qualified supplemental benefit;" and TAM 9533004, certain group medical benefits. The last one is a somewhat unimportant one. I'm going to spend my time on the others.

Revenue ruling 94-74 was a very long-awaited ruling. Basically, it dealt with whether you have a change in method or whether you have a mathematical or posting error. The difference in the result is major. If it's a change of method, you must spread the change over ten years and, as I indicated before, once you have a ten-year spreadable event, it's very difficult to tell whether that's a good answer or a bad answer without doing the arithmetic for it. On the other hand, if you have a mathematical or posting error, the revenue ruling gives a very extraordinary answer. If you have a mathematical error and the error occurred in a closed year, then begin the first open year (on January 1) with the corrected reserve. Believe it or not you get a negative or positive fresh start. You thought fresh start was done with; now you've got fresh start over again.

The ruling cited four cases, one that was ruled a mathematical error, and the others were ruled method changes.

In the actual facts cited in the ruling, the mathematical error (where the company left out a block of business) occurred in an open year and the Service allowed the taxpayers to just go back and make the corrections to amend that year's return. The interesting thing that the ruling did not speak to on the mathematical error issue was, "What if the error had occurred in two or more consecutive years?" Steve Hooe of the Service has a rather strong opinion on this. He has publicly stated that any repetitive computation, even an inadvertent omission of a block of policy cells in consecutive years, would be considered a method change.

Relating to the other items, one case was the correction of an interest rate where the company had not used the applicable federal rate (AFR). Instead, it had used the statutory prevailing rate. The correction was a method change, a change of erroneous method. That was a ten-year spreadable event. The next case, correction of mortality table, was a situation where the company had reinsured a block of business and erroneously used the date of the treaty rather than the issue dates of the underlying policies. The third method change was a change from curtate to continuous. This ruling came out ignoring Guideline XXXII. The IRS relied on *Blue Book* language, which basically said that a change from curtate to continuous, if done statutorily, has to also be done for tax. On page 604 of the *1984 Blue Book*, you'll see that is probably a ten-year spreadable event. The Service supported its arguments by saying that curtate versus

continuous is voluntary. It's not voluntary anymore. There's a bit of an ambiguity there and a possible conflict.

TAM 9442001 involved a term insurance policy with the normal convertibility benefit and it was difficult in this case to understand exactly where the Service was coming from. It appears that they were talking about a company that was holding statutory post-conversion reserves, and it wanted to have qualified supplementary benefit treatment on the tax basis postconversion reserve. Convertibility is a named supplementary benefit in the code. The difference between a qualified supplementary benefit and a nonqualified supplementary benefit is that a qualified supplementary benefit gets, if you will, separate benefit treatment. That is, you don't have to aggregate and then compare against cash value floors. You may end up a little bit ahead of the game, and the IRS basically said that the company did not have a qualified supplementary benefit, because there was no specified extra premium.

In conclusion there are some arguments and opportunities that companies have within that ruling that you might want to take advantage of.

A very brief mention of TAM 9533004. It talked about a group insurance contract to which monies had been paid in and the company was holding active life reserves using recognized morbidity and mortality tables. The IRS held that this was an A&H contract and that you could hold Section 807(c)(1) active life reserves for tax purposes.

MR. HUGH MCCORMICK: I'm a partner in the New York office of the law firm LeBoeuf Lamb Leiby & MacRae and I practice in the tax and insurance areas. I had the honor of speaking before the Society of Actuaries (SOA) in Quebec a couple of years ago. I'm going to talk about some product developments in Washington. I'm going to talk about legislative developments and a little bit about administrative developments with the IRS. Not surprisingly, there is going to be a fair amount of interrelationship of the two.

The first subject I thought I'd touch on is currently a hot-button subject in Washington and that is the subject of COLI. Many commentators inside and outside the life insurance industry believe that congressional action on COLI is simply a matter of time, because of the perceived abuses in what's known as "janitor insurance." Janitor insurance, for those of you who aren't familiar with the term, is a life insurance program whereby a corporation will purchase, for its own benefit, life insurance policies on everyone in the corporation down to the janitor. Although industry spokespeople are always careful to point out that they've never actually seen a true janitor insurance program, in that they've never seen janitors insured, there is one COLI policy that covers 300,000 people, so there may be a janitor or two mixed in there.

The subject of corporate-owned life insurance really was first raised in the Tax Reform Act (TRA) of 1986 when Section 264 of the code was amended to limit the deductibility of interest on policyholder loans to the interest on the first $50,000 per person, officer, employee or other person interested in the business of the taxpayer.

