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## Session 97PD

### U.S. Life Company Taxation

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*Summary: As the NAIC continues to promulgate actuarial guidelines and regulations, it effectively sets tax policy, since a tax reserve method is effectively determined by NAIC definitions. The tax implications of the “Valuation of Life Insurance Policies Model Regulation” (formerly proposed Regulation XXX), Guideline 33, proposed Guideline MMM, and some recent IRS audit issues are covered.*

**Mr. Edward L. Robbins:** I’m a principal with KPMG in Chicago, soon to be KPMG/ E & Y, or some combination thereof. I’ll be moderating this session, and I’ll be making a few remarks about *Actuarial Guideline (AG) 33* right at the beginning. Let me introduce our distinguished panel. Brian Kavanagh is a member of the Academy, and he’s chief actuary and president of his own firm, Integrated Actuarial Services in Chicago. He’ll be discussing the tax implications of *Regulation XXX* or, as some people call it, *Regulation 830*, valuation of life insurance policies model regulation, the tax implications thereof. Art Panighetti is the director of tax planning at Northwestern Mutual Life in Milwaukee. He’ll be discussing the new *AG 34*, formerly proposed *Guideline MMM*, on variable annuities (VAs) and a few other selected short subjects. Our anchorman is Mike Eckman. Mike is second vice president and tax actuary at ReliaStar Financial in Minneapolis, and he’ll be speaking to some recent issues brought up on audit.

I’d like to begin the session by covering two major issues of *Guideline 33*. For those of you who are interested in learning the mechanics of *AG 33*, “it’s too late.” There was a teaching session (15TS), and then another panel discussion (97PD) that took

care of the mechanics of it, so with your permission I'm not going into the details. I want to deal with the tax implications of the original *Guideline 33* as it came out in 1995 and "son of *Guideline 33*," which is about to be approved by the NAIC in December 1997. The two issues I want to talk about are basically what are "new requirements" versus "clarifications" under these guidelines? That might sound like "hokey tax talk," but those implications are extremely important in terms of the tax character of a "new requirement" versus the tax character of a "clarification of an existing requirement." On new requirements, you're subject to the NAIC interpretation from that issue year forward. An "existing requirement clarification" is basically something you have to comply with on all your in-force business, and that generally results in what we call a ten-year spread effect on business that was issued prior to the year of change. Usually a strengthening of business that was issued prior to the year of change is a bad answer for deferred annuities (DAs) (since it results in a ten-year spread effect), so the questions "What are new requirements?" and "What are clarifications?" become rather important for DAs.

For the original guideline that came out in 1995, there were three basic causes of what I would call general tax reserve increases over the industry according to our experience. The first was testing the relative incidence of free partial withdrawals. The second was the valuation of annuitization options, which many companies weren't doing. And the third was the so-called "93% of fund value" rule. This last rule applies if you have certain prejudicial language in your contracts that allow you simply to take current settlement options equal to existing immediate annuity purchase rates at time of settlement. If you have that type of language in your contract, you have to hold at least 93% of fund value as your statutory reserve.

Anyway, the questions, back under that original guideline, were "Which of those three items were clarifications?" and "Which of those were new?" At KPMG we felt that this 93% requirement was absolutely a new requirement, despite what the preamble text of the guideline said, which was that everything was a clarification. Annuitization appeared to be pretty clearly a clarification of an existing requirement. Incidence of free partial withdrawals—that's a question. Some companies are considering it one way; some are considering it the other. In the new, revised actuarial guideline, some big changes are possibly arising from two sources. One is the concept of elective benefits versus nonelective benefits. (I always thought that death benefits were nonelective, and I guess I was right). The other is the concept of the integrated benefit stream approach to valuing Commissioners Annuity Reserve Valuation Method (CARVM) annuities that the revised, new guideline is requiring. From very preliminary indications that I've seen, it causes strengthening in some companies, but it causes weakening in other companies. Integrated benefit stream approaches could perhaps give you a better answer than you might have gotten under the original *Guideline 33*. Whether you have a spreadable weakening or a spreadable strengthening with respect to the change is another question. They always say in tax circles it's good to know the

questions. You don't always know the answers. Sometimes you don't know the answers for about five years. There is a saying that, "There's no such thing as truth. Rather, the issue is whether it's a reasonable filing position or not."

Regarding my second and last issue, the revised *Guideline 33* says that the new requirements are effective in 1998, but the guideline was approved in 1997. So what is the effective date for tax purposes, 1997 or 1998? One approach is to say, "Well, if the requirement is a clarification and thus a spreadable event on your existing business, it doesn't really matter a lot." You have to fix things up and take your ten-year spread. If it's a new requirement, then it does become an important issue. The way I'm seeing it right now, it looks like a 1997 threshold—that is, 1997 issues forward for new requirements—for a couple of reasons. The guideline talks about the ability of a company, subject to the approval of the commissioner, to build reserves on a one-third, one-third, one-third basis, beginning in 1998. You could also interpret that to be zero, one-third, one-third, one-third, beginning in 1997. Additionally, when you go to the 1984 act Blue Book, you find that it's the interpretation of the NAIC in the year of issue of the contract that becomes the tax reserve method—not the requirement but the interpretation. So it looks clear or reasonably clear that 1997 would be your threshold year. It brings up a very interesting question. For those of you who are going to suffer a strengthening, that is a bump-up in your reserve, you have a nice bump-up in your tax reserve one year before the statutory reserve bump-up. Mike Eckman asked me a little while ago, "Why doesn't the NAIC give you a horrendous requirement like 200% of your account value effective in 2026?" It would be a great solution.

**Mr. Brian Kavanagh:** Three actuaries were on their way to a Society meeting, and they were kidnapped. They were held for ransom, and when their employers refused to pay the ransom the kidnappers informed the three actuaries that they were to be shot, but they would have one last request. The first actuary pointed out that he was on his way to a Society meeting to speak on tax problems for life insurance companies. He had spent a lot of time preparing a very detailed, learned paper, and he would very much like to present it to his two fellow actuaries before being shot. That was no problem. The second actuary had also prepared a very learned paper on XXX, and he also requested that he be allowed to present it to his two fellow actuaries before being shot. The third actuary requested that he be shot first.

I feel like I'm in that situation now since I'm speaking not only on taxation situations but also XXX. Taxation is complicated. I believe XXX is also extremely complicated. Understanding some of the principles when you try to put them both together is, in fact, very tiring indeed. To try to expand it in the time available to me is not really possible. I think I can give you a few examples and point out the areas you need to look into to get the best results. As if the situation is not complicated enough, we have from a tax point of view, the IRS as of March 12, 1995, when the NAIC

approved XXX. So as far as they're concerned, it is in effect. In general most insurance companies are ignoring the fact that they can establish tax reserves under XXX, and since XXX tends to increase tax reserves, they may be getting less advantage than they otherwise would normally get.

