

1991 VALUATION ACTUARY
SYMPOSIUM PROCEEDINGS

THE NEW DAC TAX

MR. STEPHEN C. ELDRIDGE: An outline of the Internal Revenue Code provisions affecting the new DAC tax is included in this paper. The outline attempts to cover the major relevant provisions of the DAC tax. We will review these in some more detail.

As in the case of any new tax law, many questions exist about exactly what these provisions mean. Even as we speak, the Treasury is feverishly at work attempting to draft Proposed Regulations to give taxpayers some guidance on some of these unanswered questions. In order that the Treasury is able to get some Proposed Regulations out as quickly as possible, the set of Proposed Regulations which is expected momentarily will cover just a few of the relevant issues. The tougher issues will be left for a later set of Proposed Regulations. While Treasury officials have been very tight lipped about revealing how these Proposed Regulations will deal with specific questions, Treasury officials have let us know some of the issues that they are considering. Treasury officials advised of a target date for publishing these Proposed Regulations ("by the end of October").

Internal Revenue Code Provisions Affecting DAC Tax

Amount to be Capitalized

- Do not capitalize specific expenses.
- Capitalize an "amount" of "General Expenses" equal to the percentages of net premiums on life, annuity or noncancellable A&H as follows:

Annuities	1.75%
Group Life	2.05%
Other	7.7%

- Total "amount" cannot exceed the "general expenses" of the company.
- Does not apply to pension contracts, flight or similar contracts nor to certain foreign contracts.
- Treasury can set up new categories but must adjust the old category.

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- "General Expenses"
 - Specified as Code Sections 161-196 and 401-419.

- "Net Premiums"
 - Defined as gross premiums less return premiums and amounts paid for reinsurance.
 - Property & Casualty (P&C) companies determine net premium the same as life companies.
 - Phantom premiums are not premiums.
 - Special rules for reinsurance:
 1. They apply to premiums required to be included in taxable income;
 2. The Treasury will write regulations to insure consistent treatment between company and reinsurer;
 3. Generally reinsurance is treated the same as the underlying contract;
 4. Transitional problems need attention.

- For Negative premiums
 - First reduce other categories;
 - Next negative premiums reduce prior years' unamortized balance and allow a current deduction.

- No capitalization of ceding commissions is allowed on post 9-29-90 contracts.
 - Colonial American (indemnity reinsurance) and Section 817 (assumption reinsurance) thus are repealed.

- In the transition year
 - capitalize only one-fourth of 1990 net premiums.
 - DAC in alternative minimum tax (AMT) still applies for 1990 (but to only three-fourths of net premiums) and is eliminated entirely in 1991.

- "Small Companies" are considered:
 - any size company with up to \$10 million of capitalizable expenses. They can amortize \$5 million over 60 months.
 - The \$5 million reduces as the company's capitalizable exceeds \$10 million;
 - The \$5 million amount does not apply to reinsurance.

- DAC in AMT
 - For "small" companies, DAC in AMT is repealed for 1990 rather than 1991.
 - "Small" company is defined as under current law, but nonlife insurance companies are excluded.

I. Capitalization Requirement

A. Overview

The phrase DAC, or deferred acquisition cost, is misleading, because we do *not* capitalize and amortize specific policy acquisition expenses. Instead, we capitalize an amount of general expenses (a term which we will define later) and which *amount* is equal to percentages of net premiums on life, annuity or noncancelable A&H as follows:

Annuities	1.75%
Group Life	2.05%
All other Life and noncancelable A&H	7.7%

B. Annuities

The first category, which carries the lowest rate, is the category of "annuities." While being understandably vague, Treasury officials have expressed the question of exactly what definition to use for the term *annuities*. The (Congressional) Committee Reports indicate the definition of annuity contract as one "within the meaning of present law." The Treasury is not certain as to just what is the "present law." There is no definition of an *annuity* in the *tax law*, as there is in the case of *life insurance* (see IRC Sec. 7702).

C. Group

As you can see, it is rather important to classify contracts into the proper category, because the capitalization rate varies widely. In this regard, one of the more significant questions that has arisen is the definition of the term *group*. The Internal Revenue Code (hereinafter referred to as "Code") provides the following three requirements for meeting the definition of a *group*.

- The contract must cover a group of individuals defined by reference to employment relationship, membership in an organization, or a similar factor.
- The premiums must be determined on a "group basis."
- The proceeds of the policy must be payable to or for the benefit of someone *other than* the insured's employer, or an organization to which the insured belongs, or to a similar person.

1. Affinity Requirement

The first qualification for the category of group is the affinity requirement. As noted above, in addition to employment or organization membership, "other similar factors" are permitted. The Treasury is considering just what qualifies as an "other similar factor." The (Congressional) Committee Reports would seem to indicate a wide latitude for the taxpayer in this regard, as they note that credit insurance should qualify as group if it otherwise meets the test. This would suggest that the affinity could be as loose as all of the people who purchased cars on credit from "Al's Auto Parlor." Treasury may look to the NAIC model definition of group, which incidentally includes a category of "miscellaneous." Another issue is whether there will be minimum-size requirement to be a group. Treasury will be looking for employers or organizations breaking down their population into smaller groups for pricing purposes, and thus will be the question how small the group can be. The Committee Reports have indicated that the members of a family cannot be a group.

2. Group Rating

The second requirement and Code is that the premiums be determined on a group basis. The Committee Reports indicate that premiums will be considered to be determined on a group basis; for example, if there is a single contract for the group and premiums are set on a *group* rather than on an individual basis. The Committee Reports note further that merely waiving the requirement for individual medical histories doesn't cause the contract to be a group contract. The Treasury is considering a number of questions in determining whether a contract is group rated or not. For example, Treasury is considering whether it will require that all members of the group be charged the same premium. Treasury will consider whether the policy operates as a group contract. For example: are there economies of policy issue and administration because the group policyholder holds the funds and administers the contract which results in lower issue and operating expenses for the group policy?

In trying to determine whether the policy is group rated, Treasury will consider a number of successive scenarios in determining where to draw the line as to when the policy becomes individually rated, as follows:

- Suppose that no questions are asked of each applicant?
- Suppose the applicant is asked a limited number of questions, such as age, sex and whether they are a smoker or not?
- Suppose a questionnaire is required which asks if the applicant has ever been rejected for insurance; does the applicant have cancer, a heart condition or other serious condition?
- Is there a physical exam required?
- Can an individual be excluded *only*, or can the individual be charged a higher premium, or is the group premium adjusted?
- Can each individual be underwritten and the individual premiums collected through the group?

The regulations under Code Section 79 may provide some helpful guidance in this respect.

3. Beneficiary

The third test in order to be determined a "group" is that the payments must be made to or for the benefit of the policy beneficiary (i.e., to someone *other than* the employer, the insured's organization, or other similar person). The Treasury has noted no special problems and indicated that it is acceptable that payments be made to the insured's creditors in the case of credit insurance, which is supported by the Committee Reports.

D. All Other Life and Noncancelable Accident and Health

The final category includes all other life and noncancelable A&H contracts. The Code does give the Treasury the authority to set up new categories. However, in the event Treasury exercises this authority, the rates will have to be adjusted so that the total tax revenues to the government do not decrease.