In response to the 1986 legislative changes, there developed the procedure of insuring a wider base of corporate employees so that the number of potential $50,000 loans would be increased, thereby increasing the amount of deductible interest. Putting aside the well

publicized WalMart program, there are a number of programs around between 5,000 and 25,000 employees that are insured for the purpose of increasing the amount of interest that can be deducted.

The Treasury began to see glimmerings of these programs and, by 1988, at the House Ways and Means Hearings, the subject of COLI was first mentioned. Again, in 1990, there was a Treasury study released that mentioned leveraged COLI as a potential area of tax abuse. In response to some of the developments in 1990, the agents' lobbyists, the National Association of Life Underwriters (NALU) and the Association of Advanced Life Underwriters (AALU), managed to persuade Representative Kennelly and Senator Pryor to introduce what's known commonly as the Kennelly/Pryor Bill on COLI, which was aimed at janitor insurance.

It took aim at the COLI procedure of setting high interest rates with a one percent spread (100-basis-point spread) between the interest credited on the policy and the interest charged on the loan. By cranking up the interest rates as high as you can, obviously you're increasing the net after-tax return on the deductibility of the interest. The problem that was perceived to be there was that the interest rates were really unrealistic. They also took aim at the procedure of just purchasing the "janitor insurance" without notifying employees or obtaining consent. However, nothing happened with the Kennelly/Pryor Bill.

COLI was later mentioned a couple more times in legislative proposals, but nothing happened until 1995. In 1995 there began to be some press reports of the WalMart COLI program, which is, by many miles, the biggest and perhaps the most shocking (if you're anti-COLI). The Treasury and the IRS learned of this transaction, as well as others, and after almost ten years of fits and starts, we've actually seen some action.

One of the COLI brokers with whom I deal did note, with respect to the WalMart transaction, that state law, although it's not uniform, generally provides that if you have an insurable interest in a person at the time the policy is taken out, then even if the insurable interest later goes away, for whatever reason, the insurance can be continued. You can become divorced, you can fire the employee, and you do not have to terminate the insurance. Picture WalMart starting out with 300,000 employees and leaving all of the insurance in place. There's an ever-expanding universe of potential insureds, as employees leave and new employees come in. Thus, you have this ever-increasing universe of potential insureds of the COLI program. Eventually, my sources reported, as many as one in seven Americans would be covered by the WalMart COLI program.

The responses to COLI and particularly to leveraged COLI began early this year. In February, the faxes started heating up with copies of a list of questions that were being fired around from COLI brokers and COLI underwriters to their lawyers and to their accountants. It was a list of 15 or 20 questions that was prepared by the national office of the IRS, although at one point it disavowed any knowledge of this. Supposedly, the questions were prepared by the national office for dissemination to the field for auditing agents to go in and ask specific questions about COLI programs.

The questions indicated that someone had actually thought about how these programs work. The questions went into the issue of inflated interest rate spreads between

crediting rates and loan rates, experience refund formulas, and other characteristics of a leveraged COLI program. The obvious goal of these questions was to focus an agent on what was really going on out there.

According to press reports there are now a number of ongoing COLI audits. Proctor & Gamble has been mentioned. A couple of other companies have actually been mentioned in the press as having ongoing audits. For the moment, the focus of the IRS does not appear to be pursuing some of the more exotic issues involved in a COLI. The one that we always worried about as lawyers was the insurable interest issue.

If the corporation did not have an insurable interest in its employees, then arguably you did not have an insurance contract under state law. You had a wagering contract, which is what most of the old case law will tell you. If you have a wagering contract, even though it's denominated a life insurance contract, you would not have a "life insurance contract" under applicable law for purposes of Section 7702. There are also state law implications about insurable interest.

If the employer does not have insurable interest in the employee, in a number of states, the estate of the insured employee can sue to recover the proceeds. You not only have tax issues, but you also have economic issues on the direction of the proceeds.

In any event, the Service seems to be focusing more on issues about interest deductions. Apparently, they're looking at the compliance with the four-of-seven rule, and whether or not the structure of the premium payments indicate that this is really a single premium policy under which interest would be disallowed under Section 264. Then, more generally, they're reportedly pursuing sham transaction theories.

They are also reportedly looking at experience refunds, that is, experience formulas built into the contract, to see whether or not there's any risk shifting as a matter of economics. The argument is that through these formulas, it may be that no risk has been taken on by the insurance company. Then they raise the argument that in the absence of risk shifting, there is no contract of insurance. That's a little bit more of an exotic argument. It would be interesting to see where they could go with that one.