Generally, I find the basis for this is that most companies do not have the necessary systems in place in order to comply with XXX, and because of the pressure that most of us work under today with regard to doing essential things, it may be considered that since it doesn't really hurt the IRS—they get more in taxation—no one's really going to notice. Now, I pointed out to those actuaries who take that position that I think this is a legitimate position to take, but don't do it on your own initiative. Advise your management that you're ignoring the possibility of paying less taxes. If they allocate the resources to enable you to do that, then they're entitled to do so, but if you are swamped with staying current with the existing problems, I think you should at least advise your management that you're not taking advantage of something that has occurred. As Ed mentioned earlier, what happens if somebody were to say that your reserves 10 years from now have to be 200% of your account value? That would be a very good thing. In effect, that is what has happened on the life side, and, in particular, it affects not just term policies, but also universal life (UL) policies.

Now, frequently I also get the response, and it's a kind of very smug response from people who issue UL policies, that we are not affected by XXX, as if there's some kind of taint to those policies that are affected. My response to that approach is if you're not affected, you're losing a tremendous opportunity because with secondary guarantees you cannot increase your statutory reserve, but you can substantially affect your tax reserve. In general, UL tax reserves, ignoring their cash values, are approximately 70% of your statutory reserves. The reason why that differential is greater than on other products is that you are projecting normally to age 100 on benefits and discounting back. You're projecting at guaranteed rates that may be 4.5% or so and discounting back by rates that may be 2% or 3% higher. The effect, of course, is quite obvious. You have a tremendous reduction between your statutory reserves and your tax reserves. Actually, a good average may be 29%, not 30%.

With regard to secondary guarantees, you need to look upon these kinds of policies as term policies. Now, what is the advantage in that? The advantage of a 15-year term policy to establish reserves as opposed to a UL policy is that the interest differential is working not until age 100 but for 15 years, so when you project out for 15 years and discount back, typically you get the tax reserves to be 95% of your statutory reserves. In that regard the situation today suggests that there's a possibility of transferring your reserves from a UL-type status, in which the 70% rule may apply, to a term-type reserve, in which the 95% rule could apply.

Those are essentially general comments about XXX. The whole area is getting more complex. Not too many years ago we tended to think of reserves in a very static way. Today that's no longer true. They can be quite dynamic. XXX is a little difficult to read, but those of you who have read it may recall that there's one very important qualification with regard to UL and also, by implication, term policies, and that is that any guarantee made after issue needs to be assumed to have been made at issue, so post-issue guarantees can be treated, at the point of time from which they were made, as issue guarantees. Now, if you think long enough about that, you realize that instead of statically looking at the entire reserve area—both statutory and tax and statutory broken down between basic and deficiency—you can manage your reserves as opposed to accepting their particular levels in any one of these categories.

One of the problems I find with most companies is that they have valuation actuaries, illustration actuaries, appointed actuaries, and many other descriptions, but very few companies have a tax actuary, and that, I think, creates a situation within a company in which very little attention is paid to tax levels. With those companies that have tax actuaries, and we have a tax actuary on our panel, they tend not to get involved at the very early stage when products are designed. You can do only a limited number of things in the tax area after a product is designed. All the work really should be done at the design stage before it is filed and, to some extent, fixed in stone. The rewards can be fairly substantial. Some of the work we have done suggests that you can improve your profitability, for example, with UL by as much as 25% by properly planning tax implications, but if you wait until after issue, much of that opportunity is gone.

With regard to taking into consideration things like secondary guarantees, they don't have to be backbreaking. You do not have to guarantee at age 45 \$2 per 1,000 for 20 years in order to create a secondary guarantee. The language in the actual XXX says that if at any time the policy stays in force because of the guarantee, then it is a secondary guarantee. For example, your premium rate can be such that in the 20th year, and 12th month, it could be deficient, which would constitute a secondary guarantee, and, as such, you could then establish reserves on a 20-year term plan to convert them to a UL plan in order to establish your actual tax reserves.

What I'll try to do as quickly as I can is not give you solutions to these problems but to explain to you some of the problems. In general, I've been advised not to give solutions because that's a very treacherous area when it comes to taxes, but, nevertheless, I think I can give you some examples by which you can see that strategies become far more important. Anything you do can have an effect not only on your statutory reserves but also on your tax reserves, and that suggests that we need to develop some kind of mechanism. If, for example, our tax reserves go up \$100, and our statutory reserves go up \$120 as a result of whatever action you take, is that a good strategy or not? Clearly, they have a different effect on your bottom

line because \$1 million not held in taxable annuities or an increase in tax reserves may come down to the bottom line as an extra \$350,000 in that year, whereas an extra dollar in statutory reserves transfers money from surplus where it may be earning 20% to reserves where it may be earning a portfolio rate of 7%. The analysis is not too difficult, but, nevertheless, it needs to be done.

I've come up with a relatively simple formula with regard to how you can analyze whether or not a strategy is working. The formula is not very difficult, but it's based more or less on assuming that whatever the increase in the tax reserves and whatever the increased results in the statutory reserves may be, you want to be neutral as far as whatever interest earnings you can make on the various savings, and that is at the surplus earning rate minus the portfolio rate divided by the surplus earning multiplied by the tax rate. Assume you can earn three times as much on your surplus earnings as you can on your portfolio rate. That will give you a ratio of two-to-one; that is to say, for every dollar increase in statutory reserves you should have at least a \$2 increase in your tax reserves. Some of the tables I'll present give you the results of those strategies. If you finish up in a plus situation, that is a plus strategy. If you finish up with a minus situation, that would be a minus strategy. You'll see there are quite different results depending upon whether or not XXX is passed, and after XXX, and where you project your various account values to be. Bear in mind when you project account values that they may be very much related to the level of no-premium, no-lapse premium guarantee. If you have very high no-lapse premium guarantees, you can expect higher account values. If you have low premiums, you can expect lower premiums.

