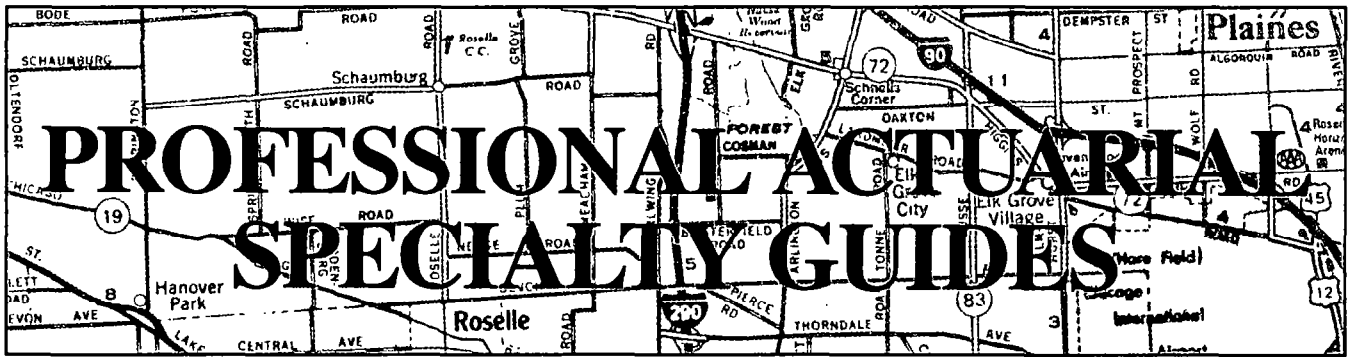


SOCIETY OF ACTUARIES



COMMITTEE ON CONTINUING EDUCATION

UNITED STATES TAXATION—LIFE INSURANCE

Overview

U. S. corporate federal income taxation of life insurance companies underwent a major revision several years ago with the adoption of the 1984 Tax Act, following two years of stopgap taxation under TEFRA (1982 Tax Act). Under the 1984 Act, there is a tax on the gain from operation plus a tax on the equity of mutual companies. Reserves are revalued under the minimum standard using the Commissioners Reserve Valuation Method, the maximum interest rate of 26 states (prevailing state assumed rate) under the valuation law, and the appropriate CSO mortality (for life insurance). The 1986 Tax Act introduced the discounting of A&H reserves (for business other than non-cancellable or guaranteed renewable) and an alternative minimum tax for all corporations which contained an adjustment for "business untaxed reported profits" (known as the "BURP" adjustment), which will be replaced for 1990 and later years by an adjustment for "adjusted current earnings." The adjusted current earnings includes a deferral of acquisition expenses. The 1987 Tax Act introduced the applicable federal rate (AFR) as the interest rate to be used in calculating reserves on new business if that rate is larger than the prevailing state assumed rate.

Actuary's Role

In general, the actuary should understand how the tax is created and take steps to optimize it, including maximizing the reserve deductions. He or she can also tax plan by appropriate timing of income, expenses, or reserves between years. In specific roles, the financial reporting actuary needs to be able to provide the tax reserves as well as the adjustments to arrive at tax dividends and equity. The valuation actuary needs to understand the taxation basis in providing an opinion on the sufficiency of reserves, including those products where cash flow testing is needed. The product development actuary needs to understand the effects of taxation on products, including the designing of products to minimize the tax.

Introduction

The SOA study note, a text of the IASA and articles, each provide a comprehensive introduction to life insurance company taxation. In addition, seminars are available from public accounting and consulting actuarial firms, though they are not enumerated here.

Society of Actuaries Study Note 343-22-87 (1987): Federal Income Taxation of Life Insurance Companies and Products in the United States by Steven W. Fickes

This study note is a good place to start in understanding current insurance company law. It provides an excellent overview of the taxation of life insurance companies in the United States. It provides a review of the Life Insurance Income Tax Act of 1959 and the problems that developed with respect to it in the late-1970's. It sketches the techniques used by companies to avoid these problems and then presents the major elements of TEFRA and the Tax Reform Acts of 1984 and 1986.

