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COMMON MYTHS IN INTERPRETING THE COMPANY TAX PROVISIONS OF THE 1984 ACT

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When I joined our law firm in 1979 to specialize in insurance taxation, the Life Insurance Company Income Act of 1959 was already 20 years old and seemed well-entrenched. Many participants in the drafting of the 1959 Act were still around and there was a detailed legislative history that made interpretation of the basic structure and purpose of the statutory provisions relatively straightforward. Yes, the three-phase system was complex and, yes, there was a lot of litigation. But, Congress' underlying tax policy was not really in dispute particularly after 1961 when comprehensive regulations were promulgated with extensive industry input and comments.

I cannot say the same thing about the Tax Reform Act of 1984. It is now 25 years old and we seem to be debating fundamental principles about what Congress had in mind and what the statute really says. There are a few of us still around who were there at the 1984 Act genesis. We think we know what was intended and are frequently frustrated by revisionist interpretations. So, as my contribution to the 25th anniversary of the 1984 Act, here are some common myths about Congress' tax policy underlying the 1984 Act that I would like to debunk.

MYTH 1 – IN THE 1984 ACT, CONGRESS ENACTED A COMPLETELY NEW TAX REGIME FOR LIFE INSURANCE COMPANIES.

NOT TRUE.

By the early 1980s, the 1959 Act's three-phase system had become broken. The Menge Formula incorporated into taxable investment income (Phase I) was out-of-date and the phase system could be gamed to reduce tax liability, particularly with reinsurance. So, Congress wanted to eliminate the primary source of the problem—the three-phase system—in favor of a single phase based on gain from operations. If we were to compare the 1984 Act gain from operations with its predecessor in the 1959 Act, there is remarkably little difference. The changes made basically fall within three categories: 1) special deductions were eliminated as part of the repeal of Phase III; 2) life insurance reserves went from a net level premium basis to a preliminary term basis through the repeal of former section 818(c) and the adoption of section 807(d); and 3) simplification and clarification changes were made in an attempt to avoid much of the litigation that had occurred under the 1959 Act. Thus, for example, the definition of net investment income was simplified for proration in section 812 and premium recognition was placed on an accrual basis (thereby eliminating recognition of deferred and uncollected premiums). So, when we look at gain from operations in the 1984 Act, we are really just seeing a stream-lined version of the 1959 Act. That is why the legislative history tells us in effect: In reading the 1984 Act, do not try to reinvent the wheel; if the 1984 Act did not make a specific change, you should just go back to the 1959 Act for guidance. The basic point here is that most of the statutory provisions under the 1984 Act are carried over from the 1959 Act and the original well-established tax policy underlying those provisions did not change.

MYTH 2 – CONGRESS' PRIMARY GOAL IN THE 1984 ACT WAS TO RAISE REVENUE.

NOT TRUE.

The late 1970s and early 1980s were a period of great change in the life insurance industry. The advancements in computer technology gave insurers the ability to unbundle their contracts and make mortality charges and interest credits transparent. Universal life was born and policyholders were given flexibility within the contract to determine the level of premiums they would pay and the amount of death benefits they desired. The popularity of universal life, which credited excess interest and adjusted mortality charges for favorable experience, prompted stock companies to issue contracts that had many of the same economic benefits of participating whole life insurance issued by mutual companies. Mutual companies responded by offering their own universal life contracts so that their products would have the unbundled transparency that the marketplace was demanding.

The convergence of product offerings, coupled with a broken and out-of-date three-phase tax system, called for a legislative solution. How should the tax law be changed to ensure a level playing field in light of the rapidly changing and converging marketplace? Mutual and stock companies disagreed bitterly for many years whether the 1984 Act achieved its goal of fairness among segments of the industry and, thankfully, the repeal of section 809 has put an end to that corrosive debate. But, in interpreting the 1984 Act, the fundamental point to remember is that the changes in law were primarily driven by a Congressional desire to provide a level playing field among segments of the industry.

MYTH 3 – BY THE ENACTMENT OF SECTION 807(d), CONGRESS INTENDED THAT LIFE INSURANCE COMPANIES WOULD BE ALLOWED A DEDUCTION FOR THE SMALLEST AMOUNT OF LIFE INSURANCE RESERVES PERMITTED BY STATE REGULATORS.