These are very routine assumptions that I've made with regard to the examples I've prepared. I've obviously tried to keep the examples extremely simple, so I've assumed that the policy, of course, is kept in force by a no-lapse guarantee and that the no-lapse premiums are level and are not deficient, and that also is important. Even though they're secondary guarantees, they may not be deficient because you're determining whether or not they are secondary guarantees based on guaranteed assumptions and not on valuation-type assumptions—that the policy was issued mid-1995 and, therefore, is covered by the NAIC XXX regulation, that there are no post-issue guarantees as it's a very static situation, and reserves are unaffected by the cash value minimum. The strategy that I mentioned earlier, the one I'm using here, is that one basic reserve dollar increase can be offset by a \$2 increase in the tax reserve. Implicit in that is the assumption of paying approximately one-third—the tax rate is one-third—and also the fact that maybe surplus earnings are three times your portfolio earnings, which would result in a two-to-one ratio.

The first result is based on a relatively low account value of \$500 and, therefore, would probably reflect a situation in those policies in which the no-lapse premium was relatively low (see Table 1). The three lines of results are if you do nothing, which is the first line, and the answer obviously from a strategic point of view is

zero. There's no increase in either your tax reserves or your statutory reserves. And again, I'm showing the tax reserves as a percentage of the basic reserves. There are no deficiencies. It's indicated here that it's 71%, not a very good result from a point of view of trying to maximize tax reserves. XXX is in effect today from a tax point of view, but outside New York not from the statutory point of view.

TABLE 1  
 Strategy for UL Account Value = \$500  
 Face Amount = \$100,000  
 Male Age = 45 NS  
 Valuation Duration = 2.5 years  
 No Lapse Guarantee = 15 years

	Tax Reserve	Basic Reserve	Strategic Points Gain*	Tax as Percentage of Basic
No Security Guarantee	\$245	\$347	0	71%
Security Guarantee, No XXX Adoption	347	347	102	100
Security Guarantee, XXX Adoption	662	746	(380)	89

\* Strategic points are tax reserve increase less twice basic reserve increase.

If you had a 15-year guarantee as outlined in this example, the situation for your reporting at the end of this year would be given by the second line. Your tax reserves would, in fact, be equal to your statutory reserves, and from a strategy point of view, the actual gain is indicated there to be 102 points, and the percentage of taxes, the percentage of basic, is 100%. You can't do much better than 100%, and if your strategy requires that both of them are increased by \$1 in each category, that would have a negative effect on the number of points. In this particular example you achieve an ideal result as far as taking some action before you have to do so as far as your statutory reserves are concerned.

The third line relates to what will happen after XXX goes into effect. Let me sidetrack. Some extremely bad advice has been given to many actuaries with regard to when XXX will come into effect. I've heard prominent members of the Society banter the year 2000 around as if it was cast in stone. It is certainly not cast in stone. Texas, according to my information, will pass XXX, will not have a 51% provision, and XXX will be effective next year. The date has not yet been announced, but I would assume that the latest possible date would be December 31, 1998. The reason I think they may pick that date is so that there will be enough people who have passed it next year so it becomes effective generally on January 1, 1999, throughout the U.S., but that is only part of the problem. This is extraterritorial. If one key state passes this regulation, most companies are going to have to comply in every state; otherwise they may have to jeopardize their license in that state. These are companies that are selling 30 competitive no-lapse guarantees in their UL contracts or in their term contracts. Wisconsin still is scheduled for January 1, 1998. For most companies Wisconsin is a fairly important state. They cannot afford to jeopardize their ability to do business in that state for some temporary gain. The Life

Council thinks that Wisconsin is going to change that to January 1, 1999. Well, they have information that I do not have, and I've talked to the subcommittee that makes those decisions, and they certainly haven't made that decision yet.

The next example shows what happens if, in fact, there is a \$1,000 account value as opposed to \$500 (see Table 2). From a strategy point of view before XXX the results are good. They're not 100% or 95%. After XXX they're still not as good, but they're not negative. Their strategy points are 69, and for those people who think that the account value is between, say, \$500 and \$1,000, this strategy in both those situations is working out either very good if it's low or reasonably good if it's high. However, if you've misjudged the situation and the account values are more like \$2,000, which is relatively high, you can see that you get no advantage because the higher reserves are what is determined by UL (see Table 3). So your strategy has come to naught. You finish up with a flat-across-the-board 71% in each of these situations. Again, this is not a very satisfactory result.

TABLE 2  
Strategy for UL Account Value = \$1,000  
Face Amount = \$100,000  
Male Age = 45 NS  
Valuation Duration = 2.5 years  
No Lapse Guarantee = 15 years

	Tax Reserve	Basic Reserve	Strategic Points* Gain	Tax as Percentage of Basic
No Security Guarantee	\$491	\$694	0	71%
Security Guarantee, No XXX Adoption	662	694	172	95
Security Guarantee, XXX Adoption	662	746	69	89

\* Strategic points are tax reserve increase less twice basic reserve increase.

TABLE 3  
Strategy for UL Account Value = \$2,000  
Face Amount = \$100,000  
Male Age = 45 NS  
Valuation Duration = 2.5 Years  
No Lapse Guarantee = 15 Years

	Tax Reserve	Basic Reserve	Strategic Points* Gain	Tax as Percentage of Basic
No Security Guarantee	\$ 981	\$1,389	0	71%
Security Guarantee No XXX Adoption	981	1,389		71
Security Guarantee, XXX Adoption	981	1,389		71

\* Strategic points are tax reserve increase less twice basic reserve increase.

However, we know there's a certain amount of dynamic nature to what we can do. So we could, if we found ourselves in that situation, increase the no-lapse guarantee, say, to 23 years (see Table 4). Now the picture changes a little bit where



the strategy will produce a point gain, and we can be very happy that has given us at least some beneficial rewards. If, however, you make a mistake and are too generous with your no-lapse guarantees, you can see that before XXX comes into effect you're looking very, very good (see Table 5). You're back to the 100% as far as statutory reserves and tax reserves. However, once XXX goes into effect, a disaster has occurred. Your strategy has backfired, and now you have a serious strategy loss with regard to what you want to accomplish. These are rather flat results, which I present only to indicate that you have to be extremely careful with regard to not only the guarantees you may make at issue but also any subsequent guarantees that you may make. There are significantly better strategies than the ones I'm showing here obviously, but those are rather involved, and I don't have the time to get involved with them. There are many strategies that can be developed, however, in which the situation in which you get into a negative position doesn't arise, and those are obviously the ones that you would want to employ.