Level: Basic

Pages: 142

Life Insurance Accounting, (1988) text book of Insurance Accounting and Systems Association, Chapter 12: "Federal Income Taxation", p.12-1

This chapter contains a comprehensive description of federal income taxation applicable to life insurance companies including the history of the legislation through the 1986 Act. It also includes a description of FASB 96. This chapter will be a good starting point for actuaries who would like to understand federal income tax.

Level: Basic

Pages: 38

Journal of the American Society of CLU (March and May, 1985): "The Structure of Life Insurance Company Taxation—The New Pattern Under the 1984 Act" by William B. Harman, Jr., p.56 (March) and p.76 (May)

These articles provide an extensive discussion of the background and the workings of the 1984 Life Insurance Company Tax Act with comparison to the predecessor 1959 Act where appropriate.

Level: Intermediate

Pages: 24

Development of Current Tax Law

The 1984 Act resulted in a massive revision to life insurance taxation after the 1959 Act and the stopgap legislation for 1982-1983. This was followed by additional changes in 1986, 1987, and 1988. What is given here are the actual portions of the laws along with the relevant Congressional Committee reports, and "bluebooks."* Also included are panel discussions from SOA meetings.

Tax Reform Act of 1984, including Congressional Committee Reports and "bluebook". Code sections 801-818, 845, 7702. Act section 216.

Life insurance companies are taxed on the operating gain. There is a special 20% life insurance company deduction (haircut), so that the tax rate for life insurance companies is only 80% of the corporate tax rate. The 20% special deduction was repealed in 1986. In addition there is a small company deduction. Tax reserves are defined. There is an "add-on" tax on the surplus of mutual companies which is expressed as a reduction in the dividend deduction. Handling of reinsurance transactions is elaborated. Life insurance is defined for federal tax purposes.

Level: Intermediate

Tax Reform Act of 1986, including Congressional Committee Reports and "bluebook". Code Sections 55-56, 806, 832, 846.

The 20% special life insurance company deduction (haircut) is repealed. Discounting of A&H reserves and P&C reserves is done using a rolling average of the applicable Federal mid-term rates (section 1276(d)) as the interest rate and is called the "applicable Federal rate" (AFR). An Alternative Minimum Tax (AMT) is re-defined for all corporations—to include an adjustment for book income for 1987-1989 and for adjusted current earnings for later years.

Level: Intermediate

Revenue Act of 1987, including Congressional Committee Reports. Code sections 56(f), 807, 813, 842.

The reserve interest rate definition was changed to use larger of AFR and prevailing state assumed rate. Here the AFR was defined as the section 846(c)(2) rate for the year of issue.

Level: Intermediate

Technical and Miscellaneous Revenue Act of 1988, including Congressional Committee Reports. Code Sections 7702, 7702A.

Defines a new class of life insurance contracts (modified endowments) by reference to a seven-pay test. Applies annuity rules to distributions and loans under modified endowments. Mortality and expense assumptions used in computing definitional limits and seven-pay premiums must be reasonable on new contracts.

Level: Intermediate

RSA** 11 (1985), No. 2, "Federal Income Tax Accounting—United States", p.803

Discusses tax allocation among product lines and allocation of mutual surplus. Looks at allocation and tax sharing with subsidiaries. Considers reinsurance and deferred taxes in GAAP.

Level: Intermediate

Pages: 19

RSA 11 (1985), No. 4, "Federal Income Taxes—Insurance Company Perspective", p.1655

Describes parts of 1984 Tax Act including small company deduction, special life insurance deduction, ACLI efforts on reserve questions and clarifications, pro-rating of tax-exempt income, equity tax for mutual companies, and data that stock and mutual companies have to furnish IRS so that earnings rates under section 809 can be calculated. The after-tax earnings rates on various stock and mutual products are also examined.

Level: Intermediate

Pages: 30

RSA 13 (1987), No. 3, "Impact of Federal Income Tax on Financial Management", p.1101

Discusses changes in tax rates, capital gains, alternative minimum tax, A&H reserve discounting, reinsurance, merger and acquisitions, investments, and mutual company considerations.