1. Combination Contracts

The question arises as to what to do with combination contracts. The Code states that any *annuity* contract which is combined with a noncancelable A&H insurance contract is to be treated as a noncancelable A&H insurance contract that is subject to the 7.7% rate, rather than the annuity contract of 1.75%. The question is, what happens with other possible combination contracts? Are the components to be combined and the highest rate used, or is the contract to be broken down into its components and the rate for each component applied separately? Treasury has noted a potential combination contract combining life insurance and cancelable A&H insurance. The question is whether the entire premium is subject to the 7.7% rate; or instead, is the portion of the premium attributable to the cancelable A&H treated separately (i.e., is it subject to the 20% unearned premium reserve adjustment)?

2. Timing Issues

The Treasury has raised questions with respect to the timing; that is, at what point the premiums are subject to the DAC tax; and also the Treasury noted issues of attempting to avoid duplication of premiums for DAC tax purposes. For example, Treasury has noted premium deposit fund problems. If the premium deposit fund is held with respect to contracts of one specified category of insurance contract, then the only issue is: at what point do you subject the premium to DAC tax, upon receipt by the fund or upon application of the fund towards the contract provision? However, a further complication is raised when the funds in the premium deposit fund may be applied to premiums in more than one category. Should the rules require that the highest possible rate be used with subsequent adjustments, if the fund is applied to categories with a lower rate?

Another interesting problem noted by the Treasury is how to handle retired-lives reserves. Clearly the reduction of the reserve is treated as a negative premium, and the transfer of that amount to the application of a contract is a positive premium. However, the reduction in premium includes interest credits made to the reserve over a period of years. The Treasury is considering the possibility of treating those interest credits, as they are made, as DAC-able premiums, or premiums for DAC tax purposes. The authority for this treatment appears to be lacking.

E. Excluded Contracts

Excluded from these DAC rules are:

1. "Pension contracts" as defined by the Code;
2. Flight or similar contracts;
3. Certain contracts issued by branches of U.S. life insurance companies located in other countries, which are issued directly and not assumed through reinsurance.

II. Calculation of the Amount of Premiums Subject to DAC

A. Net Premiums

The capitalization rates are applied to net premiums in each of the three categories. Net premiums are defined as gross premiums less return premiums and also less amounts paid for reinsurance. For this purpose, *gross premiums* does not mean gross premiums *written*, but means gross premiums which are includable in taxable income under the Code. P&C companies will determine net premium in the same way as life companies will. One exception to the rule just noted, that premiums are those which are includable in taxable income under the Code, is that phantom premiums are not included for this purpose. Thus, amounts of policyholder dividends that are used to reduce currently payable premiums (while they would be treated as a policyholder dividend out and a premium coming back) are not treated as premiums for DAC purposes. Similarly, the phantom premium that arises when a company charges less than the maximum mortality charges that it may charge under the contract does not constitute a premium for DAC purposes.

B. Reinsurance

1. Reduction of Premiums for Reinsurance

A ceding company can reduce its gross premiums by premiums ceded *if* those premiums will be included in the calculation of U.S. taxable income of the reinsurer. That is, the ceding company can take a credit for those premiums if they are paid to:

- Another U.S. company;
- A U.S. branch of an alien insurer;
- An alien insurer which is either a "regular way" or "an insurance" Controlled Foreign Corporation, the income of which is taxable to a U.S. shareholder under Subpart F of the Code;
- An alien insurer that has made an election under Code Section 953(d) to be taxed as a U.S. company for all purposes.

2. Consistency Requirement

One important requirement in this area of reinsurance is that the ceding company and the assuming company both treat an item consistently in the determination of premiums subject to DAC. The Treasury will write regulations to insure that this result is obtained. Treasury's concern here is that it will not be whipsawed by taxpayers taking inconsistent positions. One major challenge the Treasury faces in this area is the degree of taxpayer reporting that it can require under the statute, and just how that reporting should be accomplished.

3. Category of Reinsurance Premiums

Generally, reinsurance is treated the same as the underlying contract. That is, the ceding company takes credit for premiums against the same category which it has ceded off. Likewise, the reinsurer will record premiums in that same category. The only exception to this rule, which I noted earlier, is that a reinsurer cannot use this rule to take advantage of the exclusion for certain foreign contracts from the DAC rules.

4. Transition Problems

A number of transition problems will be encountered. The DAC tax will be an added cost to summary insurers under contracts entered into prior to the effective date of this tax, where the reinsurer, of course, has not priced for this additional burden. The termination of pre-DAC contracts will generate unexpected DAC tax burdens to some companies, and unexpected DAC tax benefits to others.

5. Calculation of Reinsurance Premiums

Treasury will write regulations dealing with the calculation of the premium to be transferred in reinsurance contracts. Prior to the issuance of those regulations, limited guidance was offered in the Committee Reports.

Essentially, under coinsurance, the asset transfer will be included in premium income of the assuming company and reduce the premium income of the ceding company. In modified coinsurance, the asset transfer, which is deemed to be retransferred by the reinsurer back to the insured, will not reduce premiums of the ceding company nor be included in premiums of the reinsurer, for purposes of the DAC tax.

There are many issues to be dealt with in determining the amount of the premium which reduces premiums of the ceding company as includable in premium income of the assuming company. While Treasury will and has been struggling with these issues, recall that consistency between the parties will be required so that any amount includable in the reinsurer's DAC-able amount will be treated as a reduction of the ceding company's DAC-able amount. For those of you who would like to delve into this subject at much greater length, I refer you to a paper written by Thomas G. Kabele, Ph.D., FSA, that reviews a variety of optional treatments of the various components of a reinsurance contract.

C. Negative Premiums

Reinsurance, or the termination of a reinsurance contract, may create negative premiums within a category. This negative premium will produce a negative capitalization amount, which reduces the positive capitalization amounts from the other categories for the current year. If the negative in the current year exceeds all of the positives for the current year, that excess negative reduces the opening balance of unamortized amounts as of the beginning of that taxable year and results in an amortization reduction in that amount for that year. Any remaining negative cannot be carried forward and is lost.

D. 1990 Capitalization

For the year 1990, the DAC rules required that one-fourth of 1990 net premiums be capitalized, rather than using actual premiums received after the date of the enactment of the law.

III. Limitation on the Total Amount to be Capitalized

The Code provides that the total amount to be capitalized (i.e., the percentages within each of the three categories multiplied by the net premiums in each of those three categories) is limited by the total amount of "general expenses" of the company. The Code defines these expenses specifically as those appearing in Sections 161-196 and 401-419. These cover general and miscellaneous deductions, and pension and compensation deductions. Among the expenses that Treasury is considering putting into this category are an insurance company's deductions for claims, policyholder dividends, the operation's loss deduction and the net deduction on assumed reinsurance transactions. A major question in calculating this limitation will be the treatment of ceding commissions in reinsurance transactions. Treasury may treat the ceding commissions paid as a general expense of the reinsurer. This would have the effect of increasing the general expenses of the reinsurer, and thereby avoiding what Treasury has come to know as "Grand Canyon Re." The Grand Canyon Re concept was that a new Arizona reinsurer would be set up (which would have little or no "general expenses"), and would reinsure all of the direct premiums in America. Because the company would have few "general deductions," only a nominal amount of premiums would be subject to DAC. Thus, all of the direct premiums would have fallen (untaxed) into the Grand Canyon.

What is also interesting is the other side of that ceding commission paid by the reinsurer. The Treasury may treat the receipt of that ceding commission by the reinsured *not* as a reduction of its general expenses, but as an item of "other income." The effect of this would be to maximize and duplicate the total limitation under the statute. The authority for doing this appears to be very weak. However, annual

allowances in reinsurance that are commensurate with the ceding company's annual expenses may be treated as "general expense" to the reinsurer and negative "general expense" to the reinsured.

