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Letter to the Editor

Dear Kristin,

The Taxation Section provided a very valuable service by addressing the impact of the Camp proposals on the taxation of life insurance companies in the supplement to the October 2014 edition of *Taxing Times*. Daniel Stringham, in his analysis of the proposed changes to the deferred acquisition cost (DAC) rules,[1] and Brion Graber and Peter Winslow, in their analysis of the impact of the Camp proposals on life insurers,[2] articulate a number of concerns about the merit of Camp's proposed changes to the DAC rules. There is another, potentially very significant, issue that influences the merit of the proposed changes in the DAC rules. DAC rules are not the only tax rules that impact the amount of acquisition costs that a life insurer must capitalize. The Commissioners' Reserve Valuation Method (CRVM) and other tax reserve valuation rules also influence the amount of acquisition costs that life insurers must capitalize and therefore should be taken into account in assessing the merit of increasing DAC rates.[3]

In order to determine the proper tax base for an insurer, federal income tax rules require the capitalization and amortization of an appropriate amount of acquisition costs. A Treasury Department official stated in ILM 200220006,[4] "Congress created a proxy system [under] section 848 to serve as the measure of the expenses incurred by an insurance company in connection with specified insurance contracts which should be capitalized."[5] Under this system, an insurance company generally must capitalize a portion of its "general deductions" in an amount equal to the cumulative impact of the "net premium" of each "specified insurance contract" times the prescribed rate for such contract.

The Camp proposal would increase the DAC rates that apply to insurance companies that issue "specified insurance contracts." Under current law, DAC rates are 1.75, 2.05 and 7.7 percent, respectively, for specified insurance contracts that are (1) annuities, (2) group life insurance contracts and (3) not described in (1) or (2). The proposal would decrease the number of categories from three to two and increase the rates that apply to specified insurance contracts. Under the proposal, DAC rates would be 5 and 12 percent, respectively, for specified insurance contracts that (1) are group contracts and (2) are not described in (1).

In order to assess the merit of any changes in the DAC rules, one should take into account the impact of other tax rules that influence the capitalization of acquisition costs. Life insurers establish tax reserves for life and other insurance contracts that are computed under prescribed preliminary-term methods and modified preliminary-term methods (such as CRVM), which include an expense allowance and a relatively small increase in initial-period reserves. These rules increase the total amount of a life insurer's capitalized acquisition costs.

A senior Treasury official and commentators recognized the impact that acquisition costs have on the amounts life insurers are allowed to add to reserves, long before the Camp proposals and even before Congress enacted section 848 in 1990. When Congress was considering the legislation that resulted in the Tax Reform Act of 1984, which prescribed tax reserve valuation methods for insurance contracts issued by life insurers, John E. Chapoton, the Assistant Secretary of the Treasury Department for Tax Policy, indicated that states permitted preliminary-term reserve valuation methods because life insurers pay significant initial-year loading expenses.[6] He stated, preliminary-term "methods generally acknowledge that virtually all of the first-year premium in a cash-value policy is used to pay loading and mortality charges and do not call for any significant increase to reserves in the first year of the policy."[7] In 1992, a commentator criticized the DAC rules under section 848, in part, because "the enactment of section 848 was undertaken in the total disregard of the fact that the 1984 act's mandate to use preliminary-term reserves was intended, in part, to effectuate the capitalization of policy issuance expenses."[8]

Capitalizing more than the actual acquisition costs would overstate an insurer's taxable income for a given taxable year; that is, it would impose a tax penalty. Consequently, in order to assess the merit of any changes in DAC rules, Congress should take into account the impact of both DAC and other tax provisions to determine the appropriate amount of acquisition costs that tax rules should capitalize.

Sincerely yours,
Emanuel Burstein[9]

END NOTES

1 *Taxing Times* (vol. 10, issue 3 supp.) at 25 (October 2014).

2 *Id.* at 5.

3 Tax reserves for annuities, however, are not determined under rules that raise the concerns addressed in this letter.

4 Feb. 5, 2002.

5 *Id.* at 4–5.

6 *See*, Tax Treatment of Life Insurance Companies, Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means, 98th Cong., 1st. Sess. at 50–51 (1983) (Statement of John E. Chapoton, Asst. Secretary, Department of the Treasury).

7 *Id.* at 51.

8 W. Harman, Jr., Two Decades of Insurance Tax Reform, *Tax Notes* (vol. 57, no. 7) at 912 (Nov. 12, 1992).

9 Emanuel Burstein is the author of the recently published third edition of *Federal Income Taxation of Insurance Companies*, which is published in print and as an e-book by InsuranceTax.com. The topic of DAC is addressed at pages 175–192, and tax reserves are the subject of Chapter 6.