Level: Intermediate

Pages: 35

** RSA means *Record of the Society of Actuaries*

* The "Committee Reports" are the reports of the House Ways & Means Committee, Senate Finance Committee, and Conference Committee which describe the House and Senate versions of the various provisions of the tax bill and the resulting version that ended up in the conference version.

The "bluebook" is the General Explanation of the tax act provided by the Joint Committee on Taxation and is published about 6 months after the bill is enacted. It gets its name "bluebook" from the fact that the cover of the book is blue.

Reserves

Describes provisions of the 1984 Act relating to establishment of reserves for tax purposes, along with A&H reserve treatment in the 1986 Act, and definition of a new interest rate (AFR) to be used in reserve valuation under the 1987 Act.

RSA 11 (1985), No. 2, "Life Insurance Tax Law", p.759

Discusses reserve computation issues, ideas for planning by delaying implementation of mortality tables, marginal tax rates for small companies, treatment of tax-exempt investments (and their marginal tax rates).

Level: Intermediate

Pages: 20

Code section 807 and Act section 216 from 1984 Tax Act, Committee Reports, and "bluebook"

Defines tax reserves under 1984 Act. Computation of Federally prescribed reserves must be done using the CRVM, CARVM, or a 2-year preliminary term method and the prevailing state assumed interest rates, and mortality/morbidity tables must be used. Reserves are subject to a cash value floor and a statutory cap. Fresh start on reserves.

Level: Intermediate

Code sections 832 and 846 from 1986 Tax Act, Committee Reports, and "bluebook".

Describes discounting of A&H reserves for business other than non-cancellable or guaranteed renewable.

Level: Intermediate

Code section 807 from 1987 Tax Act, Committee Reports

Reserve interest rate definition changed to use larger of applicable federal rate (AFR) and prevailing state assumed rate. The AFR is a rolling average of mid-term rates pertaining to Treasury notes of length 3-9 years.

Level: Intermediate

Proceedings of Insurance Accounting and Systems Association (1984), p.207

The 1984 Tax Act changes drastically the method of computing life insurance reserves for tax purposes. The article lists the ground rules for computing tax reserves under the 1984 act. The article also explains transitional (fresh start) rules as to reserves as of December 31, 1983 and January 1, 1984.

Level: Intermediate

Pages: 2

ACLI General Bulletins

These are available in member companies of the ACLI or may be obtained from the Society of Actuaries for a nominal fee.

Bulletin	Title	Date
3531	NAIC planning to adopt life insurance reserve requirement with possible significant tax implications	11/26/84
3659	1983 Annuity mortality tables become prevailing table for federal income tax purposes	12/13/85
3773	IRS issues temporary and proposed regulations relating to mortality and morbidity tables for tax reserves	1/29/87
3801	Supreme Court issues important tax ruling regarding the deductibility of estimated reserves	5/7/87
3803	IRS issues schedule of prevailing state assumed interest rates and prevailing commissioner's standard mortality and morbidity tables for tax reserves and guidance regarding their use	5/12/87
3808	Change in commissioners reserve valuation method section of NAIC Universal Life model regulation to be considered for NAIC adoption in June 1987	5/29/87
3890	Applicable federal rate for computing tax reserves for 1988 is 7.77%	3/7/88
3999	Applicable federal rate for computing tax reserves for 1989 is 8.16%	12/20/88
4011	ACLI recommends adoption of 1985 Commissioners' Individual Disability Tables for use under IRC section 807	1/18/89
4053	Clarification of use of 1980 CSO smoker and nonsmoker mortality tables under section 807 (relating to tax reserves) sought from IRS	4/13/89

Level: Intermediate

Alternative Minimum Tax

The 1986 Act completely redefined the alternative minimum tax to make it a serious threat to many companies. Initially for 1986-1989 a major component of the tax base is untaxed book income, while for 1990 – on it is tax-exempt and tax preference income and deferred acquisition costs of all life insurance companies.