Most recent news on what the Service has done on COLI is that as of the last couple of weeks, they have appointed someone who will actually be a COLI coordinator in the national office and who will be coordinating questions as they come up from the field. There have also been some press reports about a proposed Technical Advice Memorandum that the national office is supposedly working on. How that plays through in light of the proposed legislative changes is not clear, but there's no particular reason to believe that the proposed legislative changes would necessarily derail some of the audits. The Service, even with the legislative changes, can still go in and look at old policies and decide that they were sham transactions or violated 264 or raise other issues.

I mentioned the legislative proposals. In September, the House Ways and Means Committee announced anti-COLI legislation. Under the original proposal, interest on COLI policies would have been disallowed, as of the end of the year, without any grandfathering. A four-year phase-in of income on policies surrendered in 1996 would be allowed. That was about the only kind of relief provision that was built into the first proposal. After the lobbyists got to work, a few days later there was grandfathering of

policies issued prior to mid-1986, which was the effective date of the 1986 legislation on corporate-owned life insurance policies, that is, the $50,000 per employee limit. Also, a four-year phase-in of the nondeductibility of interest would be allowed. That's where the House Ways and Means proposal sits at this point.

The Senate has recently developed its own COLI proposal and, according to what was on the wire services, the finance committee would allow the following: interest would be disallowed on loans after 1995; interest on pre-1996 loans would continue to be deductible for a period of time (basically five years to the extent that the interest on the loan does not exceed the lesser of the contract loan rate or a percentage of the Moody's corporate bond yield average, monthly average corporates) phasing down over five years from 100% of that rate to 80% of that rate over five years and then zero after the fifth year.

Again, pre-mid 1986 policies would be grandfathered, subject to a requirement that a "market rate of interest" would be used, and the market rate of interest again is the Moody's bond yield. The agents' lobbying groups and the American Council of Life Insurance (ACLI) were successful in getting "a carve out" for some small COLI policies. The key-person policies would not be affected by the new legislation, which is subject to a rule as to a market interest rate. Key persons are defined as officers and 20% owners. The greater of five key employees or 5% of employees could be insured, but there would be a limit of 25 key employees in any event. So no more than 25 employees could be covered under a leveraged COLI program. To the extent that there is compliance with this rule, the interest deduction will be allowed. This goes primarily to small business corporate-owned programs and buy/sell agreements and those kinds of arrangements using life insurance.

A four-year phase-in of income on surrender of a COLI policy over the next five years is another provision. As I read it, you're allowed five years to surrender the policy and then you get a four-year spread thereafter. From a company's point of view, there is a relief provision. Issuing insurers would be allowed to accelerate deferred acquisition cost (DAC) tax amortization attributable to surrendered COLI policies. They'd be able to take the unamortized balance of their deferred DAC and take it as a current deduction.

The COLI marketers that have been out there for the past eight or ten years have been focused very much on exit strategies. I understand that typically what's proposed or what has been put in place is to cease borrowing, and then the policies are reduced to paid up status under the nonforfeiture laws. The policies then run off over time and have no negative tax ramifications.

The COLI legislation does leave some uses of life insurance open. Obviously the proposed legislation is aimed at leveraged COLI programs. I do know from our practice that there are a number of unleveraged COLI programs being put in place. Banks, for example, are very interested in COLI programs as funding vehicles for employee benefit programs. There is an Office of Controller of the Currency (OCC) opinion or guideline that sets the limits on when a bank can purchase and how much life insurance a bank can purchase on its employees. I know a number of banks have been actively buying nonleveraged, separate account based variable COLI contracts.

Also the use of trust-owned life insurance is a variation on the COLI product. The non-leveraged COLI product is occasionally used as a funding vehicle for benefits through a voluntary employee benefits association (VEBA), which is a tax-exempt organization described in Section 501c(9) that is set up for employee benefits purposes. We have seen a few uses of COLI-type products in that setting where the trustee of the VEBA takes out the insurance. The trustee owns and is the beneficiary under the program insuring lives of members of the VEBA and the life insurance benefits are used as funding vehicles for the benefits. The fact that you have tax-free inside build up and tax-free earnings on the contract avoids some of the ramifications of Sections 419 and 419A.