IV. Amortization Rules

A. In General

The amortization period is 120 months. The ratable amortization begins on the first day of the second half of the taxable year, so that a half-year's amortization takes place in the current year. One question that arises is: how will a later negative amount which reduces prior balances be applied? That is, will the period be shortened, or will the period remain the same but the amount be reduced?

B. Small Companies

Small companies again were able to obtain special relief provisions. For purposes of the DAC tax, a "small company" is not defined in relation to the size of its assets, but rather in relation to the size of its DAC-able amounts. A company with up to \$10 million of capitalizable amounts will receive the full benefit of the small company provision, in that it can amortize up to \$5 million over a period of 60 months rather than 120 months. This \$5 million rapid amortization is reduced as the company's capitalizable amount exceeds \$10 million and is eliminated when the company's capitalizable amount equals \$15 million. A "small company" cannot increase its premiums to \$5 million via the route of reinsurance. Such premiums must be obtained by direct writings in order to qualify for the 60-month amortization period. Tracing rules may be required where such "small companies" write business directly, assume business in reinsurance, and also retrocede and cede out.

V. Alternative Minimum Tax

A. Other than Small Companies

For other than small companies the prior law requirement to do GAAP deferred acquisition costs (DAC) in the Alternative Minimum Tax (AMT) calculation still applies for 1990, but only with respect to approximately three-fourths of the net premiums for 1990. The prior law requirement to calculate GAAP deferred acquisition costs in the AMT calculation is eliminated entirely in 1991 for these companies.

B. Small Companies

For "small" companies, the prior law GAAP deferred acquisition costs in the AMT calculation is repealed for 1990 rather than 1991. For this special purpose, small companies are defined as they are for purposes of the small company deduction (i.e., controlled group assets do not exceed \$500 million by year-end), but other than life insurance companies are excluded from the definition of controlled group for this purpose.

VI. Deductions for Ceding Commissions

With respect to ceding commissions on reinsurance contracts subject to DAC entered after September 29, 1990, ceding commissions will now be fully tax deductible; i.e., the Colonial American case, which denied deductibility (but rather required capitalization and amortization), is now overruled, as are the regulations that required capitalization and amortization of the ceding commission in assumption reinsurance transactions.

With respect to contracts not subject to these new DAC rules, the rules requiring capitalization and amortization of ceding commissions still apply.

**FINANCIAL IMPACT OF DAC TAX:
TAX/STATUTORY ACCOUNTING PRACTICE (SAP) RESERVE
DIFFERENCES UNSETTLED TAX ISSUES**

MR. JOSEPH A. SIKORA: *The following section covers the financial impact that the DAC tax has on profitability; the financial impact that the widening difference between tax and statutory reserves has on profits; and some of the considerations that should be addressed by the valuation actuary when faced with unsettled tax issues arising from open tax years.*

Pricing Impact of DAC Tax

The DAC tax was thrust upon the industry in 1990 after many months of heated discussions and lobbying. This new tax is based on the theory that a depreciable asset is created upon the sale of an insurance policy. Congress felt that a future utility exists as the result of this sale. The initial expense incurred in selling a policy is an investment that should be spread over the useful lifetime of the policy. After much debate and lobbying, Congress decided to take a simplified approach of determining a tax based on the aggregate premium that a company collects.

The approach taken by Congress resulted in a profitability shock to the industry. While the industry can deal with a tax that is prospective, it has some difficulty dealing with a tax that was not anticipated at the time when a product was sold.

The actual cost of this new legislation on any particular product is difficult to measure since there is a great deal of interpretation as to the proper way to measure the impact. This difficulty stems from the fact that over the life of the product no new taxes are being assessed. It is just the timing of when these taxes are payable that changes.

The use of a zero discount rate in comparing before and after DAC tax profits gives the result that overall profitability has not changed. Conversely, the higher the discount rate used on these comparisons, the more significant the impact. The proper discount rate to use for these comparisons is the tax-adjusted rate that a company would be charged in

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order to borrow the additional funds required for the payment of this accelerated tax. This rate would vary depending on the sources of funds available and the creditworthiness of the company.

The cost of the DAC tax for products at a 7.7% deferral rate ranges from 0.8% of premium up to 1.75% of premium. The wide variance is due to the discount rate as well as the point in time in which a product is viewed -- at issue or possibly ten years after issue.

In addition to the discount rate having an impact on the profitability of the business, the incidence of premium payments plays an important role. The premium payment patterns illustrated in Chart 1 are: (1) a large first-year pour-in followed by a series of premium payments that fall below the base premium and then remain level; (2) the Guideline 7-pay premium; (3) the Guideline level premium; and (4) the minimum premium under which the policy would mature if interest-rate levels and cost of insurance (COI) charges at issue remain in effect throughout the lifetime of the policy. For this particular policy, the introduction of the DAC tax results in profits being reduced by 25%, 75%, 170%, and 50% for the test premium patterns. A profit reduction of 170% means that the policy moved from a profit position to a loss position.

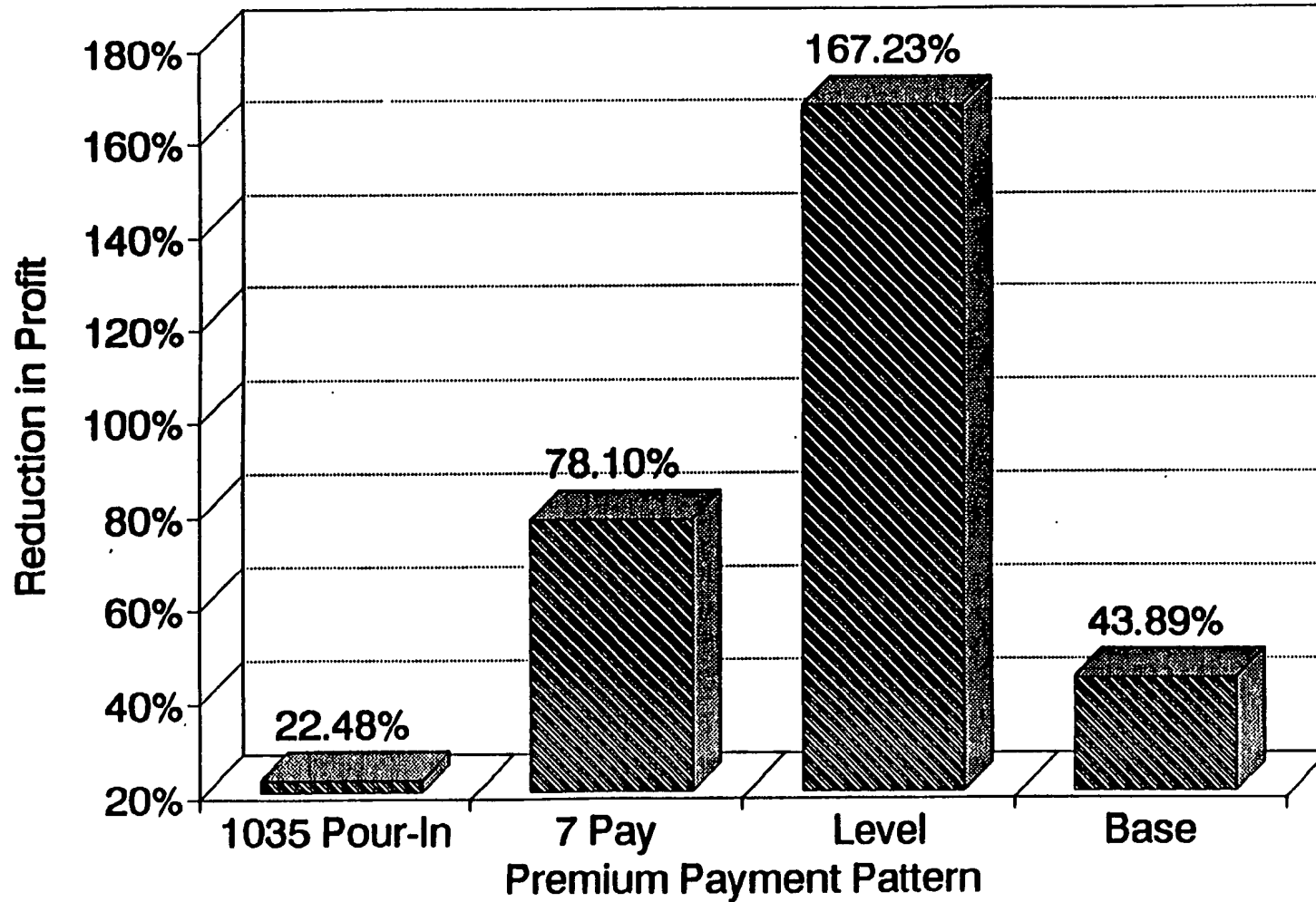
Product Adjustments to Recover Lost Profits