TABLE 4  
 Strategy for UL Account Value = \$2,000  
 Face Amount = \$100,000  
 Male Age = 45 NS  
 Valuation Duration = 2.5 Years  
 No Lapse Guarantee = 23 Years

	<b>Tax Reserve</b>	<b>Basic Reserve</b>	<b>Strategic Points Gain*</b>	<b>Tax as Percentage of Basic</b>
No Security Guarantee	\$ 981	\$1,389	0	71%
Security Guarantee, No XXX Adoption	1,127	1,389	146	81
Security Guarantee, XXX Adoption	1,127	1,389	146	81

\* Strategic points are tax reserve increase less twice basic reserve increase.

TABLE 5  
 Strategy for UL Account Value = \$2,000  
 Face Amount = \$100,000  
 Male Age = 45 NS  
 Valuation Duration = 2.5 Years  
 No Lapse Guarantee = 30 Years

	<b>Tax Reserve</b>	<b>Basic Reserve</b>	<b>Strategic Points Reserve</b>	<b>Tax as Percentage of Basic</b>
No Security Guarantee	\$ 981	\$1,389	0	71%
Security Guarantee, No XXX Adoption	1,389	1,389	408	100
Security Guarantee, XXX Adoption	1,596	2,007	(623)	79

\* Strategic Points are tax reserve increase less twice basic reserve increase.

I've been talking, obviously, about UL, and Ed did ask me to talk a little bit about term because no one else apparently was going to cover that. Term is much more complex than a UL situation, and the actual strategies that need to be employed

with regard to term almost defy the imagination, but, nevertheless, if you put them into effect, you can have tremendously beneficial results. I can give you a few simple pointers. Before XXX, if you put some strategies that once determine your tax reserves onto XXX, the only thing you can do is gain because your tax reserves are not effective with regard to statutory because it doesn't apply. They can, however, substantially increase your tax reserves to the point where the cap comes into effect so your statutory reserves will always equal your tax reserves. Anyone who's not using XXX for their term business is not taking advantage of what's clearly available today.

Post-XXX, the picture becomes extremely complex, but let me throw out something so it will at least give you some thought. The basic reserves, the statutory reserves, are the higher of either unitary reserves or the segmented reserves. Reserves are equal to basic reserves plus deficiency reserves. The trick is to establish your guarantees so that the prevailing method, be it unitary or segmented, yields the highest basic reserve. If you have one method yielding \$10 basic, \$90 deficient, and another method yielding \$80 basic, \$20 deficient, you'd be better off with the second method. Now, to ensure that you can use the second method, make sure your guarantees are such that the second method gives \$101 reserves so you finish up, say, with \$80 tax reserves reduced by, say, the interest backwards and forwards, which may make it \$77. It's far better to have that as a tax reserve rather than, say, \$19. There are other complications with regard to term business, but we don't have time to get involved with them today.

I'll consider some of the complications next. I'm generally looking at tax reserves, and I'm not mindful of some of the other considerations that clearly need to come into play. If you have lower premiums, for example, you may get more business, and that, from a strategy point of view, may be far better than any kind of tax savings that could be affected. The policy provisions themselves are very important when you establish your guaranteed periods and the amount of your guaranteed premiums. Obviously, the post-issue guarantee dynamic has to be done almost on a seriatim-type basis, and to that extent you need fairly sophisticated software to accomplish it. It cannot be done from a theoretical point of view where you can sit down and say, I imagine this will be the result. It's very definitely dependent on your actual population or what you project your population to be.

There is the possibility that you can manipulate your cost-of-insurance (COI) charges to achieve certain account value levels. The opposite of that, of course, is that if you keep your COIs too low, it may create deficient premiums. Deficiencies may be created after XXX goes into effect. In everything you do, above all, there's almost no plus to creating deficiency reserves per se, unless for marketing reasons that's the only way you can go. As I mentioned, everything varies very much by age, duration, and underwriting class. The analysis cannot be general. It has to be specific. And state variations will cause you some concern. I talked about the pre-

XXX and the post-XXX. Unfortunately, there's another state—maybe you want to call it limbo—but it's that time during which some states pass XXX but not your home state. You can take some strain in those states because you don't have to publish information from it. If you want to think from a strategic point of view, you could have three strategies in effect, one before you have to comply with XXX, one in which you don't have to comply with it in your home state, and one in which you have to comply with it in your home state. They're all distinct, different strategies, and to the degree that you may feel that you want to adopt one or the other, it depends very much on the expected savings as far as the tax goes. By the way, I should emphasize that although I'm treating it from the tax point of view, clearly from a company point of view you're looking on it as a guarantee to your policyholders, and you want to make sure you get the maximum benefit from those guarantees because once you make the guarantees, the tax benefits flow from those. You're not making these changes only to affect certain tax benefit arrangements. The changes are to be made to improve your guarantees to your policyholders because you can't take away guarantees; you can only give them. Your strategy has to bear that in mind too.

When do you have conflicts? If you have very low no-lapse, you have deficiencies; if you manufacture the COIs to achieve certain targets, the guarantee reduces flexibility and actions the company may take in the future. There's the whole issue of having simple policies compared to something that is more complex. A benefit cost kind of analysis needs to be done, and, again, we're back to the old issue of whether or not it's an essential job for the company to get this particular program in place compared to other jobs it may have, and, of course, the actual software you need to do to be able to handle this thing is not available usually. I have not known any company that developed it. There are some vendors, obviously, who have. And that is more or less all I have to say on it. It's a relatively straightforward, simple situation, and I hope I have been able at least to open your mind up a little bit to the possibility that substantial savings can be affected. One company we did an analysis for, a medium-sized company, was able to increase their tax reserves without affecting their statutory reserves by \$20 million, which is not pennies.

**Mr. Arthur V. Panighetti:** One of my topics deals with some tax simplification ideas, and I was very happy to hear that even a liberal democrat like Professor Reisch can support tax simplification. The other topic that I'm going to cover is *Guideline MMM*, and relevant to yesterday's stock market plunge, it created many more new minimum guaranteed death benefits (MGDB). There will be two distinct parts of my presentation. The first will be a discussion of *Guideline MMM* which is now called *Guideline 34* since it was adopted last month.

I think this guideline has some interesting aspects for tax reserves. It also shows that the evolution of CARVM, particularly as it relates to VAs, is making a significant shift toward greater complexity. After the *MMM* presentation I'd like to share with

you the fruits of a Northwestern Mutual Life department-wide task force effort. We hypothesized that we had a reasonable business like the federal government. We developed several changes to the current tax law that might move us toward more simpler, easier-to-administer tax rules.

Actuarial guidelines in general provide regulators and actuaries guidance in applying the valuation and nonforfeiture laws. Several actuarial guidelines provide actuaries with interpretations to apply CARVM in determining reserves. To this extent they also help us determine how to apply the Commissioner Reserve Valuation Method (CRVM) and CARVM to calculate the federally deductible tax reserves.