Just a quick note on other product-related legislative proposals that are of interest. In both the House bill that was passed earlier in this year and in the Senate proposal, there is intended to be legislation on long-term-care contracts and accelerated death benefits. This is also an issue that has been around for a number of years since the late 1980s and early 1990s. The ACLI and the Health Insurance Association of America have been asking for legislation that would make the tax treatment of long-term-care contracts more regular. You can make a number of arguments that long-term-care contracts were simply a form of accident and health insurance that fit within the existing statutory guidelines. But nobody has ever been comfortable with that answer, including the IRS, and so the consensus has been that legislation is necessary.

With any luck, long-term-care and accelerated death benefit legislation will go through this year. Basically the legislation would provide a new Section 7702B, which would make long-term-care insurance taxable as if it were conventional accident and health insurance. The long-term-care contract will have to meet certain requirements, such as being guaranteed renewable. It may not provide for a cash value except upon surrender and would pay for certain defined services for chronically ill individuals. Chronically ill individuals are persons who cannot perform two of five designated activities of daily living, which are things like dressing, eating, or toileting.

The House bill and the Senate proposal will also allow tax-free treatment for benefits paid under accelerated death benefit life insurance contracts. The Service has, over the years, taken the position on accelerated death benefits; they are not eligible for exclusion under Section 101A of the code, because they're not paid on account of death, which is actually a conclusion I have trouble disagreeing with. The legislation would basically deem a death to have occurred in the case of a terminally ill individual.

A terminally ill individual is a person who has been given a diagnosis showing that he or she has no more than 24 months left to live. The bill also would cover viatical settlements. Viatical settlement companies go to an ill individual and purchase their death benefits under life insurance contracts issued by, in most cases, a totally unrelated insurance company. The IRS issued a private letter ruling saying that viatical settlements were taxable. So this legislation would clarify the treatment of viatical settlements, and actually reverse the IRS's position.

Another contentious issue in Washington is the subject of banks and annuities, in particular, the retirement CD or what's known as the Blackfeet National Bank annuity. It has been interesting watching developers of the Blackfeet National Bank annuity struggle with the regulatory regime and the banking authorities and insurance authorities, all the while, whistling past the graveyard over the tax treatment of their product.

The developers of the retirement CD started out on a roll. They got opinions that the retirement CD would be eligible for FDIC insurance. The OCC said that it was a proper activity of a bank to issue annuities, because annuities were not insurance; they were investment products. Therefore, under what's known as the incidental powers clause of the National Banking Act, a federally regulated bank could issue these annuity CDs. Then the Supreme Court, in the *Nations Bank* case (or the *VALIC* case, as most of us know it), basically took the same position that annuities are not insurance products, but investment products, which had the effect of validating the position that the OCC had already taken with respect to the retirement CD.

The people who backed the retirement CD went around the country fighting with insurance regulators as to whether the retirement CD was an insurance product under the insurance laws. They've had mixed success. They've won in some states, they've lost in some states, although I don't think anything conclusive in any state has really happened yet.

Strangely enough though, although the feature of tax deferral is the critical issue for the retirement CD, the developers chose not to approach the IRS. They did not do anything other than obtain opinions from reputable tax counsel that the retirement CD would be treated for tax purposes as an annuity contract, and that's where things came to a head early this year. The developers brought the product to market. Then, on April 6, 1995, the IRS, which had not been previously approached by these folks, but had been approached by the ACLI and others, came out with proposed regulations. The proposed regulations, which were issued under Section 1275 of the Code, the original issue discount (OID) rules, basically brought the retirement CD and the whole subject of bank annuities to a halt.

The issue that is addressed in the proposed regulations is whether or not a contract that is otherwise an annuity contract can also be a "debt instrument" subject to the original issue discount rules. Whether the retirement CD is an "annuity" was not clear. Under the rules of Section 72 and other rules, it's clear that an annuity contract can be issued by someone other than an insurance company, so presumably that would cover a bank-issued annuity. The position that the developers took on annuity status for their contract is probably valid. I'm not sure I would have opined the way that some of their counsel opined, but it's at least a good argument that the retirement CD and similar products were annuities for purposes of Section 72.

The issue here is that if you have a debt instrument as defined in Section 1275, it can be both an annuity contract and a debt instrument, and in that case, the OID rules override the Section 72 rules. The net effect of that is the OID rules cause the income under the contract to be taxed currently. In other words, the inside build up will be taxed as if it were a zero-coupon bond or some similar instrument, whereas under the annuity rules, there's no taxation on the inside build up until it's actually taken out either as an annuity or as some type of surrender.