There are several ways that a company could attempt to recoup the DAC tax from in-force policies:

1. Increase premiums,
2. Decrease policyholder dividends,
3. Increase expense charges,
4. Decrease credited interest rates, and
5. Increase the cost of insurance charges.

CHART 1

**Reduction in Profit After DAC Tax
by Premium Payment Pattern**



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Premiums on in-force business are likely to be increased for group life and reinsurance assumed business. Indeterminate premium policies are also likely candidates for premium increases.

Policyholder dividends could be reduced on traditional business to account for the reduced profitability. Both Prudential and Metropolitan announced that they would take this action to recover the DAC tax from their policyholders. Expense loads on interest-sensitive products could be increased up to policy maximums to account for the additional tax expense that the company is incurring.

On annuities as well as UL products, the reduction in credited interest rates is the least noticeable approach. Many companies were still crediting relatively high interest rates when the DAC tax became effective. The reduction in credited rates has become even more palatable as rates have continued to fall.

COI rates on UL business could be increased to cover the new tax. The change that would be needed is a little more difficult to determine due to the interaction of the account balance in determining the net amount at risk which in turn drives the mortality charges.

New business can use the previous tools as well as opening up the possibility of adjusting agents' compensation. Companies took advantage of the DAC tax to correct some deficiencies in the products they were marketing.

What is the magnitude of the adjustments needed?

The profits of the UL policy with a Guideline 7-pay premium would decrease by 1.5% of premium. In order to return the company to the same profitability position, first-year commissions would need to be reduced by 20% of first-year premium! Alternatively, COI rates would need to be increased by 50% or the spread between earned and credited rates would need to increase by 65 basis points.

In reality an agent would not sell this product if his compensation was impacted to the degree needed or be able to sell the product in today's low interest-rate environment with the required interest-rate spread. In reality, the company is not able to be made whole. There will be some shaving of compensation and an increase in COI rates but little hope for an increase in interest spreads. Everyone loses with the new tax: agent, policyholder, and company.

Impact of DAC Tax on Reinsurance

There has been a ripple of change in the reinsurance arena. Reinsurers are now faced with an unforeseen tax that eats into their slimmer profit margins. Prior to the passage of the DAC tax law, there was a great deal of lobbying occurring with regard to the applicability of any new tax to reinsurance.

The original bills were silent with regard to reinsurance. The reinsurers wanted the DAC tax to apply only to direct business; while those companies that had a great deal of reinsured business wanted the tax applied to premiums net of reinsurance.

In the end everyone lost again to some extent. YRT reinsurance and coinsurance were fully deductible by ceding companies and fully included in income by assuming companies. Modified coinsurance was treated differently. Premiums were deductible by the ceding company only to the extent that they exceeded the increase in reserve and the implied investment income. The ceding company could be put in the position that it would owe more tax with a modified coinsurance reinsurance treaty than if no reinsurance were in place at all.

In addition to modified coinsurance resulting in a different tax treatment than normal coinsurance, YRT and normal coinsurance have also been impacted by the DAC tax. The impact that the DAC tax has on profits and the incidence of profits for a 10-year level term policy and for a YRT policy are indicated in the next few charts.

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I have assumed that YRT premiums are the net of the coinsurance premiums and the reinsurance allowances. This treatment tends to overstate actual YRT charges but should not distort the relationships between the three types of reinsurance. Modified coinsurance reinsurance tax deductions are the net of reinsurance premiums and reserve increases with implied reserve interest. Coinsurance premiums are fully tax deductible.

Since YRT reinsurance offers the smallest deduction for DAC tax purposes, these results presented in Chart 2 are not surprising. Profits for modified coinsurance are reduced more than for normal coinsurance, which is as expected.

As shown in Chart 3, when the reduction in profits is related to pre-DAC tax level of profits, the three alternatives match over the first five years followed by a deterioration of profits for the coinsured policy. This apparent dichotomy results from the overall incidence of profits for the coinsured policy being lower in the later years than the other two alternatives. The overall reduction in internal rates of return for the three alternatives are:

Coinsurance - 56%
Modified coinsurance - 25%
YRT - 32%

As illustrated in Chart 4 the reduction in profits on the YRT policy is not as smooth as under the 10-year level term policy and also a different relationship among the three alternatives exists. For the level premium product, the profit reduction followed the magnitude of the DAC tax premium. The largest reduction occurred in the first year for the level premium product while this is only the case for the modified coinsurance reinsured policy.

The yearly relationships between the three alternatives tends to vary significantly. For instance, the YRT alternative represents the smallest impact in the first year, the largest loss in the second year. In the third year profits are increased as the premium from the