*Guideline MMM* has as its specific purpose to provide a method of applying minimum reserve standards for MGDB provided in VA contracts. As we will see, this guideline raises some interesting issues as an interpretation of CARVM under tax law.

The first potential issue, as Ed alluded to with *Guideline 33*, is the implementation date. The guideline will be effective December 31, 1998, and will affect all contracts issued since 1981. A grade-in period of up to three years for statutory reserves may be allowed in some circumstances. This raises that first question. When is it effective for federal income tax purposes? As Ed alluded to, you could argue 1997 because that's when the NAIC approved it or 1998 since it came into being. I agree with Ed. I think it will probably be effective 1997, but, once again, it could be an issue, and it seems that any reserve increase would be spread over ten years.

The guideline states that the reserves for the MGDB are to be valued employing two CARVM calculations. One of these is the integrated reserve. This reserve represents a total reserve held in support of the contract both in the separate account and in the general account.

The other specified CARVM calculation is called the separate account reserve, but little is specifically said on how this reserve should be computed, only that it is the reserve that should be held in the absence of the MGDB reserve. The guideline acknowledges that the industry has struggled with the issue of how to apply CARVM to VAs. It seems that there's no intention to change companies' current practice, at least in regard to their separate account reserving. The actual MGDB reserve is really just simply defined to be the excess of the integrated reserve over the separate account reserve but not to be less than zero. The MGDB reserve is to be held in the general account.

In reviewing this guideline a question that could be raised is this: Does *Guideline MMM* indirectly define CARVM for all the benefits of the VA beyond just the

reserve for the MGDB? If this is true, it might mean that the guideline would be applicable for determining the appropriate CARVM methodology for tax purposes for the entire VA contract. If we look to the purpose of the guideline, it clearly limits itself to the valuation standards for the MGDB. The guideline also acknowledges that no industry standard has existed for applying CARVM to variable annuities in general. The guideline mentions that some companies have held account values in the separate account while others have held surrender value. It is stated that those companies that hold surrender values may need to hold the additional MGDB.

If you go back to look at that simple formula, the application of CARVM is specified for the integrated reserve, and there's no specific CARVM methodology that's provided for the separate account reserve. The MGDB reserve really is just a plug between the integrated reserve and the separate account reserve, so if a company's separate account reserve exceeds the integrated reserve, that amount would still continue to be held in the separate account and no MGDB reserve would be necessary. If a company's separate account reserve is less than the integrated reserve, then the guideline would seem to provide an interpretation of CARVM for the entire contract reserve.

How is CARVM applied to the integrated reserve calculation? The first step is to reduce the account assuming an immediate drop. Following this reduction the reduced account value is projected at a net assumed rate. Both the immediate drop percentage and the gross assumed rate vary by asset class and are specified in the guideline. From this projected reduced amount account value a stream of net amount-at-risk is determined based upon the structure of the MGDB. A new mortality table that is specified in the guideline is applied to this stream to determine a future projected stream of expected death claims associated with the MGDB; it essentially defines the net amount at risk that's mortality-adjusted.

The second step is to project a stream of the unreduced account values at the valuation interest rate, less appropriate asset-based charges. The valuation interest rate should be the annuity valuation rates consistent with the standard valuation law. The new mortality table mentioned before is applied to this stream of projected account values to determine another future projected stream of expected death claims based upon the account value.

The third and final step is to project that same stream of unreduced account values in the second step but ignoring the MGDB. This would primarily be the surrender values, but it will also include any other benefits provided under the contract, except the MGDB. The stream of base benefits is discounted for survivorship based upon the valuation mortality, and all three of these benefit streams are then combined. The greatest present value benefit becomes the integrated reserve.

As I mentioned, the valuation rate to be used in projecting unreduced account values is reduced by appropriate asset-based charges, and the gross assumed returns after the immediate drop are also to be reduced by the asset-based charges. The appropriate level of charges, if any, with which to reduce the projected rate has not been clear in the past, and the guideline requires that the charges be reflected, but only the appropriate charges. I guess a question for tax reserves is, How are these projection rates, both the valuation rate and the gross assumed rates, to be modified for the application of the applicable federal rate for tax reserves? I'm not sure there's a clear answer to that yet.

The mortality table presented in the guideline is the 1994 VA, MGDB mortality table. It's derived from the 1994 group annuity and mortality basic table, and it's increased 10% for margins. In order for a mortality table to be prevailing for tax purposes it has to be enacted into law by 26 states. Since actuarial guidelines are not enacted into law by the states, it's unlikely that this table will be permitted for federal income tax (FIT) purposes. This introduces yet another difference in the statutory and tax reserve calculations.

The guideline has some interesting treatment for reinsurance. It provides a specific calculation for both the reinsurance assumed reserve and the ceded credits. For the reinsurance ceded the integrated reserve is calculated net of reinsurance. The benefit streams are modified to reflect both the reinsurance premiums and reinsurance recoveries. For reinsurance assumed the reserve is the maximum difference of the present values of the future reinsured death benefits and the future reinsurance premium. For both reinsurance ceded and assumed the period in which the greatest present value occurs does not have to be the same period calculated without the effect of reinsurance.

This introduces the strong possibility that the reinsurance credit might not match the reserve assumed. In fact, the guideline recognizes the possibility that the credit could be negative. Now, it seems to me that once reinsurance amounts fail to be a zero sum gain, particularly if the presence of reinsurance can actually increase your tax reserves, I think we're facing some potential problems selling this to the IRS. The guideline specifies that the valuation assumptions used by the assuming company are to be consistent with those used by the ceding company. Although this is frequently the case, it's not always true for tax assumptions, and companies would usually like to be free to choose their own tax assumptions.

Next, I'd like to switch gears from the complex to the simple and present some potential legislative improvements. Let me set the political stage for tax simplification. We have this summer's tax bill, which raised the tax code to new heights of complexity. We have House Majority Leader Dick Armey, who's quoted as saying the current tax code will be "roadkill" before you know it, and he proposes a single rate flat tax. We have Congressman W.J. Tauzin (R-LA), who says

“rip the IRS out by the roots.” He proposes a national sales tax. We have Newt Gingrich calling for sweeping tax reforms, including simplification of the code. We have a congressional commission on restructuring the IRS saying that the tax law is overly complex. We have a president and Congress currently addressing IRS reforms. We have a deficit that’s vastly reduced and a potential for a budget surplus in the near future. All this adds up to be a backlash against complexity with less federal revenue pressures maybe in our future.

