The Actuary

December 1986 – Volume No. 20, Issue No. 10

The Actuary
The Newsletter of the Society of Actuaries

VOL. 20, No. 10 December, 1986

REINSURANCE SECTION

by Gene Woodard

The Reinsurance Section was formed in the fall of 1982. The primary purposes for its existence are to keep its members informed with respect to issues affecting reinsurance from either the ceding company's or reinsurer's perspective, and to provide a means by which educational as well as other information can be disseminated to its members.

One of the tools used by the Section is the offering of various programs, including special topics seminars, in conjunction with the Society's Regional and Annual meetings and geared to the interests of its members. Another tool is the Section's Newsletter which is published 3-4 times a year providing updates on current topics and other articles of interest.

The Section's activities are directed and managed by the Section Council which consist of nine members of the Section. The Council officers for the 1986-1987 year are: Denis Loring, Chairman; Johanna Becker, Vice Chairman; Diane Wallace, Secretary; and Denise Fagerberg, Treasurer. The ongoing activity of the Section is carried out by committees. Each member of the Council serves as a liaison to one of the committees. The current committees are as follows.

Administration	Program
Education	Statistical
Elections	Treaty
Financial/Tax	Underwriting
Newsletter	Other Sections

A summary of the recent activity of the committees will conclude this report.

Administration

During 1985 and early 1986, this committee was involved in a study of the

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TAXATION OF LIFE INSURANCE COMPANY PRODUCTS

by Stephen W. Kraus and Richard V. Minck

The latest saga of Tax Reform is over. The Congress has enacted, and the President has signed, what has been called the most comprehensive revision of the federal income tax system since its inception in 1913 — The Tax Reform Act of 1986 ("Act"). The insurance business and its policyholders faced major threats at the start of the tax reform process which would, by Treasury estimates, have raised $100 billion over a five-year period. Most of these threats were not enacted by Congress. While the insurance business avoided disaster on the major policyholder issues, the final bill was not greeted with any sense of triumph. The Act will cause many insurance company clients to pay more taxes. Changes in taxation of employee benefit plans are also important, but these are outside the scope of this article.

When the tax fight started, prospects for the insurance business were gloomy. In November 1984, the Treasury Department released its plan to the President on "Tax Reform for Fairness, Simplicity and Economic Growth." Several of the proposals would have had a significant adverse impact on the products sold by life insurance companies. Most critical was the proposal to tax the owners of life insurance policies or annuities on the annual increases in the cash surrender value of their policies — the so-called "inside build-up." The Treasury plan would also have treated policyholder loans and partial withdrawals as coming first from any previously untaxed "inside build-up"

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AN APPROACH TO ENHANCING LONG-TERM CARE INSURANCE

by Heidi Rackley

The 65-plus population is the fastest growing age group in the United States. Not only is this segment growing in absolute numbers, but also in socio-economic power. Those persons turning 65 today are on the whole better educated and healthier with a greater future life expectancy than their counterparts in prior generations. They also represent greater purchasing power. On average, they own 80% of the equity in their homes; many receive private pensions in addition to Social Security benefits; and some will have accumulated assets tax-effectively in Individual Retirement Accounts.

With the emergence of seniors as a major new market force, actuaries will be called upon to develop products and services geared specifically to their needs. One of the areas of greatest need, and hence opportunity, is the delivery and financing of long-term care. Long-term care refers to health or personal services required by persons who are chronically ill, disabled or retarded, in an institution or at home, on a long-term basis. The array of services encompassed within the long-term care industry ranges from Meals-On-Wheels, homemaker and visiting nurse services to community based programs including senior citizen centers, adult day care and respite care, and finally to services rendered in an institutional setting such as a congregate care home, intermediate care facility, skilled nursing facility or state mental hospital. As one might surmise from the breadth of this array of services, fragmentation among both provider services and funding sources is a major problem for persons currently in need of long-

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Taxation of Life Products

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and thus includible in the policyholder's income.

The Treasury's proposal, which generated much comment and objection from the life insurance business and other affected taxpayers, was replaced by a modified Administration program entitled "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity." This proposal was sent to the Congress in May 1985. The President's proposal continued to advocate the current taxation of the "inside build-up" on life insurance policies and annuities. It did not recommend any specific changes relating to the tax treatment of policyholder loans. However, interest on policy loans to individuals would be subject to the general limitation on deductibility of nonbusiness interest proposed by the Administration.