RSA 12 (1986), No. 3, "Federal Tax Law", p.1643

Describes proposed changes to tax law (ultimately enacted in 1986 Tax Act), including alternative minimum tax with its book income adjustment for business untaxed reported profits (BURP) as well as the discounting of P&C (A&H) reserves.

Level: Intermediate

Pages: 26

Code sections 55 and 56 of 1986 Tax Act, Committee Reports, and "bluebook"

With the 1986 Tax Act coming into existence, the alternative minimum tax becomes a potential item of tax for all companies. For the years 1987-1989, there is a book income adjustment for BURP which adds half of the excess of book income over taxable income to the base in defining alternative minimum taxable income. For 1990 and later an "adjusted current earnings" (ACE) adjustment, which includes a provision capitalizing acquisition expenses, is used in defining the alternative minimum taxable income.

Level: Intermediate

Proceedings of Insurance Accounting and Systems Association (1988), p.87

The 1986 Tax Reform Act enacted a new alternate minimum tax provision. It is a parallel system of separate computations. These are three articles by three different authors that explain how to compute the new alternate minimum taxes, including an explanation of preference items as well as book income adjustments which are applicable to the 1987-1989 tax return. The articles also explain the mechanics of ACE which becomes effective for 1990 and later. The articles also incorporate the 1987 Tax Act changes applicable to alternate minimum taxes.

Level: Advanced

Pages: 8

Section 809 (Surplus Tax)

The 1984 Act defined a tax for mutual companies on their equity which is intended as a tax on the "ownership element" of policyholder dividends.

Code section 809 from 1984 Tax Act, Committee Reports, and "bluebook"

Defines how the mutual life insurance company surplus tax is calculated by multiplying the differential earnings rate (DER) times company equity. The DER represents the difference of the stock industry earnings rate and mutual industry earnings rate. The effect is a limitation on deductible policyholder dividends.

Level: Intermediate

Proceedings of Insurance Accounting and Systems Association (1984), p.205

The 1984 Tax Act contains a new provision which reduces the deductible amount of policyholder dividends and reserves available to mutual life insurance companies. The amount of this reduction is called the differential earnings amount. The article sets out technical details of how the differential earnings amount is computed.

Since the 1959 Act, the tax benefit available from nominally tax exempt interest and from the intercorporate dividends received deduction (sections 243, 244, and 245) has been limited to a benefit for the "company's share" of such interest or dividends received. The 1984 Act substantially changed the definition of the "company's share." The article explains the new provision.

Level: Intermediate

Pages: 3

Reinsurance

After the "modco fiasco" in the few years prior to TEFRA (1982 Tax Act), Congress desired to restrict the ability of life insurance companies to do financial tax planning by the use of reinsurance. The result was section 845 of the Internal Revenue Code (IRC). A 1989 U.S. Supreme Court case settled the treatment of commissions for the reinsurer.

RSA 11 (1985), No. 3, "United States Life Insurance Tax Law," p.1441

Extensive discussion of foreign insurers and reinsurance considerations under Code section 845. Product impact is essentially a repeat of the panel discussion in RSA 11, No. 1.

Level: Intermediate

Pages: 58

Code section 845 and Act section 216 from 1984 Act, Committee Reports, and "bluebook"

Prohibits tax avoidance schemes of reinsurance transactions. Gives the IRS power to unwind both sides or only one side of a reinsurance transaction in calculating taxes if the Secretary finds a "significant tax avoidance effect."

Level: Intermediate

"Reinsurance and Financial Planning," tapes of SOA seminar (1988)

Includes discussion of the tax implications of reinsurance agreements. Includes review of section 845 concerning the power of the IRS to reallocate earnings if there is a tax avoidance effect and the status of the rules governing the handling of expense allowances.

Level: Intermediate

Tapes: 8

RSA 14 (1988), No. 4A, "Reinsurance Tax Issues," p.1907

Discusses reinsurance commissions before the 1989 Supreme Court case on treatment of commissions on indemnity insurance from the reinsurer's point of view. Also discusses section 845(b) and foreign reinsurance.