The specific issue addressed by the regulation is the definition of debt instrument. There are two exceptions from the definition of debt instrument for annuity contracts. The first exception covers any annuity contract issued by an insurance company subject to tax under Subchapter L. This leaves a question of what if it's a tax-exempt entity (for example, a 501C(3) or 501C(4) insurance company) that issues annuity contracts. Are

those annuity contracts for tax purposes? What if it's issued by a foreign insurance company that's not subject to tax under Subchapter L? There are a handful of issues that flow out of that "subject of tax under Subchapter L" formulation.

More importantly, there's another exemption. The second exemption is for annuity contracts that are both subject to tax under Section 72 and where the contracts must depend in whole or in substantial part on the life expectancy of one or more individuals. In other words, you can be an annuity contract and theoretically be taxed under Section 72, but you can still be subject to debt instrument treatment if you haven't met the second part of the test.

The proposed regulations were designed to implement or to interpret the second exemption. Not surprisingly, the developers of the retirement CD thought that their instrument passed. They thought that they had a substantial life contingency built into their contract. The reason that they took that position is that at maturity of the contract, no less than one-third of the cash value at that time had to be taken as a life annuity. The other two-thirds could be taken as a lump-sum settlement, but one-third had to be taken as a life annuity.

The flaw in their argument from my perspective was that on any day up to the maturity date, you could take 100% of the cash value subject to a surrender charge that could be as low as 1%. There's no bar to taking 100% of the cash value out any day up to the maturity date. Once the maturity date occurred the person was bound, under the contract, to take one-third of the cash value as a life annuity.

The Service looked at this contract; they also looked at the law and decided that the substantial life contingency exemption from the OID rules was intended only to cover "payout" annuities. They believe the exemption was intended to cover private annuities primarily, and perhaps charitable gift annuities, and other annuities that went into payout status shortly after the money was invested. The proposed regulations that were released on April 7, 1995 took the position that if an annuity contract or purported annuity contract is not issued by an insurance company, the annuity will be taxed currently under the OID rules unless it goes into payout status within one year after the initial investment is made, payments do not increase over the term of the payout period, and payments will be made at least annually over the life or lives of one or more individuals.

The proposed regulations did grandfather outstanding contracts that were issued before April 6, 1995. Contracts issued after April 6 will continue to be tax deferred until the regulations are finalized and for 30 days thereafter. As long as the IRS takes to finalize these regulations, retirement CDS will continue to be tax-deferred instruments. Once the regulations are finalized, if the contract was issued after the effective date, then the OID rules will apply.

The underlying premise of the proposed regulations is that the general rule under the tax law is current taxation, and that deferral is proper only in limited circumstances. The thing that one has to keep in mind is the revenue impact. The Treasury simply cannot bear the impact of allowing tax deferral that currently applies to annuity and life insurance contracts to also apply to new instruments that are simply called "annuities."

The net result of opening the tax deferral regime to bank annuities would be the end of the "inside build up" for anything that's called an annuity without regard to the identity of the issuer. I think it's important to keep in mind that this whole issue of banks and annuities really goes to bank-issued annuities, not bank-sold annuities, which are a whole separate issue. It goes to the inside build up of the annuity product in general. The revenue impact just couldn't be sustained and if somehow or another these regulations were reversed, (that is, the Service had reversed the position that it had taken in the proposed regulations) and something favorable for the banking industry came out, the net result would be the end of the inside build up.

The ACLI has asked the IRS to provide a quick "fix up" program for failed life insurance programs, for failed variable contracts, and for failed or defective annuity contracts. I want to take a minute to mention that it has been my experience in doing due diligence on acquisitions that I see a large number of Section 72S problems. As you are at your companies or as you're looking at acquisition targets, you should be aware that there are a number of questionable annuity contracts out there in the market. This fix-it program would be important because it would allow companies with questionable annuity contracts to come in and get them fixed without having to pay the full amount charged on the 7702 fix-it program, which is the tax plus the interest (that is, the tax on the inside build up plus the interest). I've heard of one company approaching $40 million or $50 million dollars. This ACLI program could be very important and it's something that should be watched carefully.

MR. JULIAN J. DUKACZ: I'm going to talk about the tax reforms proposed earlier this year by the finance department in Canada. Prior to 1969, mutual companies were exempt from taxation in Canada and stock companies were taxed only on transfers to the shareholder's account. In 1969, they introduced an income tax system, and even though 25 years has gone by since then, the government got very little income tax revenue, despite having made massive changes to the rules during that time. There were many reasons for that, including some reasons that stem from the tax rules themselves.