CHART 2

**Reduction in Profits From DAC Tax
10-Year Level Term**

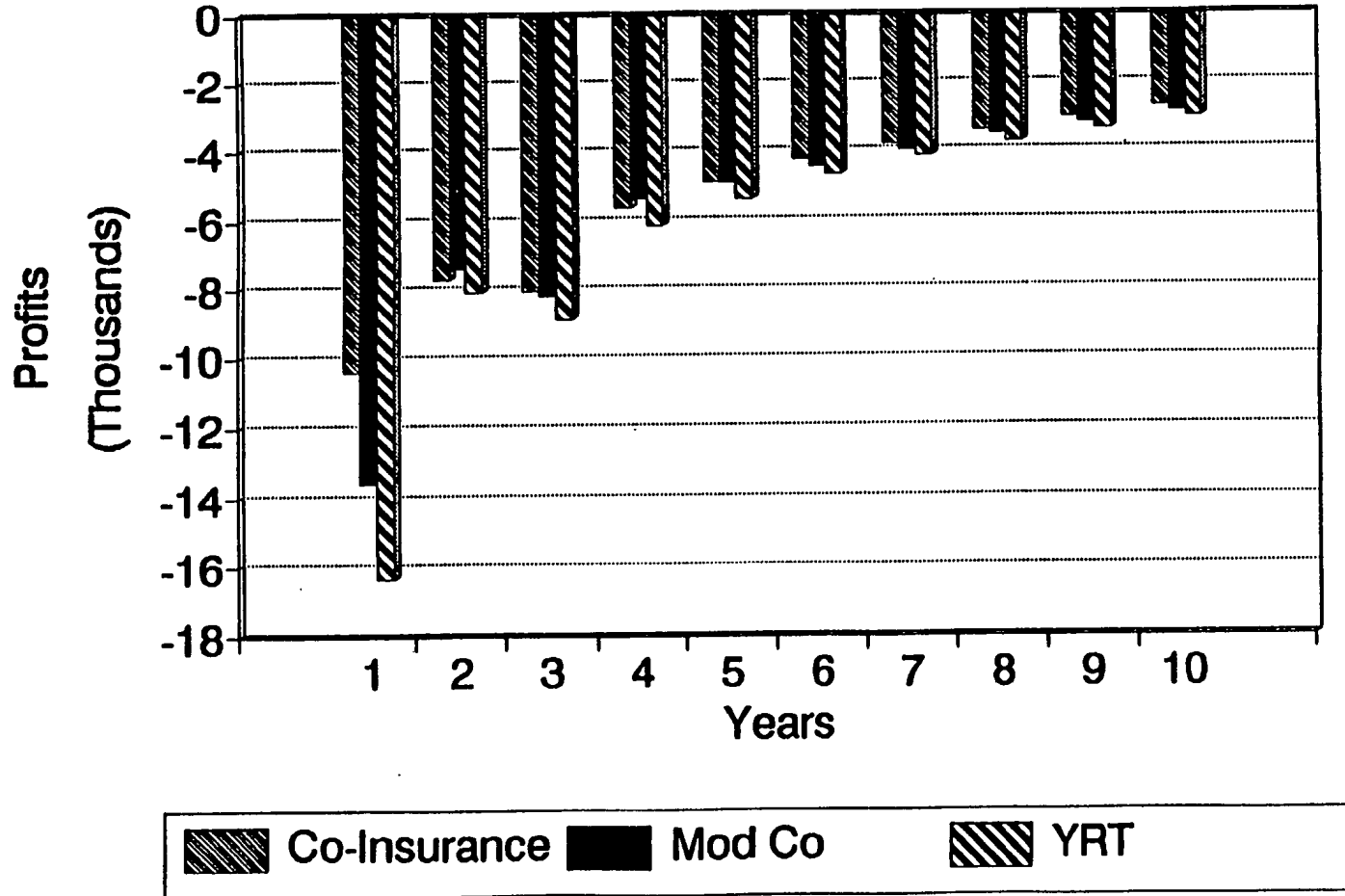


CHART 3

Reduction in Profits as a Percentage
10-Year Level Term

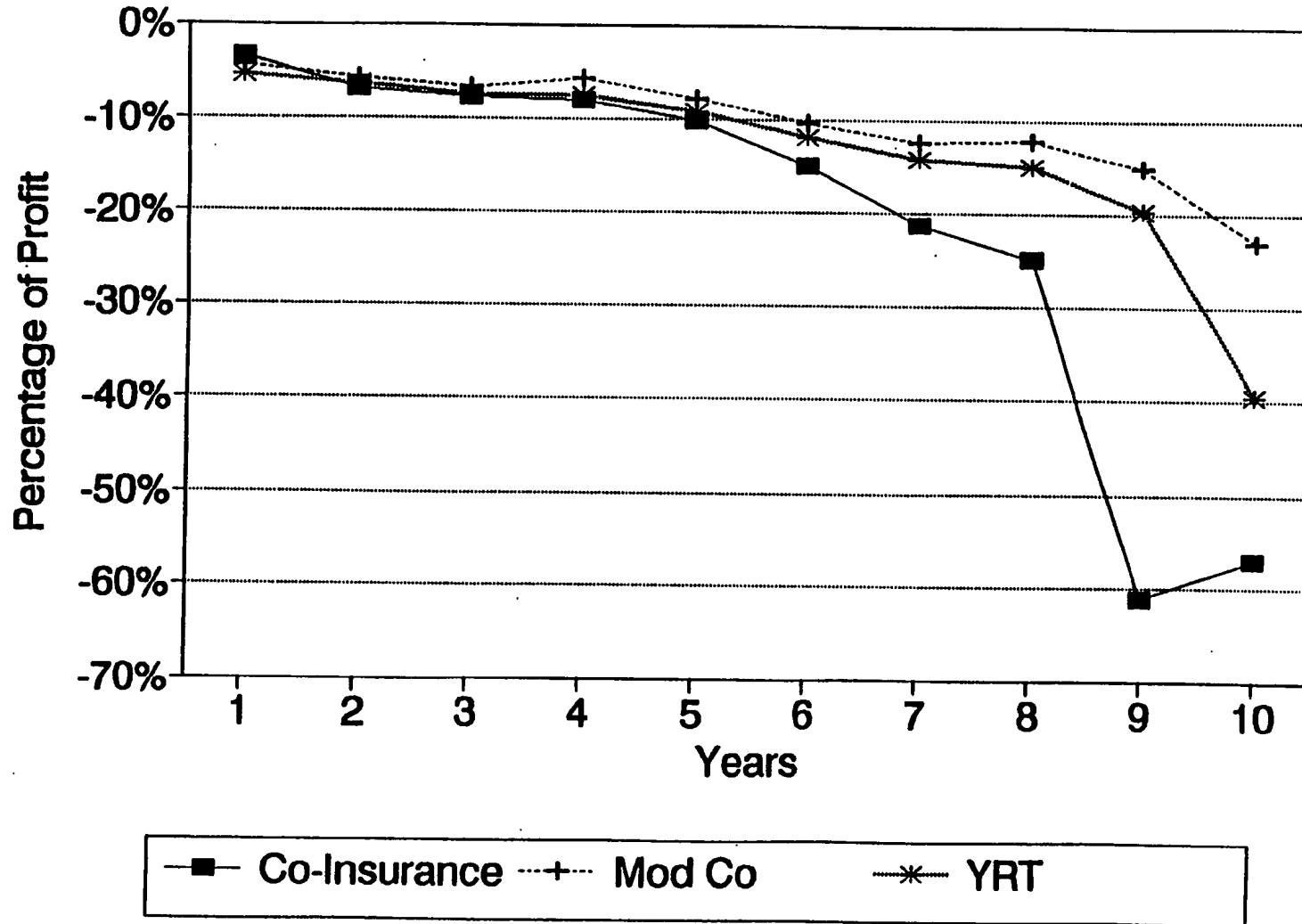
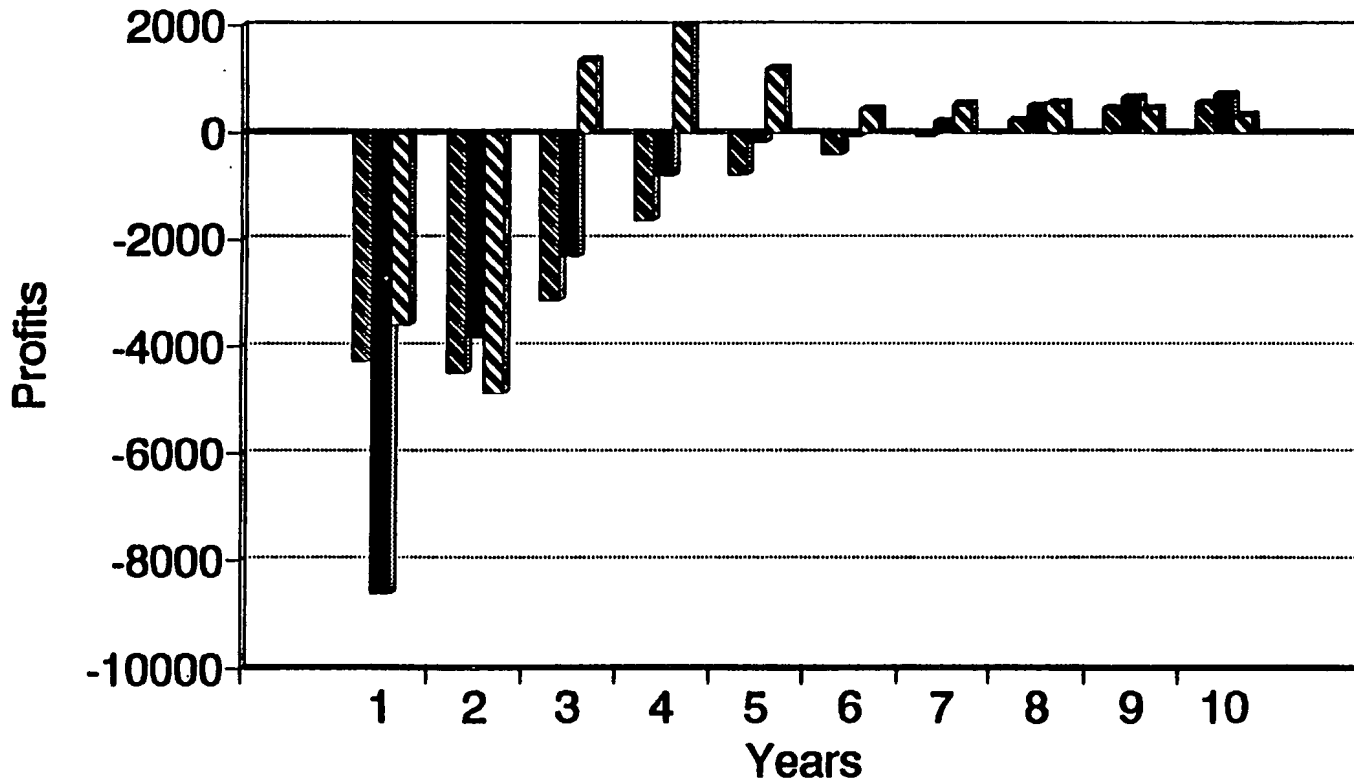


