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THEN AND NOW

By Paula Hodges

Where were you 30 years ago? The Product Development Section of the SOA was formed in 1982, and its first newsletter was printed a year later, in October of 1983. As we approach this anniversary, I thought it would be fun to ask "What were we thinking?" when that first newsletter was printed back then. The following is a reprint of an article from the very first edition of the "News from the Individual Life Insurance and Annuity Product Development Section." I requested some assistance from the Taxation Section Council and Friends of that Council to decipher the changes between the life insurance tax environment back in the 1980s compared to today.

Then: Major changes in the IRS tax code in the 1980s dramatically impacted pricing of life insurance and annuity products. The 1980s tax code is the framework for determining what qualifies as life insurance for U.S. tax purposes . The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) dramatically impacted pricing of life insurance and annuity products. Some components of the vast amount of tax regulation that came about in the early 1980s:

- Special tax rules recognize the nature of life insurance, including federally prescribed tax reserves
- Product development reflected new company and policyholder tax limitations
- Definition of life insurance contract in Section 7702 applicable to all life insurance contracts
- Special life insurance company deduction (25 percent)
- Section 809 limiting deduction of mutual company dividends ("mutual company equity tax")
- Section 815 continuation of 1959 Act Phase III (PSA) tax on stock companies
- Section 845 expanded the authority of Treasury to examine and make adjustments to taxable income related to reinsurance contracts

Since Then: The tax code continues to be the framework for determining what qualifies as life insurance for U.S. tax purposes. New regulations have been layered on:

- Tax Reform Act of 1986 and Revenue Act of 1987
    - Eliminated special life insurance company deduction
    - Eliminated deduction of policy loan interest for individuals and limited for corporations
- Technical and Miscellaneous Revenue Act of 1988
    - Enacted Section 7702A creating modified endowment contracts
    - Introduced reasonable mortality and expense charges for 7702 and 7702A
- Revenue Reconciliation Act of 1990
    - Enacted Section 848 (the "DAC tax")
    - Imposed 20 percent haircut on UPR relating to cancellable A&H contracts
- Revenue Reconciliation Act of 1993
    - Enacted Section 197 (15-yr amortization of ceding commission)
- 1996 Tax Legislation: Small Business Job Protection Act, Health Insurance Portability and Accountability Act
    - Accelerated Death Benefits, Long-Term Care, Modified Guaranteed Annuities
    - Eliminated deduction of policy loan interest for corporations (with limited "grandfather")
- Pension Funding Equity Act of 2004

- Repeal of 809 which had limited deduction of mutual company dividends ("mutual company equity tax")
- American Jobs Creation Act of 2004
    - "Suspension" of 1959 Act Phase III (PSA) tax on stock companies
- Pension Protection Act of 2006
    - LTC-annuity combination contracts, subject to life DAC rate of 7.7 percent
    - Enacted Section 101(j), which provides requirements for corporate owned life insurance
- Principle-Based Reserves, Notices 2008-18 and 2010-29
    - Statutory deferred tax assets
    - Codification first permitted limited admissibility in 2001 – SSAP 10
    - This limited admissibility was expanded
        - Temporarily – SSAP 10R
        - Permanently – SSAP 101 – effective 2012 and later

Then: Our Product Development Section, and its newsletter, focused its research and communications primarily on the U.S. tax code, as that was the key dynamic at that time.

Now: With many more multi-national firms and jurisdictions, we need to concern ourselves with IFRS, Solvency II, ORSA, PBR, and a host of other issues. Taxes continue to be such an important topic that we now have an SOA Taxation Section devoted to that topic. The Taxation Section is seven years old and is about 850 members strong.

Then: Richard Kling—Chair of the Individual Life Insurance and Annuity Product Development Section

Now: Paula Hodges—Chair of the Product Development Section

Paula in 1980s:

Paula now:

Then: The only sure thing in life was death and taxes.

Now: The only sure thing in life is death and taxes.

The more things change, the more they stay the same.

The following is from the Oct. 21, 1983 newsletter of the "Individual Life Insurance and Annuity Product Development Section."

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HOUSE WAYS & MEANS PASSES TAX BILL

H.R. 4065, The Life Insurance Tax Act of 1983, was approved by the House Ways and Means Committee on October 5. Action by the full House was expected the week of October 24.