Level: Intermediate

Pages: 10

RSA 15 (1989), No.2, "Reinsurance Tax Issues," p.809

The reinsurance Supreme Court case on commissions was being argued when this panel discussion took place. Discusses reinsurance commissions and section 845(b) as well as tax planning opportunities between companies in a regular tax position and companies subject to the alternative minimum tax (AMT).

Level: Intermediate

Pages: 20

Colonial American Life Insurance Company v. Commissioner of Internal Revenue, S. Ct. Docket No. 88-396. Can also be referenced as 57 U.S.L.W. 4726 (June 15, 1989)

The U. S. Supreme Court held that ceding commissions paid by a reinsurance company under an indemnity insurance contract must be capitalized and amortized over the anticipated useful life of the assets.

Level: Intermediate

Product

The 1984 Tax Act changed the earnings for companies compared to prior (TEFRA) days with the loss of the IRC section 818(c) credit, larger policyholder dividend deductibility, and a surplus tax for mutual companies. Sections 7702 and 7702A defined or redefined what can be called life insurance under the Internal Revenue Code.

RSA 11 (1985), No. 1, "Federal Income Tax Impact on Product Design and Cost", p.207

Describes impact of FIT on rates of return of various products under 1984 Tax Act along with TEFRA and 1959 Act. Describes tax impact of book-to-tax surplus adjustments and allocation of surplus tax.

Level: Intermediate

Pages: 67

RSA 13 (1987), No. 2, "Impact of Federal Income Taxes and Product Development", p.727

Discusses inside build-up as one of the few remaining tax shelters, interest deduction on policy loans, business-owned individual life insurance, deductions for policy reserves.

Level: Intermediate

Pages: 23

RSA 14 (1988), No. 2, "Impact of Federal Income Taxes on Product Design", p.915

Covers definition of life insurance (section 7702), policy loans (and interest on them), exchanges, excessively high and low mortality guarantee charges, treatment of variable contracts under section 817.

Level: Intermediate

Pages: 25

Code Section 7702 from 1984 Tax Act, Committee Reports, "bluebook"

Defines "life insurance contract" for all purposes of the Internal Revenue Code (income, estate and gift, excise and employment taxes). This determines the availability of "inside buildup" and the exclusion of death benefits from income as well as having the consequences for life insurance company taxation.

Level: Intermediate

Code Sections 7702 and 7702A from 1988 Tax Act, Committee Reports

Defines a new class of life insurance contracts (modified endowments) by reference to a seven-pay test. Applies the annuity rules to distributions and loans under modified endowments. Mortality and expense assumptions used in computing definitional limits and seven-pay premiums must be reasonable for new contracts.

Level: Intermediate

Code Sections 72, 79, 101, and 264

Section 72 sets forth the rules for taxing amounts received under annuity, life insurance, endowment and modified endowment contracts. Section 79 sets forth the tax treatment of employer funded group term life insurance. Section 101 provides the tax treatment of death benefits, and section 264 gives the tax treatment of certain amounts paid in connection with life insurance contracts.

Level: Intermediate

Journal of the American Society of CLU (November, 1984), "The New Federal Tax Definition of Life Insurance Contract" by Jeffrey Hahn and John Adney, p.40

Discusses the background and the technical detail of the statutory definition of a life insurance contract (section 7702).

Level: Intermediate

Page: 14

Journal of the American Society of CLU & ChFC (May, July, and September, 1989) "The Great Single Premium Life Insurance Controversy" by John Adney and Mark Griffin, p.64 (May), p.74 (July), p.70 (Sept.)

Discusses in exquisitely excruciating detail the background and the content of the 1988 definition and tax treatment prescribed for modified endowment contracts. Also discusses the requirement in the 1988 law that mortality and expense assumptions used in computations under section 7702 be reasonable.

Level: Intermediate

Pages: 37

This Actuarial Specialty Guide on U.S. Taxation – Life Insurance was developed under the auspices of the Professional Actuarial Specialty Guides Committee on Continuing Education by

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