CHART 4

**Reduction in Profits From DAC Tax
Yearly Renewable Term**



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first year is amortized, and finally in the ninth year the YRT reinsured policy throws off the smallest amount of profit of the three.

When reductions in profits are presented as a function of pre-DAC profits, the results presented in Chart 5 pretty much follow the results illustrated in Chart 4. YRT and coinsurance profits are pretty much the same over the first two years. YRT profits zoom up while coinsurance losses slowly decrease until the policy gets above water in the eighth year.

The losses under the modified coinsurance policy between years one and two are not as pronounced as in Chart 5. Modified coinsurance profits slowly climb thereafter. The overall reductions in the rate of return as a percentage of the pre-DAC tax rate profits are:

Coinsurance - 14%
Modified coinsurance - 8%
YRT - 4%

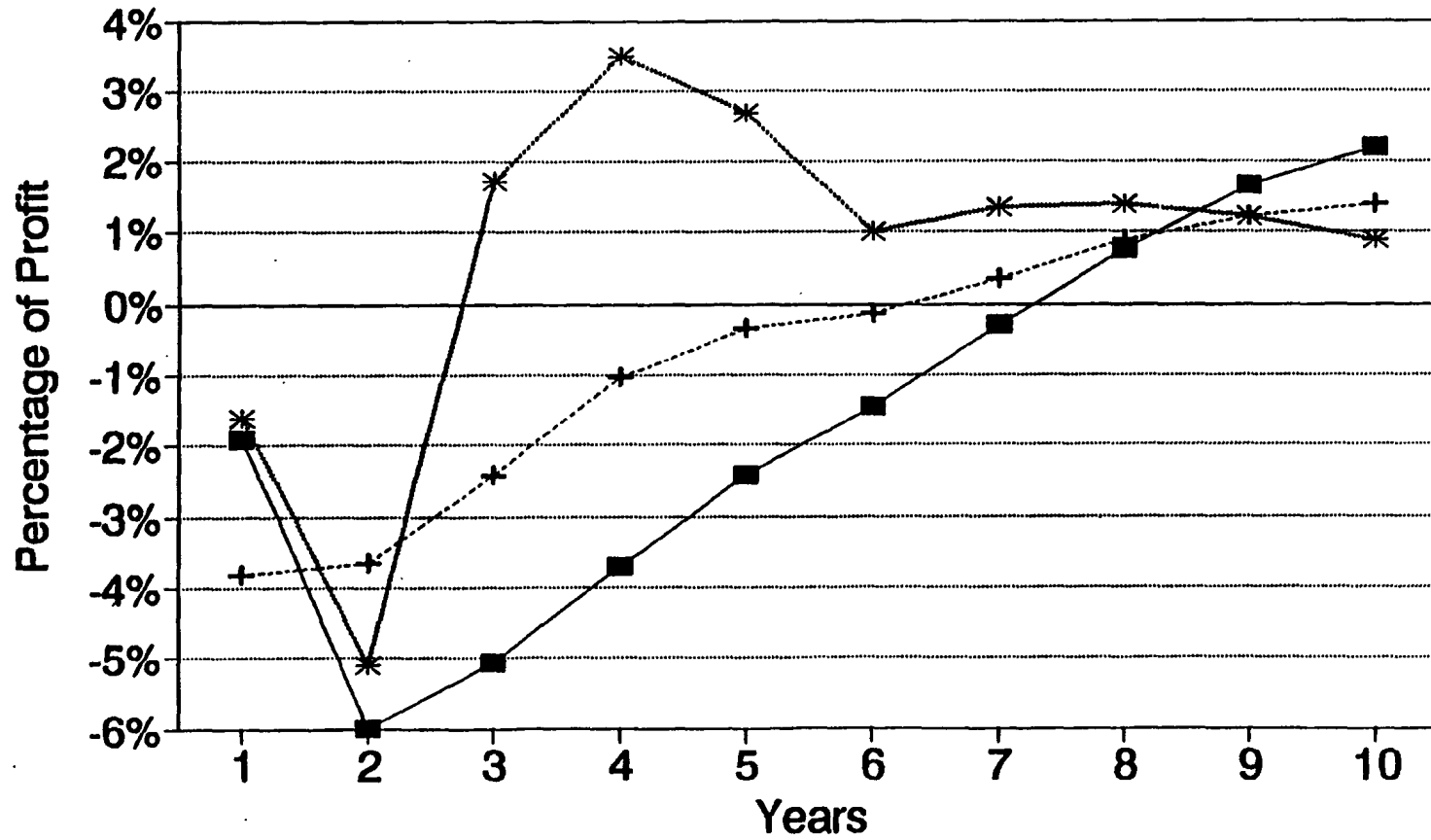
A quick comparison between the two sets of results indicates that the severity of the impact of the DAC tax is significant:

	<u>10-Year Level</u>	<u>YRT</u>
Coinsurance	56%	14%
Modified coinsurance	25	8
YRT	32	4

Under both products, the coinsured product suffers the most, while a flip-flop occurs in results between the modified coinsurance and YRT policies. The conclusion that you can draw from this analysis is that the impact of the DAC tax is another factor to consider when evaluating reinsurance needs.