NOT TRUE.

Congress did intend that the deduction for life insurance reserves would be reduced under the 1984 Act. In the 1959 Act, statutory reserves were the basis of computing the deductions for life insurance reserves. These could be determined on a net level premium basis and, if they were not, section 818(c) permitted an election to convert preliminary term reserves to net level premium reserves either exactly or by a crude, and sometimes overly generous, formula. In the 1984 Act, Congress changed this by limiting all companies to preliminary term reserves (CRVM) regardless of the statutory reserve method used.

Once this basic change was made, the driving force behind most of the other adjustments to life insurance reserves in the 1984 Act was a desire for a level playing field. Thus, mortality tables and interest rates were to be the same for all companies by reference to a 26-state rule and the reserve method would be determined by the National Association of Insurance Commissioners (NAIC) regardless of whether a particular state permitted smaller or higher reserves. These uniform reserve standards were adopted recognizing that the minimum reserve levels required by the majority of states and the NAIC were conservative. It was not until 1987 that Congress attempted to address the conservatism in tax reserves and, then, only in one factor – the assumed discount rate.

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MYTH 4 – STATUTORY RESERVES HAVE LITTLE RELEVANCE IN COMPUTING TAX RESERVES UNDER THE 1984 ACT.

NOT TRUE.

Life insurance company tax practitioners generally know that, under the 1984 Act, statutory reserves are still important in determining life insurance company qualification, the cap on deductible insurance reserves, certain reserves for supplemental benefits and several non-life insurance reserves under section 807(c). But, the importance of statutory reserve assumptions in federally prescribed reserves is often overlooked. Although NAIC actuarial guidelines have provided greater uniformity in interpretations of CRVM and CARVM, much uncertainty and divergence of practices remain. State regulators frequently permit actuaries the flexibility to adopt one of several permissible interpretations. In these circumstances, the legislative history says that the assumptions used for statutory reserves should govern for tax purposes. So, despite Congress' goal for a level playing field, the amount of tax reserves can differ between companies depending on their statutory reserve assumptions.

Where there are several permissible interpretations of CRVM or CARVM, the 1984 Act sometimes has been misinterpreted to require the lowest reserve assumption permitted by 26 states. This is not what the 1984 Act

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provides. The legislative history says that if the NAIC has not prescribed a specific interpretation of CRVM or CARVM, then the interpretation of 26 states will govern before resorting to the assumptions made for statutory reserves. The apparent rationale for this legislative history is that, where 26 states have adopted a specific interpretation, the NAIC tacitly has adopted a rule by the actions of a majority of its members. The legislative history does not suggest that a single 26-state interpretation has been adopted where a majority of states permit several permissible interpretations one of which may consistently yield lower reserves. In such cases, the permissible assumption used for statutory reserves properly governs even if it yields higher reserves, just as it would if the NAIC were to issue a guideline that permits several interpretations of CRVM or CARVM. The 1984 Act only requires tax reserves to be the lowest reserve permissible by 26 states when the NAIC specifies that method or when 26 states specify that method as the only proper interpretation of CRVM or CARVM.

MYTH 5 – FOR PURPOSES OF THE STATUTORY CAP, STATUTORY RESERVES ARE LIMITED TO SECTION 807(c) RESERVES.

NOT TRUE.

Under the 1984 Act, statutory reserves as defined in what is now section 807(d)(6) served two functions. The excess of statutory reserves over tax reserves served to increase a mutual company's equity base, and thereby taxable income, in the now-repealed "add-on tax" imposed by section 809. Statutory reserves also served—and continue to serve—as a limitation on the amount of deductible tax reserves. For these purposes, statutory reserves were defined broadly to include all reserves reported on the annual statement "with respect to" reserve items described in section 807(c). This definition incorporates two important concepts. On the one hand, the reserves do not have to qualify as section 807(c) insurance reserves to be included in statutory reserves, but, on the other hand, there must be a factual nexus between the reserve and an insurance reserve described in section 807(c). This "with respect to" wording of the statute was intentional and served the tax policy goals underlying both sections 809 and 807. For the "add-on" tax, the equity base started with statutory surplus and capital and was increased by, among other items, any excess of statutory reserves over tax reserves. Congress was concerned that mutual companies would artificially reduce their equity base by reporting a portion of what otherwise could be section 807(c) reserve items as some other type of liability on the annual statement. The broader "with respect to" language ensured that all reserves for the contract would be taken into account to the extent they exceeded reserves described in section 807(c), wherever they appeared on the annual statement.