Canada had, over the period, a very substantial number of general tax incentives. Bond losses were treated as ordinary losses relieved against other income. Tax reserves were, as we will see, probably too generous. Canada taxes life insurance companies only on their Canadian business. They had problems attributing the right amount of investment income to that business and this is a problem for both resident and nonresident companies that have branches in Canada.

Over the years most of the general incentives have been reduced or removed. For example, prior to 1994, capital gains were taxed at only 75% on a realized basis, then in 1994 the rules were changed to require 100% taxation on a mark-to-market basis. Bond losses are now spread over the remaining terms to maturity, and the government has looked at tax reserves three times in the past. In 1969 they allowed net level premium reserves. They did impose a statement reserve ceiling. In 1978 they moved to the full preliminary term method, with a cash value floor but no statement reserve ceiling. In 1988 they went to a one-and-a-half year preliminary term.

In terms of attribution of assets, in 1969 they had a simple rule. Basically, worldwide investment income was prorated to Canada using a reserve ratio. That was for resident companies. For nonresident companies, they allowed companies to make a branch

election. A couple of the larger U.S. companies that have branches in Canada argued that they kept separate books for their Canadian business. In 1972, the resident companies argued that they too should be allowed to make this branch election and that led to something called a Canadian investment fund (CIF) and designation process. The CIF is simply a measure of the assets determined for tax purposes to be related to Canadian business. Once that is determined, then companies are required to designate specific assets, and income from those assets would then be taxed. In 1975 the government identified, with industry's help, a number of deficiencies that could be corrected. In 1978 and again in 1988 they tightened the rules.

In very simplistic terms, the way the current tax formula works is a company would take its total invested assets, less certain exclusions, times the ratio of reserve liabilities in Canada to total. This approach emphasizes formula over facts, and it also has a lot of exclusions. An important exclusion from total investment assets is investments in shares of financial institutions. When this formula was developed, companies were not getting into subsidiaries or diversified financial services. Today these exclusions are very substantial and that has been the result of a lot of leakage. Of course, the exclusions from the formula gave rise to planning.

In 1988, the investment income tax was added. This is the tax on the inside buildup in policies that are exempt from accrual taxation. In 1990, the government ran out of patience waiting for income tax revenues from our industry and they imposed a capital tax. In 1992, having realized the miraculous effectiveness of the capital tax, an additional capital tax was added and again a promise to look at income tax was made. Because of the two capital taxes, the industry urged the government to get on with it and sure enough, in January 1995, they released a long-awaited proposal for reform. We were expecting the reforms to focus on income tax and hopefully remove the capital tax, but the proposals intended to increase the capital tax as well.

For income tax, they're proposing to lower reserves and they're also going to tighten up the attribution rules for multinational insurers. The additional capital tax was intended to sunset at the end of this year and they proposed to allow that to happen. However, they beefed up the base for the basic capital tax more than is required to offset the reduction from the repeal of the additional capital tax. In the Canadian life insurance company statements, realized gains and losses are amortized on a 15% declining balance basis and that gives rise to a liability. The government proposal would include deferred realized gains in the capital tax base.

Another feature of the capital tax base is that the excess of statement over tax reserves is included, and of course, their proposals for reducing tax reserves would increase that. Changes are proposed for the investment tax and policyholder taxation. All of these changes are intended to be effective January 1, 1996.

Over the years there has been ongoing discussion between the industry and the finance ministry about reinsurance. We wanted the definition of insurance to be expanded to include reinsurance, but the government, in its discussion paper, suggested that wasn't necessary because reinsurance is insurance. Finance officials had, over the years, talked about an "845" provision, but there was nothing along those lines in their proposals. For noninsurance business, which is a growing part of our activities (for example,

administrative services only [ASO] for fee business), the government may want to tax that on a worldwide basis, which is the general tax scheme in Canada.

The discussion paper refers to location of risk. It's an interesting problem. Multinational companies in Canada will carry on business in certain countries, particularly reinsurance, where they have no permanent establishment. Because of technical problems with the definition of life insurance reserves, we would not get reserve deductions and that business would be taxed on a cash basis.

The industry proposed that Canadian business be defined to exclude the insurance or reinsurance of foreign risks. The government declined and apart from that, has said nothing on this. This could be a most important part of the regulations when they do come out.