CHART 5

Reduction in Profits as a Percentage
Yearly Renewable Term



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Financial reinsurance has become more expensive for the ceding company. The assuming company wants to be put in the same profitability position as that which existed prior to the appearance of the DAC tax. Financial reinsurance yields decreased as a result of the DAC tax for the companies that are providing the relief. The impact varies depending on whether the treaty is coinsurance or modified coinsurance and on the time to recapture.

If a company recaptured business during 1991, the reinsurer could realize a windfall since the transfer of the liability would be considered a negative premium while the DAC tax was applied to only a small segment of the premium. In reality, the assuming and the ceding companies reach an agreement as to the financial impact of the recapture. The reinsurer does not want to benefit from the effect of the DAC tax if the ceding company is adversely impacted.

If there were no agreement, the ceding company would pay a significant additional tax upon recapture. This new tax could result in a 10% reduction in the return when compared with a pre-DAC tax internal rate of return. Reinsurers had a mixed reaction last year-end as to whether they would charge client companies for the new DAC tax. This has cleared itself up now; ceding companies will be charged by the reinsurers for the DAC tax.

Assumption reinsurance was impacted in a similar manner as financial reinsurance. Assumption reinsurance results in a large premium transfer from one reinsurer to another with a resulting premium reduction and decreased DAC tax for the seller and premium recognition and increased taxable income for the buyer. Due to the tie-in of the DAC tax to premium, the economics of assumption reinsurance were changed by the new tax.

Sellers will be getting less now for the business being sold following the introduction of this DAC tax. Since the reserves net of the purchase price are considered premiums, the selling company obtains a benefit while the assuming company suffers an additional tax liability. There is a loss to the seller, however, in that he implicitly ends up paying for the DAC tax of the buyer.

For instance, assume that a block of single premium life business has statutory reserves of \$105 million. The net transfer by the seller is \$100 million. Thus prior to the DAC tax, the profit to the seller is \$5 million. Since the buyer will be forced to pay tax on 7.7% of the \$100 million premium, the seller will end up receiving less since he will need to reimburse the buyer for this additional amount.

Impact of the DAC Tax on Cash-Flow Testing

Cash-flow testing is touted as a tool to use for testing the impact that various economic conditions have on the health of the company. The normal risks that are thought of are default, disintermediation/reinvestment, and product risks. Now a C-4 risk has reared its head: the DAC tax.

The DAC tax changes the incidence of profits with a requirement of an earlier need for cash to pay for the acceleration of taxes. It is this acceleration of taxes that results in the decreased profitability of the business.

What is unpleasant about the DAC tax is that a company may be forced to pay taxes even though it normally might otherwise have a tax loss. This will eat into the surplus of the company. Current statutory accounting rules do not recognize this prepayment of taxes. There is a possibility that a company may fail a particular cash-flow test because of this acceleration of taxes.

Tax/SAP Reserve Differences

Several years ago the industry was congratulating itself on getting a "fresh start." Now, we are starting to suffer from the bad smell of deteriorating profit margins. A contributing factor to this situation is the widening differences between statutory and tax reserves.

Chart 6 illustrates the problems that companies are faced with as statutory reserve strain continues to exceed tax-deductible reserves. The statutory reserves in this example are based on 5.0%.

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As may be seen, there is no significant difference in results at the end of one year. All policies are in the same loss position. When tax reserves are determined at a rate 50 basis points higher than statutory reserves, profit reductions fall in a fairly narrow range of 10-15%. As tax interest rates have risen over the past few years, early profits have fallen tremendously with an accompanying adverse impact on company profitability.

The overall rates of return have suffered accordingly as illustrated in Chart 7. While the differences in rates were relatively narrow, the decrease in rate of return of 15% was not too significant. The widening difference between statutory and tax reserves has resulted in a Draconian depression in rate of return in the vicinity of 50%.

Charts 6 and 7 illustrated what has been happening over the years on a policy-level basis to insurance companies. In reality, most companies have experienced a slowing of the narrowing of the difference between statutory and tax reserves.

This process will soon result in a slow widening of the difference between statutory and tax reserves that will accelerate as newer business becomes even more significant. As companies begin to pay an increasing level of taxes, they will begin to search out mechanisms to reduce taxable income -- a tax consultant's dream come true! This will result in aggressive tax postures.

Unsettled Tax Issues

A company is faced with an unsettled tax issue only if it takes a so-called aggressive stand on a tax issue. A company usually obtains an opinion from a tax attorney as to the probability of a successful outcome or the possibility of settling on the tax issue at a lower value.

At this time the company needs to make a decision as to the reporting requirements that are needed. Full disclosure of the aggressive position would be explicitly stating that position in the footnotes and establishing a liability on the balance sheet equal to the