For the statutory reserve cap, a broad definition of statutory reserves served the tax policy objective of a level playing field. Congress' goal was that all life companies obtain comparable tax reserve deductions for the same products, but only if the company did not hold smaller reserves on its annual statement. But, to prevent an unfair result, statutory reserves were broadly defined so that the cap would come into play only where the company does not have sufficient reserves on the annual statement for the contract wherever those reserves might be reported.

A good example of the practical effect of Congress' tax policy is the treatment of deficiency reserves. Although deficiency reserves were not deductible under the 1959 Act, an actual disallowance was rare. The reason was that statutory reserve interest rate and mortality assumptions could be adjusted to increase basic deductible reserves and eliminate the need for deficiency reserves. The 1984 Act eliminates this tax planning opportunity when dealing with the statutory reserve cap. The level-playing-field objective is served by including deficiency reserves within the statutory reserve cap whether or not a company

adjusts statutory reserve assumptions to avoid deficiency reserves. Because deficiency reserves are part of basic CRVM reserves as defined in the Standard Valuation Law by the NAIC, they are reserves held "with respect to" section 807(c)(1) life insurance reserves and included in statutory reserves. The legislative history reconfirms that Congress intended deficiency reserves to be included in statutory reserves for purposes of the statutory reserves cap.

MYTH 6 – NAIC ACTUARIAL GUIDELINES HAVE NO RETROACTIVE EFFECT.

NOT TRUE.

Section 807(d) provides that life insurance reserves generally are required to be computed using the tax reserve method prescribed by the NAIC as of the date the contract was issued. Because of this basic rule, it is frequently asserted that actuarial guidelines have no retroactive effect on contracts issued prior to the actual date the guideline is adopted. But, this assertion is almost always wrong, which is why life insurance companies are currently challenging this position in litigation.

It is true that an actuarial guideline adopted in a year after a contract is issued may not represent the NAIC's express interpretation of CRVM or CARVM prior to its adoption. However, an actuarial guideline may represent one of several permissible interpretations of the Standard Valuation Law even before it is adopted by the NAIC. And, rarely does an actuarial guideline overrule a single interpretation of CRVM or CARVM previously adopted by 26 states. In these circumstances, where an actuarial guideline represents one of several permissible interpretations of the Standard Valuation Law at the time the contract was issued, as a practical matter, it becomes the method that should be used for tax purposes. At such time, the basic rule that statutory reserve assumptions must be followed takes over because at the time the contract was issued there was no definitive NAIC or 26-state interpretation.

So, as a general rule, almost every actuarial guideline has retroactive effect when statutory reserves are changed to comply with the guideline (subject, of course, to the possible application of the ten-year spread rule of section 807(f)). A notable exception from this general rule will be Actuarial Guideline 43 which supersedes two previous guidelines. For variable annuity contracts issued prior to the adoption of Actuarial Guideline 43, the NAIC had prescribed Actuarial Guidelines 34 and 39 which should continue to apply to previously-issued contracts.

CONCLUSION

There was a great deal of litigation over the complex provisions of the 1959 Act. These disputes rarely involved a disagreement about Congress' tax policy, but instead usually concerned whether a particular item met the Code's technical definition. The 1984 Act successfully eliminated most of these disputes by repealing the three-phase system and making many technical amendments. But, for some reason, after 25 years, we are still arguing about Congress' basic tax policy objectives in the 1984 Act. But, if we go back and examine what Congress was trying to accomplish, most of these disputes should go away. When interpreting the company tax provisions of the 1984 Act, ask yourself: Will this interpretation promote a level playing field and will it be consistent with how gain from operations was interpreted under the 1959 Act? Divergence from these two basic principles in interpreting the 1984 Act provisions should have clear support in the statute or legislative history. ◂

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