In this environment we considered what changes we might make to the tax rules if we had an opportunity. Although achieving any change would involve more than a little bit of good luck, we wanted our suggestions to be reasonable. After we eliminated the idea of tossing out the entire tax code, we judged our suggestions on the following criteria. We looked at the tax compliance items that caused us the greatest administrative headaches. As many of you are aware, many tax rules that insurers must deal with were not conceived with easy compliance in mind. Changes we might suggest that would alleviate the administrative burden were favored. In order to be feasible our suggestions had to have minimal revenue effect to the government. Much as we like to save substantial tax dollars, these ideas would probably go nowhere here in Washington. And, we considered the cost-effectiveness of certain tax collections. If it costs \$1 to raise 50 cents in tax, the idea was right for our list.

Start with the deferred acquisition cost (DAC) on internal exchanges. Section 848 of the code requires that the insurers capitalize a proxy for their acquisition expenses and amortize these expenses over ten years. The regulations provide that for some internal exchanges the reserves are used as a proxy for the premiums in calculating the acquisition expenses. The internal exchanges must be sorted and reported in several unique ways just to determine whether they’re subject to the DAC tax. In the end there’s not usually a substantial increase in the amount capitalized for DAC given because of these exchanges.

These DAC rules on internal exchanges give us a barrier to updating policies for changing circumstances, and in most cases little or no additional compensation is paid to the agent, yet the full value is subject to acquisition expense formula. An existing DAC balance is not written off as with GAAP, and this results in double counting of the acquisition expenses in many cases. And, finally, let me mention the old argument against DAC in general. The CRVM tax reserves already have an expense allowance. A very simple solution that we proposed is just to modify Section 848(d) to clearly exclude all internal exchanges from the DAC base. This would be unlikely to generate significant increases in a company’s internal exchanges, but it would remove a financial obstacle that probably costs nearly as much money to calculate as the tax that’s raised.

The second tax improvement on our list has to deal with the applicable federal rate

(AFR). The AFR is the rate that is used to value tax reserves if it's higher than the prevailing state rate, that is, generally the statutory rate. The AFR is a rolling 60-month average of 3- to 9-year Treasuries called midterm rates. This averaging period ends in December of the prior year. The problem is that the statutory rates are determined over a much shorter period—12 months usually for annuities and 12 or 36 months for life insurance. When the market rates decline significantly, as they have in recent years, the tax reserves are calculated at a much higher rate than market. This situation is particularly acute on immediate annuities.

Our idea is to determine two AFRs, one for annuities and the other for life. The midterm rate would be averaged over 12 or 36 months as appropriate. The end point of the averaging period would remain the December of the prior year in order that the tax-interest rate would be known in advance of the year. This would generally narrow the spread between the statutory and the tax-interest rates from year to year. It would reduce the need for repricing. It would smooth out after-tax profits, and it would promote fairness among different issue year generations of policyholders.

A third idea dealt with Section 7702, which provides design and administration limits on life insurance policies in order that they qualify for the tax-deferred inside buildup. There are two tests: the guideline premium test and the cash value accumulation test. The rules of Section 7702 are not very clear. Much uncertainty exists, and little formal guidance comes from the government. The system design and administration is expensive. If you find a problem or there's a retroactive interpretation from the IRS, it could create a legal nightmare. Policies are found to be out of compliance. Also, each test—the guideline premium and the cash-value accumulation test has their own advantages and disadvantages, and sometimes a good answer might be in-between.

Our solution was to eliminate the guideline premium and the cash value accumulation test. We would retain the cash-value corridor test but on a modified basis. New cash-value corridor percentages would determine what the death benefit would need to be in relation to the cash value. Corridor percentages would be calculated using assumptions that yield a ratio similar to the net single premium in the cash-value accumulation test. The advantages would be that all products could use one test, and much of the onerous testing, particularly with adjustment events and force-outs, could be eliminated.

Now, I'm not naive enough to think that any of these ideas have much hope of coming into being soon. It helps to be prepared to know what you want, if you're ever given the opportunity. I hope I've given you all something to think about.

**Mr. Michael V. Eckman:** I'm an actuary with ReliaStar Financial Corp. One of my jobs is to work with the corporate tax department and the business units to produce



the tax return entries related to reserves, liabilities, and other actuarial items. I also work with IRS auditors representing the company's point of view with respect to actuarial issues. To better control the information given to the IRS and to limit the business units' involvement in the day-to-day activities of the audit, we've put together a team that works with the IRS on each audit. The team consists of the head of the corporate tax department, a lawyer from corporate law, and me. My review will concentrate on what I call the actuarial aspects of the tax return. The actuarial aspects deal with the reserves and liabilities reported in the tax return and items related to the reserves and liability. I can tell you what the IRS has audited, what adjustments have been proposed, how we've responded to the proposed adjustments, and the effect on taxable income.

As I review the examples, you need to keep in mind that these issues vary by company. Their importance may be viewed differently by various IRS examiners, and their resolution is negotiated along with other proposed adjustments in the tax return. Therefore, not every company will have the same issues or the same settlement of even similar issues. In general, the IRS is searching for ways that life insurance companies may be trying to defer tax by conservative reserving methods. Also, since the passage of the 1984 tax act and the 1987 tax reserve discounting rule, the IRS is trying to enforce compliance with those rules and methods.

The IRS reviewed Schedule H of our annual statement and noted that it showed significant redundancies.

TABLE 6  
A & H CLAIM RESERVES

Year	Shortage (Redundancy)
1994	(39,618)
1995	(40,604)
1996	(29,123)

I discussed the results with the group A&H actuaries, and our analysis showed that the annual statement data overstated the redundancy and that several adjustments had to be made. First, we had to remove the administrative-services-only (ASO) business. We hold both a due premium and a claim liability for this business, but the claim payments don't run through Schedule H. Therefore, the reserves appear to be more redundant than they, in fact, are. We were able to demonstrate this to the IRS and remove these ASO reserves from the analysis. Second, we argued that the LTD reserves had to be removed. Section 807 of the law specifies the basis of those reserves, and if the reserves were redundant, the solution lay in changing the law and not in making any arbitrary adjustments. We were successful in that argument too.

Finally, we had to correct several errors in the annual statement data. We found that

claim payments and liabilities had been incorrectly allocated between current and prior years. The redundancies still existed but were much smaller than in the original Schedule H.