For tax reserves, the proposed rules are quite simple. For annuities without life contingencies, they're proposing reserves computed at level interest rates that equate the opening reserve to the premium. The idea is to give us the same treatment as banks, in particular to give us deductions for our acquisition expenses. For other business, they're proposing 95% of the smaller of statement reserves or statement reserves computed without regard to tax. The statement reserves can be negative under the policy premium method that has been used since 1992. The reserve rules would have applied to all old and new business and as a transition the opening difference between old and new reserves would be included in income over ten years.

For the attribution of assets, they're now trying to emphasize fact over formula and they're also trying to make the thing comprehensive, with no exclusions.

The general scheme now would determine the Canadian assets; that's the quantum of assets that will be designated from the annual statement. It equals all of the Canadian liabilities plus something called Canadian capital. Canadian capital is specific capital that is factually connected with the Canadian business, for example, the cash surrender value (CSV) floor for Canadian business, plus a share of proratable capital.

Risk-rated ratios based on our minimum continuing capital and surplus requirements (MCCSR) rules, which are similar to the risk-based capital (RBC) rules, would apply to total pro-ratable capital which would be assets less liabilities and excluding separate provisions that are dedicated to particular territories. For the attribution rules, the government proposed a minimum surplus of 7%, which we saw as being a gentle variation of the 842B provision in the Internal Revenue Code.

The program did ask for commentary on the impact of the proposals. The industry, as a whole, and individual companies, did a lot of work. The effect of the reserve reduction on the industry's annual taxes was estimated to be about a $180 million increase in tax over the transition period of ten years. The companies specifically found that, depending on the business products, specific results were all over the place.

We looked at premiums, and they would have to be increased substantially to maintain our return on investment targets. Reserves provide for income tax. Most companies are on a deferred tax accounting basis. The tax provisions, both the current payable as well as the deferred, would have to go up. A very large liability must be set up for the

ten-year reserve reduction clawback. The bottom line impact was horrendous. Return on equity was horrendous. Our MCCSR ratios went down because available capital was reduced, that is, cash was being converted into deferred tax assets, which is not a good number for available capital. Obviously, we would have been in a situation of having to do massive product redesign and marketing.

Not surprisingly, there ensued the inevitable lobbying, except this time it was with great intensity. It focused on reserves. That was the real problem that gave rise to these horrendous results. We argued that the 95% was arbitrary and simply wrong. It was not right in any case. We argued that the ten years was too short. We did analysis showing the clawback really should be something like zero for five years and straight line over 30 years. We found they were particularly concerned with the small companies and they formed a group and did their own lobbying; it was a group of 25 growing specialty companies. They were disproportionately affected by all this and, based on the numbers that they calculated, it was a question of survival for them. The CIA was asked to help. They argued that the transition should be much longer. The insurance regulator hired an independent firm to look at the small company group analysis and that firm did agree with the grave concerns raised in their submission and advised finance accordingly. So changes to the proposals are expected.

The present expectations are that for tax reserves for annuities without contingencies, the finance ministry will stick with its proposal to give us parity with banks. For other business or for existing business, they will continue current tax reserves. For new business, they'll allow 100% of statement reserves. Our additional capital tax stays. This was something that the industry offered up in order to buy a better deal on reserves. However, deferred realized gains would be out.

For the attribution of assets, they are expected to back away from their minimum surplus and the reason given was that they were concerned about treaty violation.

If that's not enough, there are potential future issues out there for us to deal with soon. A couple of years ago, Quebec started taxing the employer-paid health benefits. The federal government has been interested in that for the last couple of years, but lobbying has kept it at bay. But the expectation is that at some time they're going to take the political hit and bring this in. After all, they need the money.

There's been a great deal of talk there about attacking retirement savings. It's a big pool of funds. It looks very attractive to our revenue-starved deficit-laden government. Things that have been mentioned are possibly limiting contributions, or taxing the inside build up, or taxing the total assets of the funds.

The current government promised, as part of its platform, to replace the goods and service tax (GST) with something that could be more tolerated by people. Right now life insurance products are exempt, but the government will be looking at whether they should continue to be exempt, whether they should be taxable, whether they should be zero rated and what compensatory tax would be appropriate.

At the moment, the GST is a federal tax. Each of our provinces except one has retail sales taxes and they will be looking at harmonizing those. There are a couple of provinces right now that impose both a premium tax and a retail sales tax on group

premiums. We're concerned that if they merge with the GST, we could find ourselves with double taxation premiums.