Why did the Administration propose that the "inside build-up" be taxed currently? They argued that investment income on the savings component of life insurance policies or deferred annuities is similar to investment income earned on savings instruments issued by other financial institutions. According to the Treasury explanation, the tax-favored treatment accorded the investment income credited to insurance policies or annuities encourages individuals to save through life insurance companies and thus distorts the flow of savings and investment in the economy.

The industry countered the Administration's argument for taxing the inside build-up in testimony before the House Ways and Means Committee, the Senate Finance Committee and the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs. Some of the many points raised were:

(1) Current tax treatment of life insurance and annuities followed the basic tax principle that an individual should not be taxed on amounts which have not been received and which cannot be obtained without giving up valuable rights;

(2) In developing the Tax Reform Act of 1984, the Congress had thoroughly examined the taxation of life insurance and annuities and had made any needed revisions in the law; and

(3) Permanent life insurance and annuities are unique products; their social purpose has led to their purchase by the vast majority of Americans.

Both the Treasury proposal and the President's proposal also advocated changing the tax treatment of employer-provided health insurance. The Treasury proposal would have imposed a "cap" on nontaxable employer contributions to health plans (i.e., employer contributions would be included in an employee's gross income to the extent they exceeded $70 a month for individual coverage or $175 a month for family coverage). In addition, under the Treasury proposal the cost of the first $50,000 of group-term life insurance — which is currently excludable from taxable income — would have been taxable.

Although the President's proposal did not attempt to change the treatment of group-term life insurance, it did try to tax some portion of employer-provided health insurance with a "floor" approach (i.e., employer contributions to a health plan would be included in an employee's income up to $10 a month for individual coverage or $25 a month for family coverage). The President's program also advocated a new set of uniform nondiscrimination rules to apply to all welfare benefit plans.

There was great opposition to these proposals. Millions of people wrote to Congress with a clear message. Do not tax my insurance or employee benefits! When the House Ways and Means Committee reported out its bill, the "inside build-up" on life insurance and individually owned annuities was not to be taxed. No new taxes were to be imposed on group life or health insurance. This result was ratified as the measure moved through the House, the Senate, and finally the Conference Committee.

A number of insurance-related changes were, however, made by the Act. For example, the "inside build-up" on corporate-owned deferred annuities will be taxed in the future. Exceptions to this rule are made for annuities held by an employer with respect to a terminated pension plan and for annuities used to fund structured settlements.

While the Act does not contain a provision specifically changing the tax treatment of life insurance policy loans made to individuals, the provision that completely disallows (after a transition period) any deduction for interest on consumer borrowing applies to policy loans to individuals. In addition, the Act disallows a deduction for intere[st] on loans against corporate-owned lif[e] insurance policies covering a key employee to the extent the aggregate of such loans is in excess of $50,000 for that employee. This provision is effective for loans under policies purchased after June 20, 1986.

The Act contains a technical correction to Section 7702 of the Internal Revenue Code dealing with the definition of life insurance that will have ramifications with regard to partial withdrawals from life insurance policies. The technical correction modifies and clarifies the present law that governs how distributions in connection with reductions of future benefits will be treated for tax purposes. Under the Act, some of the cash distributed to a policyholder may be treated as being taxable income, rather than as being a return of the policyholder's investment in the contract. This tax treatment will apply if the reduction in future benefits occurs during the 15-year period following the issue date of the contract.

Although the "inside build-up" on [a] life insurance contract is not includibl[e] in current income for regular tax purposes, a new preference item (business untaxed reported profits) used to determine the corporate alternative minimum tax could affect corporate-held "key man" life insurance policies. A minimum tax could be triggered because the "inside build-up" on corporate-owned insurance policies (plus the excess of any death benefits paid over the policy cash values) may be treated as "business untaxed reported profits."

Another technical correction to the 1984 Act favorably clarifies the status of typical experience-rated group insurance contracts under the Code. This amendment is important because if an experience-rated group insurance contract were to be considered a "fund," any experience refund or policy dividend could be subject to a 100% excise tax as a prohibited reversion to the employer under the welfare benefit fund provisions of the Code.