TABLE 7  
A & H CLAIM RESERVE ADJUSTMENT (000)

Year	Shortage (Redundancy)	5-Year Average	Reserve Adjustment
1994	(19,014)		
1995	(20,542)	-18.6%	(15,493)
1996	(8,173)	-15.9%	(12,257)

For the group A&H adjustment we negotiated with the IRS a five-year average of the run-off of prior years' reserves. If we have overstated the prior years' liability, the adjustment assumes that the current years' liability is also overstated. The five-year average is applied to the current year's liability to come up with an adjustment to the end-of-the-year reserve. One final calculation is required for the group A&H adjustment. We assume that the reserves subject to the adjustment are reduced by one-half year's interest as prescribed by Section 846. Table 8 shows that the reduction to the annual statement liability itself is further reduced by a half year's interest and itself has an income effect.

TABLE 8  
A & H DISCOUNT ADJUSTMENT

Year	Reserve Adjustment	Discount	Income Effect
1995	(15,493)	515	
1996	(12,257)	387	127

The IRS spent some time in recent audits comparing the life and waiver incurred but not reported (IBNR) liabilities to the actual run off. Their two concerns were the size of the liabilities and the possible double counting because both the claim liability and a policy reserve might be held. In general, we calculate the IBNR by applying a factor to the amount of in force at the end of the year. A review showed that the factors we used were more conservative than the actual run off justified. The business units naturally pointed out that the intention was to hold a conservative liability, as they didn't want to be caught short. After reviewing the information with their zero tolerance attitude, the IRS proposed an adjustment that reduced the life and waiver IBNR. In the end we negotiated an adjustment that uses a three-year moving average of the actual claim run off to the in-force amount. In effect, if we overstated our IBNR by an average of 5% over the last three years, then we're assumed to have overstated it by that same percentage at the end of the current year. Once we had calculated the IBNR that was acceptable, we calculated a reduction to the policy tax reserves. The reduction is an estimate of the policy reserves held on the IBNR claims.

We hold some amount of IBNR that's not calculated according to a formula but held in the nature of a contingency reserve. Unfortunately, we couldn't produce any run-off studies that were directly related to this amount of miscellaneous IBNR. The IRS disallowed the deduction of the miscellaneous IBNR, and we've removed it from the liabilities in the tax return. We've made some corrections and modifications to these adjustments over the years. One in particular was to consolidate the amount of the adjustments so that any redundancies would be offset by any shortages. Both the redundancies and shortages are calculated using the formulas that we negotiated with the IRS. In total, the resulting tax liability is not allowed to be greater than the statutory liability.

TABLE 9  
CONSOLIDATION OF ADJUSTMENTS

LOB	12/31/95	12/31/96	Income
Life	(5,552)	(2,014)	(3,538)
Life	4,837	3,574	1,263
A & H	(14,979)	(11,870)	(3,109)
Total	-(15,694)	-(10,310)	-(5,384)

One proposed adjustment that I've heard of but that we have not received personally is one that requests the elimination of policy reserves on contracts that are beyond the end of the grace period. The IRS argues that these contracts are no longer in force, and that the reserves should be eliminated. I know that companies have argued against this adjustment by pointing out that in practice the grace period is often extended, and that if the reserves were released, we really should set up a due-and-unpaid surrender value.

The IRS argued that the group A&H claim expense liability that we calculate as a percentage of the claim liability was not a legitimate tax reserve. As part of the settlement of the audit, we agreed to remove this liability. There was a one time increase to the amount of federal income tax we paid, but on the other hand future decreases in this claim reserve liability will not be included in future taxable income. What we're really talking about here is that these adjustments affect the timing of the tax since we're dealing with reserve liabilities. We're reducing a liability from its annual statement liability, and that does increase the current year's FIT. The lower liability means that future FIT will be lower. Since we allocate the FIT to business units, these tax audit adjustments really become a business unit issue. Holding conservative IBNR or other discretionary liabilities in the statutory statement has a cost in that not all of the liability will be deductible for tax purposes. The business units have begun to keep this adjustment in mind as they calculate these liabilities. As I mentioned above, even developing the data we need to calculate these adjustments has also caused the business units to correct some errors in the data they have used in the past and to improve the data collection process.

Section 807 prescribes specific reserve methods, mortality tables, and rates of interest for the calculation of life reserves. Because of the small amount of total reserves and large number of different contract forms on some of our older blocks of business, we decided upon an approximate tax reserve calculation. First, though, I'll give you a little background on our 807(c)(1) reserve calculation. When we began to implement the 1984 tax act, we recognized the size of the task of recalculating all the life tax reserves in compliance with the law, and we began to develop a method that would allow us to comply but required the fewest changes to our valuation systems, almost all of which were built in-house. We first divided our in-force block into three blocks.

Block 1 contained the contracts for which the statutory reserve equaled the cash surrender value. Because of the comparison of cash surrender value, federally prescribed reserve, and statutory reserve in Section 807(d)(1), the cash surrender value is the tax reserve, and we don't even bother to calculate a federally prescribed reserve.

Block 2 contains the contracts for which the federally prescribed reserve is calculated and the comparison in Section 807(d)(1) is performed. Block 2 contains all new business and all in-force contracts for which we hold a significant amount of reserves on a reasonable number of policies. Block 3 contains the in-force accounting for a relatively small amount of reserves but a large number of contracts no longer sold. Tax reserves for Block 3 are calculated as the Block 3 statutory reserve multiplied by the Block 2 tax reserve divided by the Block 2 statutory reserve. The IRS has reviewed this calculation a couple of times. I can say that although they did not really like it, they found it to be a reasonable and acceptable approach to the problem of valuing tax reserves. They didn't propose any adjustments. As the years pass, the amount of reserves estimated continues to decline as contracts leave the books. We have also on our own moved some of the contracts from this block to Block 2, in which an exact calculation is performed. In this way we were able to show the IRS that we were serious about reducing this estimated tax reserve and calculating everything on an exact basis.

One audit issue is that the IRS has several times requested evidence that the supplemental benefits that we classified as qualified for which we hold tax reserves equal to statutory reserves do, indeed, meet the qualifications of Section 807(e)(3)(c). We have been successful in providing the contract wording, schedule of premium rates showing the separate charges, and the detail of the reserve calculation. The IRS has never proposed any adjustments to these reserves.

