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FROM THE EDITOR
TO OUR READERS

By Christian DesRochers

"You've got to ask yourself a question: do I feel lucky?"
—Clint Eastwood, *Dirty Harry*, 1971

What does luck have to do with *Taxing Times*? Luck impacts a number of things, including the tasks of putting the issues together and publishing them on time. However, in this column, I'd like to talk about risk and tax risk in particular. Several months ago, I attended a meeting of insurance professionals, in which the issue of the various risks that insurance companies face was discussed. As I listened to the presentation (complete with the mandatory PowerPoints), I was struck by the lack of discussion of tax among the various risks that an insurance company faces. As tax professionals, perhaps we have not done enough to educate management and others as to the various tax-related issues that insurance companies face. Alternatively, we may be doing such a good job managing those risks that others don't need to worry, since we have it all under control. However, the skeptic would say that the truth lies in the former, and not the latter, observation.

We can classify tax risk into two broad categories: The first deals with products, while the second relates to the taxation of life insurance companies. With respect to products, the interest earned on life insurance and annuity products is not taxable to the policyholder until it is distributed, and life insurance death benefits are not taxable to the beneficiary, for both individual and corporate policyholders. This treatment had been applied to life insurance and annuity products since the inception of the income tax. However, since the treatment of "inside buildup" is considered a tax expenditure by the Treasury and Joint Committee on Taxation, it is receiving increasing scrutiny in the current economic environment, as both states and the federal government continue to look for increased sources of tax revenue. Thus, one key product risk is that the current tax treatment of life insurance and annuity products could be changed legislatively. That risk is well recognized by industry leaders, and obviously the industry would strongly resist any legislative change.

Another risk to products is where the tax law changes and the treatment of a life insurance product or the demand for that product is modified. The changes to the deductibility of policy loan interest, first to individuals, and later to corporations, were an example of a changing tax environment that affected the way in which life insurance products were sold. A similar example is the estate tax. If the estate tax were to be permanently eliminated, the demand for products would also change.

Since 1984, the tax treatment of life insurance has come with an administrative cost, in the form of the definition of life insurance under section 7702 and the modified endowment contract (MEC) rules under section 7702A. I can speak with some firsthand knowledge that at the time no one really considered the long-term implications of record keeping and data integrity when these provisions were being put in place. Since administration of the rules falls across multiple disciplines—tax professionals, actuaries and policy administrators—it is often the case that errors are made in the design and administration of products, particularly where products are moving from one administrative system to another. In some cases, errors may go undiscovered for a significant period of time. While there are procedures in place within the Internal Revenue Service to deal with "failed contracts" and "inadvertent MECs," the process can be very resource intensive and costly. A closely related product tax risk is that the actual failure or concern with potential failure to properly administer contracts can lead to increased due diligence expenses and significant remediation costs relative to a sale or acquisition of business or a company.

From the corporate side, there are a number of issues to consider as well. As is the case for policyholder issues, there is also legislative risk on the corporate side. We see that in the on-going efforts in the administration's budget proposals to alter the tax treatment of dividends received at both the general and separate accounts through changes in the dividends-received deduction. Whether changes will be made to the taxation of life companies as part of broad corporate tax reform is also an issue. The effects of the development of principle-based reserves are also unclear, not only with respect to the deductibility of non-formulaic reserves, but also with the continuing issue of changing reserve standards in the face of a statute that looks to issue-year reserves. During the financial crisis, we saw the mismatch of hedge income with asset adequacy reserves, which are generally not deductible, creating issues that are still being resolved today.

Corporate tax is also a significant element in the analysis of acquisitions and reinsurance. If the projected (or hoped for) tax treatment of a transaction does not ultimately emerge, then the risk to profitability is just as real as one that arises from a misestimate in projections of future actuarial assumptions, or from any other tax-related issue.

What does any of this have to do with risk? Unless one follows Clint Eastwood, or perhaps Napoleon who sought out lucky generals, tax risk in its various forms is very real, and it can have a significant economic impact on an insurance company. The challenge for tax professionals is to raise awareness among the various constituencies that, along with other risks an insurance company faces, tax risk is one that should be actively monitored and managed. Raising the visibility of tax among the insurance risk community would seem to be a viable and prudent first step.

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