Additionally, the Act establishes new eligibility and benefits nondiscrim[-]

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Reinsurance Section

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problems associated with self-administered reinsurance. In March 1985 an exposure draft of Guidelines for the Reporting of Self-Administered Reinsurance was released to Section members and software vendors. The draft was presented in panel discussions at the St. Louis and Quebec 1985 spring meetings. A revised version was presented for a final discussion at the Boston 1986 spring meeting. The final guidelines have been published and were read into the Society proceedings at the 1986 Annual Meeting in Chicago.

Plans underway by this committee include an exposure draft on audits conducted by reinsurers, which is planned for late 1987 or early 1988. A preliminary survey gathering data regarding audits has already been sent to reinsurers. There are also plans for a workshop on electronic data transfer.

Education

There was a one-day seminar on AIDS presented in conjunction with the spring 1986 meeting in Boston. 140 members registered for the seminar and 129 actually attended. This was considered a good turnout and resulted in a modest financial gain for the Section.

Election

In carrying out the election process each year, this committee has noted a decline in the number of ballots as well as in the percent voting. An attempt will be made to counteract this trend by expanding the biographical data included in the ballot material mailed to members. An article will also be included in the newletter prior to the election urging members to vote.

Financial/Tax

The charge of this committee was recently expanded to include the monitoring and reporting on all reinsurance regulatory activity. Initially its interest was limited to the financial and tax areas. The NAIC Technical Advisory Committee has requested advice on reinsurance ceded and this committee will be one of the sources.

Plans for the balance of 1986 and 1987 are to compile and maintain a list of industry tax, accounting and regulatory committees and appoint liaisons from this committee to each of the other groups for purposes of providing both input and resources from the Section. There are also plans for a regular column in the newsletter dealing with regulatory and other financial/tax issues of current interest.

A panel discussion and follow-up workshop on Financial Reinsurance was included in the program for the Annual Meeting in Chicago.

Program

This committee has been actively planning programs for Society Meetings for the years ahead. In addition to regular programming a half-day teaching session on negotiation is planned for 1987 and there are tentative plans to offer a teaching session on practical uses of risk theory in 1988.

Statistical

This committee will produce an annual reinsurance experience summary which will incorporate the survey previously conducted and distributed by NARE. Munich American Re will play a key role in this project.

Discussions are currently underway regarding who will be responsible for continuing the large amount mortality study initially produced by the Equitable Society. Several alternatives are being considered including a non-insurance company.

Treaty

Plans include a project to review standard treaty provisions gathering input in this review from both ceding and assuming companies.

Underwriting

A panel presentation and follow-up workshop on Reinsurance Underwriting Issues was presented at the spring meeting in Boston. This committee also produced an article on Alcohol Abuse in the June 1986 issue of the newsletter.

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Thanks are in order for the Section members who have participated actively on the Council as committee chairpersons and as program participants. The Section owes most of its success over the last few years to these individuals. Any of the readers wishing to participate in Section affairs who are not presently involved should contact Denis Loring at his *Yearbook* address. □

Taxation of Life Products

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ination rules applicable to group-term life insurance plans and group accident or health plans whether insured or self-insured.

The members of Congress primarily responsible for drafting the new provisions point out that any particular changes that result in tax increases for individuals should be considered in the context of a bill that overall will reduce taxes paid by individuals during the period 1987 through 1991 by $122 billion and increase corporate taxes for the period by about the same amount. □

STATUTORY ACCOUNTING FOR COMPUTER SOFTWARE

by Robert J. Johansen

Instructions for the 1985 NAIC Life and Health Annual Statement Blank state:

> Under no circumstances should computer software other than operating system software be considered as an asset, either admitted or non-admitted.

Historically, this rule evolved when hardware costs were substantial compared with the cost of software, much of which was either bundled with the hardware or produced by the user's staff, with or without outside assistance. Now hardware costs on a capacity basis have dropped while bundled software is rare and the costs of developing or purchasing application software have soared.

With the compexity of today's Life and Health insurance plans and processing, the costs of developing appropriate software in house are now so high as to tip the scales in favor of purchased software where, in effect, several companies share the development cost. Even so, the cost of a complete system can run to several million dollars. Under current rules this cost must be expensed in one year, dealing a severe jolt to statutory earnings. The reasoning behind the rule was that software, then often customized, did not have a resale market value.

It is time now to reevaluate the Blank's treatment of software.

Suppose we postulate that software does not have a resale market value.

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