MR. FRIEDSTAT: I always find it interesting to see how the Canadian authorities are addressing some similar issues that we've had to address in the United States, both in relation to insurance companies and policyholder and general tax issues.

MR. WILLIAM CARROLL: I'd like to congratulate the panel on a very informative session. I have a question for Ed Robbins. You discussed consequences of Regulation XXX. In one aspect of it, you talked about mortality tables. I'd like to see if I can pin you down and get a more specific answer. As I understand the law, it says the prevailing table to be used is the most recent commissioner's table permitted under the laws of at least 26 states. Then it goes on to say if there's more than one table that meets that condition as there would be when there are multiple tables out there (tables with and without select factors), that you use the one that generally produces the lower reserves. We have some prudent guidance that says the prevailing table is the 1980 CSO without the select factors, and now we have the new facts that there's a new regulation which has in it new and different select tables. Suppose that at some time 26 states adopt a regulation like XXX permitting these new select tables. Will 1980 CSO without the select tables continue to be the prevailing table?

MR. ROBBINS: First of all, let me answer that question in sections. Revenue Ruling 92-19 is specific in clarifying that 1980 CSO is to be used without select factors, but that ruling was promulgated well in advance of XXX, and at that time, the 1980 CSO table and the ten-year select factors became available simultaneously, so that you truly had two or more options under that table, that is, with or without select factors. It was apparently concluded by the Service that "without select factors" did give, in fact, the lowest reserves generally. Section 807(d) speaks to the table that gives the lowest reserves. Given the mix of business industry-wide, [we think] this was the apparent conclusion of the IRS.

It also apparently concluded that the word "generally lowest" was to be applied on an industry-wide basis rather than on a company-by-company basis. It's fairly common knowledge among actuaries that use of select factors raises reserves for whole-life, premium paying business, but lowers reserves on ART and a lot of graded premium life. It will also lower reserves on paid up insurance. You would most likely get different responses company by company.

Here is a short answer: if by 1997, for example, 26 or more states have adopted something like Regulation 830, and if the mix of business is substantially the same according to whomever made the decision in the early 1990s when 92-19 came out, then we'd probably be faced again with 1980 CSO without select factors as being the prevailing table.

MR. WILLIAM P. CHIROLAS: Ed Robbins, as I understand it, Revenue Ruling 94-74 has been tossed out by the court at this point.

MR. ROBBINS: Tossed out by whom?

MR. CHIROLAS: By some court that ruled that the strengthening rules are not appropriate.

MR. ROBBINS: I hadn't heard that. [It was concluded later than Mr. Chirolas had not been correctly informed.]

MR. CHIROLAS: You indicated that a group contract could have active life reserves beyond the unearned premium reserves.

MR. ROBBINS: I don't have much on it, because its scope apparently is quite small. I can show you what I have, Bill.

MR. CHIROLAS: There was an earlier ruling that dealt with a similar area. The idea was that under certain circumstances a group contract could qualify.

MR. ROBBINS: Was it Revenue Ruling 94-74?

MR. CHIROLAS: It's the definition of noncancelable/guaranteed renewable for tax purposes.

MR. ROBBINS: Is that Revenue Ruling 89-43? I believe it was.

MR. CHIROLAS: As I recall it could certainly well be it.

FROM THE FLOOR: I have a question for Hugh McCormick. What does the immediate DAC tax recovery on the highly leveraged COLI products mean to insurance carriers? What does that do to the revenue projections that the Senate and House were making by disallowing those interest deductions because they're going to accelerate these?

MR. MCCORMICK: I don't know the answer to that question. The House bill had, I believe, a revenue raising impact of $7 billion. I think it was started at $8 billion and then when they phased out interest deductibility, they went from $8 billion to $7 billion. With regard to the DAC tax proposal, I don't know what has been factored into revenue protections. I simply can't answer that question.

FROM THE FLOOR: One other question. If you manage to surrender in 1996, at least in the House version, are they not going to require you to complete the four out of seven?

MR. MCCORMICK: Yes. There is in both the Senate and the second House version a special rule if you surrender.

FROM THE FLOOR: But only surrender in 1996 if you keep it until the end. If you keep it for five more years, do you still get the four years?

MR. MCCORMICK: I frankly haven't thought through that detail but I think the answer to that question is yes.

FROM THE FLOOR: The four of seven rule is what I was concerned about.

MR. MCCORMICK: Presumably, if you're waiting, you're going to run the seven years.

FROM THE FLOOR: And keep paying premiums?

MR. MCCORMICK: Yes, exactly.