CHART 6

Impact on Profit from Tax Rate Changes

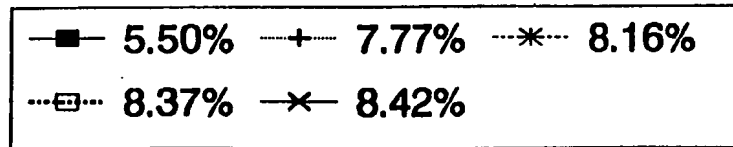
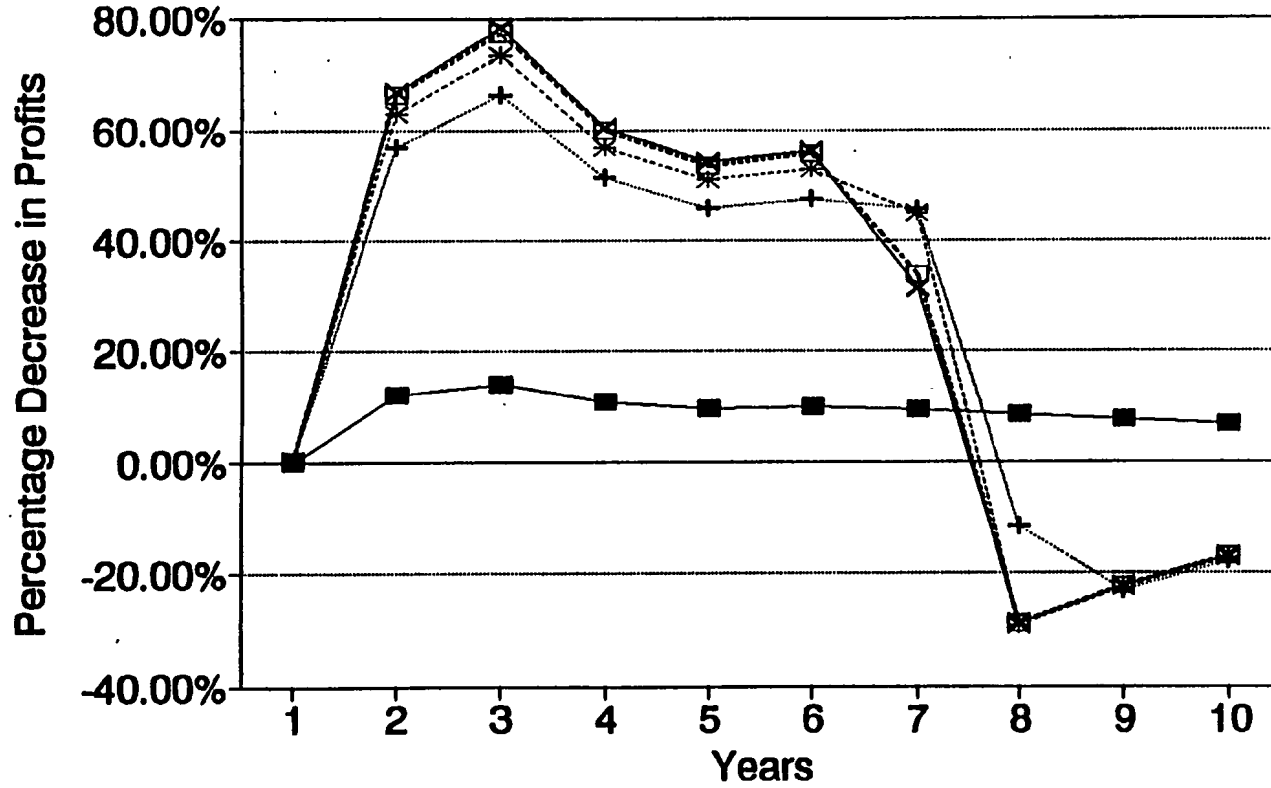
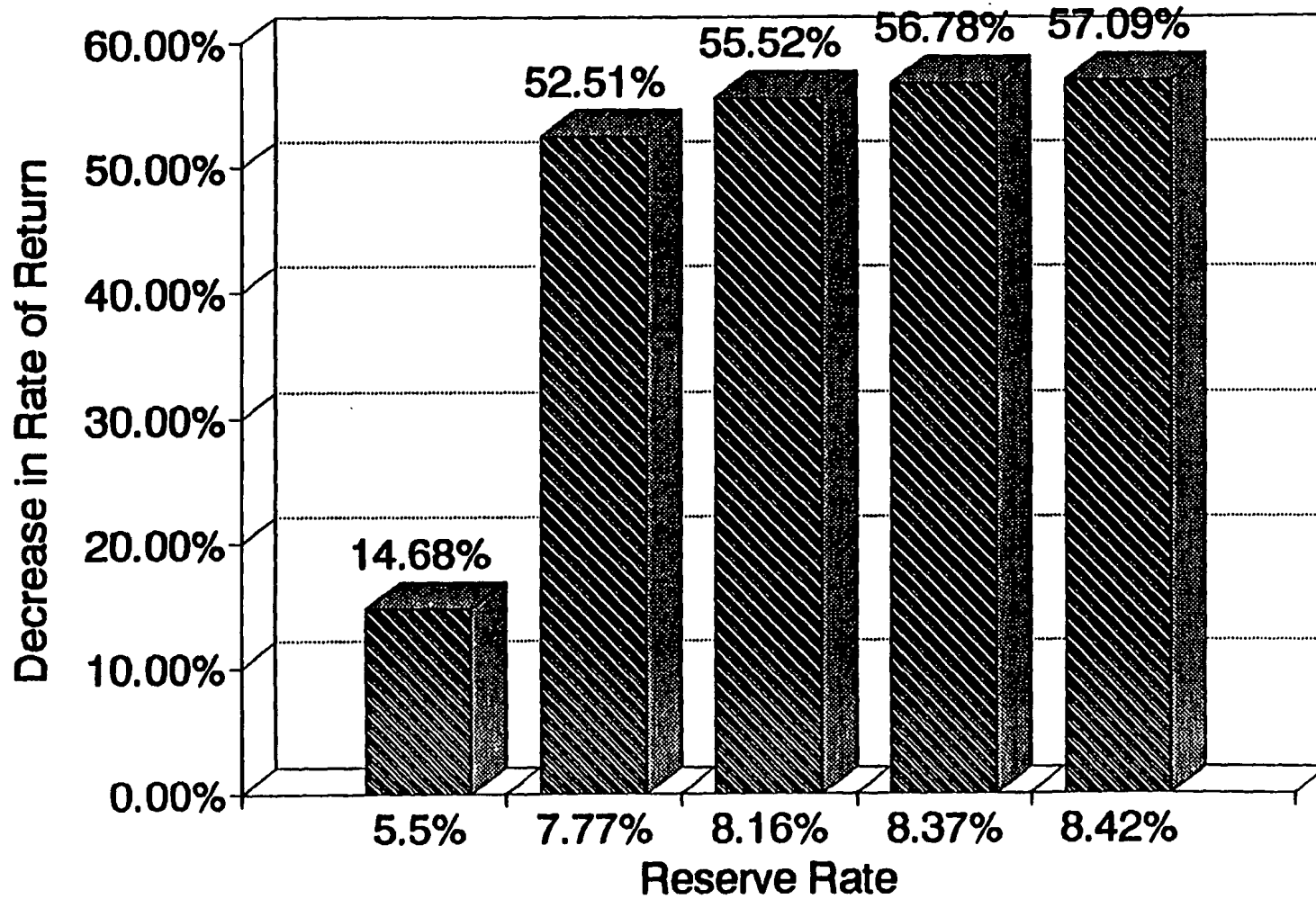


CHART 7

**Impact on Rate of Return
Variances from a Base for SAP = Tax**



amount that the tax position would yield. This approach delays the recognition of the benefit. However, explicitly revealing the aggressive nature of the approach increases the odds that the IRS would notice the aggressive deduction. In reality, no company would take this extreme approach since it helps build the IRS's case against taking the tax deduction.

The other extreme of financial reporting would be no disclosure of the aggressive position in any footnote thus recognizing the full benefit immediately. This approach works well if the company feels confident that the IRS will not challenge the appropriateness of the deduction on audit. The danger of this approach is that the company could be forced into a settlement since it could not afford to take the entire hit that the IRS proposes as an audit adjustment.

Finally, the middle-of-the-road approach would be to report a liability derived in a manner consistent with GAAP. GAAP reporting requires the disclosure of aggressive tax postures with the establishment of a companion liability. The liability is managements' best guesstimate of the additional tax and penalties that will be required when the case is eventually settled. This is where the tax opinion and estimate come in handy.

A good example of how this impacts the analysis of a company is by reviewing Executive Life's situation. In keeping with the disinformation that surrounds the problems of Executive Life, the following example may be thought of as more fictitious than real.

A few months ago the situation at Executive Life went from bad to worse when the IRS put a lien on the company for \$600 million. A portion of that lien was due to the tax posture that Executive Life took regarding 818c reserve adjustments. Executive Life took the position that no disclosure was needed and no liability was needed since it felt confident that it would win the case. The \$600 million represents the difference between \$19/1,000 and \$0/1,000 for the tax reserve adjustment.

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Over the past few years, there have been many settlements made on this issue as to what qualifies and what is the proper adjustment to make for 818c reserves. A reasonable settlement would have ranged from \$9/1,000 up to \$15/1,000. Clearly, the liability for Executive Life will not be \$600 million but will more likely be in the neighborhood of \$200 million.

The valuation actuary and his tool of cash-flow testing will be challenged by the tax burden thrust upon the industry. Companies will consider any proposition that has a glimmer of hope of reducing taxable income. The valuation actuary will need to consider the appropriateness of the disclosure approach taken by management when he or she opines on the liabilities of the company. It will be a difficult decision.