H.R. 4065 is designed to raise $3 billion of annual tax revenue, 55% of mutual companies and 45% from stock companies. This compares to an estimated $1.9 billion of annual revenue expected under the 1982-1983 law.

Taxable income is computed in a manner consistent with the determination of the statutory gain from operation, with a number of adjustments. The policy reserves used to determine taxable income are CRVM reserves using the highest interest rate permitted in 26 states at the time the policy is issued. The mortality basis would be the most recent table adopted by 26 states at the time of policy issue, with a three-year grace period to phase in new tables. If the cash value of the policy exceeds this reserve, the cash value is to be used.

The deduction for policyholder dividends for mutual companies is limited. The amount of the limitation is determined by an involved process that essentially increases taxable income by a percentage of a company's surplus. The amount of the percentage used is designed to represent the difference in the averages of the ratios of gain from operations to surplus for stock and mutual companies.

Amounts held in the policyholder surplus account as of the end of 1983 would continue in that account in accordance with the provisions of the 1959-1983 laws and would not be taxed unless withdrawn from that account.

The company's share of tax-exempt investment income is excluded from taxable income in a manner similar to the 1982-3 tax law, except that all amounts credited to policyholders, including dividends, are included in the policyholder' share. This may make investment in tax-exempt securities less attractive for life insurance companies.

A "taxable income adjustment" reduces taxable income by 25% of the amount otherwise. Thus, the marginal tax rate for most companies will be 75% of the corporate tax rate. Companies with less than $500 million of assets receive a small business deduction of 60% of the first $3 million of taxable income, phased out at $15 million of taxable income.

The difference between the reserves under 1982-3 tax law and reserves under the proposed law, which would include any adjustment to net level reserves under Section 818©, would not be considered a reserve strengthening. Rather, a company would calculate the 1984 reserve increase under the assumption that reserves at the start of the year were computed as pre-scribed by the proposed law. Any difference between this reserve and the tax reserve held at the end of 1983 would be ignored.

Amounts held in the policyholder surplus account as of the end of 1983 would continue in that account in accordance with the provisions of the 1959-1983 laws and would not be taxed unless withdrawn from that account.

H.R. 4065 also addresses a number of issues relating to policyholder taxation. The rules defining life insurance applicable to flexible premium contracts under the 1982-3 law were modified in certain minor respects and the modified rules would apply to all life insurance contracts issued before the end of 1984.

Interest on policy loans of more than $500,000 would not be deductible. Proposals in earlier versions of the bill to include in the taxable income of a taxpayer surrendering a contract the value fo the death protection received under the contract were dropped from the current version of the bill.

H.R. 4065 would extend the limit on the amount of group life insurance which may be provided tax free to employees, to retired employees, thereby limiting the market for "retired life reserves" products. It also changes the basis for taxing holders of non-qualified annuities. The requirement that annuity payments begin before age 70 ½ would be dropped, but gains under annuities where the contractholder dies prior to annuitization would be included in the decedent's tax return rather than be taxable to the beneficiary. The exemption from the 5% penalty tax for contractholders who hold the annuity for ten years or more would be repealed.

The bill also provides for certain studies to be made. The studies will examine the level of revenue produced by the 1982-3

bill, the operation of H.R. 4065 during its first three years, the relative tax burdens on stock and mutual companies, and the effect of the tax legislation on the ability of life insurance companies to attract investment capital.

At this point, the bill is supported by the Treasury and by most stock and mutual life insurance companies. It is expected that the bill will pass the House without significant opposition. While no significant opposition is expected in the Senate, Senator Robert Dole, Chairman of the Senate Finance Committee, has indicated that he expects to hold hearings on the bill and that he plans to consider possible changes in property-casualty company taxation at the time life insurance taxation is considered. Life insurance company managements are hopeful that, in consideration of the need for timely action on life insurance taxation, Senator Dole can be persuaded to consider the two issues separately.

A more detailed summary of the proposed legislation is available. Anybody interested should write the Editor at the address listed on Page 2. The Editor is also willing to provide copies of the Bill on request, provided the number of such requests is within reason.

Editor's Note:
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