Some states require that the CARVM reserve held on DAs be calculated on a continuous basis; that is, using the surrender charge on the first day of the policy year rather than curtate using the surrender charge effective on the last day of the policy year to calculate the statutory reserves. Since the continuous method

produces a larger statutory reserve, we would want to use the same calculation for tax reserves to offset the surplus strain to some extent. The IRS, however, has interpreted 807(d)(3)(B)(ii) as defining curtate CARVM regardless of what a state may require a company to hold. The law section does read that the term "CARVM" means the Commissioners Annuity Reserve Valuation Method prescribed by the NAIC that is in effect on the date of the issuance of the contract. The tax law does say that the NAIC's definition of CARVM is the one to use for tax reserves, and that one is curtate. In order to obtain the surplus relief given by the use of continuous CARVM for tax reserves, a company can change its annuity contracts. By moving the date that the surrender charge decreases from the first day of the policy year to the last day of the previous policy year, curtate and continuous methods produce the same amount of reserve. Now, of course, moving the date will increase the statutory reserves too. This solution should be pursued only if the company is willing to spend the surplus on it, or because of state requirements they are already holding continuous CARVM.

Revenue Ruling 94-74 spells out the rules for the handling of reserve corrections in the tax return. Before that ruling was issued, however, we had to deal with a number of changes to the calculation of tax reserves for UL products. Implementing the UL model valuation model is difficult, and we use three approaches. First, we contracted with an outside vendor. Second, after a time our in-house system was running, and the vendor no longer wanted to offer the service, so we moved the evaluation in-house. Finally, because of the expense and difficulty of running the in-house system, we purchased a PC-based system. As you might guess, none of these three systems produced the same reserves for the same block of UL at the dates of transition. Also, the years of transition all fell into one tax audit cycle.

Finally, as we moved from system to system, errors were uncovered, and we made corrections to the master file that affected the amount of reserves. In the end we had to work quite a bit with the IRS and developed audit adjustments that recognized the correction of errors immediately and spread the impact of the various system changes over ten years. As it happens, our negotiated settlement was in line with 94-74. As we worked with the IRS on this problem, it became very evident that they, too, were frustrated with implementing the 1984 tax act. They had no better way to calculate UL model law reserves than we did, and they were really not surprised that different systems produced the different amount of reserves.

Our valuation systems were designed to assign the original issue date of the term contract and the contract issued as a term conversion. This procedure, of course, meant that the incorrect valuation interest rate for the federally prescribed reserve would be used for that term conversion. The IRS discovered this defect in their most recent audit. We were able to correct it very quickly, and the impact on taxable income was very small. In fact, in the last audit this was the only defect they identified, so I was happy that they spent their time investigating this.

A current open issue is the provision of the 1987 tax act that disallows any strengthening to the December 31, 1996 property and casualty (P&C) reserves in conjunction with an implementation of reserve discounting. This was the case for life insurance reserves in the 1984 act. P&C companies were given a fresh start on their reserves at the time the 1987 discounting rules were implemented. Although this isn't a life insurance tax issue, the dispute does show that the IRS is now less tolerant of liberal, fresh-start provisions than they were in 1984. Also, many life companies are affiliated with P&C companies and may file consolidated returns, and this issue may be of interest to life companies because of the implications for IRS action with respect to fresh start and reserve-strengthening issues and because life companies may have a real interest in resolving the issue for an affiliated P&C company. In short, the IRS disallowed any increase in reserve from December 31, 1995 to December 31, 1996 for claims incurred prior to January 1, 1996. We argued that the information gathered during 1996 changed our outlook of the claims incurred prior to January 1, 1996. Some reserves increased while others decreased because of the information. Since the IRS's definition of reserve strengthening is taken from Revenue Ruling 88-100 this is often called the 88-100 issue. There are two conflicting court decisions on the issue. One argues that reserve strengthening has to be interpreted as a deliberate action to hold more conservative reserves and not as an increase based on new information or a formula. The other opinion with which we agree is that an increase in reserves, because of the working of a formula or new information, is not strengthening. In this second ruling reserve strengthening is assumed to be nonperiodic and involving material changes and methodology or assumptions from one year to the next. Our issue is on hold pending resolution of the difference in the court cases.

Looking ahead to the future, *Guidelines 32 and 33* have raised a potential for future issues. Since the guidelines are NAIC interpretations of CARVM and CRVM, we assume that they are the basis for tax reserves. To the extent the guidelines are retroactive, they are the NAIC interpretation of CARVM and CRVM as of the date of issue for some in-force business. For example, AG 32 requires us to establish an immediate-payment-of-claims (IPC) reserve. The additional statutory reserves can be graded over a five-year period. For tax purposes, should each of these separate five-year increases in turn be graded over ten years? Call it Option 1. Alternatively, should the entire increase in tax reserves be graded in over ten years? Call that option 2. From a tax standpoint the ten-year grading of Option 2 is more appealing. This would, however, require the company to demonstrate that on a policy-by-policy basis the resulting tax reserves were not greater than the statutory reserves. I think the IRS will take a pretty hard line on this and require the spreading of each year's strengthening so you'll end up with 16 years of reserve strengthening. Also, what is the year in which you begin the grading? If you can take this adjustment back to your first open tax year, you can remove some of the adverse effects by starting out with a smaller adjustment a few years ago and then in the interim period

getting the increases in the IPC reserves on that business. That will be another issue.

This concludes my review of the recent IRS issues I've seen that have dealt with actuarial items. We found that by working with the IRS we can come to an agreement as to workable and reasonable adjustments to the actuarial liability reported in the tax return. Again, as I mentioned in the beginning, you need to keep in mind that these issues vary by company, and their importance may vary. So the negotiated settlements may not look like the ones I've mentioned here.

**Mr. Robbins:** In regard to the three different methods for UL, how different were they in terms of a percentage difference?

**Mr. Eckman:** I have to think back. It was a small percentage difference. We're talking 2–4% on something like \$350 million of reserves. It's a significant dollar amount in any one year's taxable income.

**From the Floor:** About six months ago we saw a request for proposal from the Northern New England district that was for actuarial support of a tax audit. One of the things that caught our attention was they had some product issues in there: 7702 and some annuity issues. Has anyone actually had an IRS audit that involved product issues?

**Mr. Eckman:** Yes, we have. I'll call it a 7702 audit, in that they asked us for documentation as to what we were doing. We spelled out in some detail by product: This product is tested in the pricing process, our UL products have these safeguards built into the system, and so on. They did actually look at a sample of UL products.

**Mr. Robbins:** What we've seen is an information document request with three questions on it. The first question is, do you have a system for compliance with 7702? The second question is a very simple one with three words: Describe the system. And the third question is, Do you know of any failed policies or blocks? We have seen that, and, of course, you have to respond under penalty of perjury. That's what we've seen. We have heard that the IRS really wants to get cranked up more in this area to actually do proactive audits. It is only hearsay to my knowledge.