Article From:

The Actuary

September 1987 – Volume No. 21, Issue No. 7

The Newsletter of the Society of Actuaries
VOL. 21/NO. 7
SEPTEMBER, 1987

THE Actuary

FASB Hearing on Insurance Accounting

By William J. Schreiner

Actuaries were well represented at the June 22-23, 1987, Financial Accounting Standards Board hearing on its Exposure Draft, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Insurance Contracts and for Realized Gains and Losses from the Sale of Investments." Only a handful of the 20 commenting organizations ventured to the hearing table without at least one actuary in their delegation. The American Academy of Actuaries led off the hearing, and four of the six "Big 8" accounting firms, which participated in the hearing, included actuaries in their contingent.

The hearing was held to receive comments on the Board's proposal for GAAP accounting standards for universal life policies and related issues. The Exposure Draft addressed, in addition to universal life policies, limited premium policies, policies without mortality or morbidity risk, internal replacements, and gains and losses from investments.

None of the commentators at the hearing and very few of the 100-plus comment letters received by the Board endorsed adoption of the Board's proposal without change.

The main focus was on accounting for universal life, where the Board proposed to require the use of the retrospective deposit method, which ties the determination of the reserve liability to the account value. The opposition to this proposal divided into two camps: those who wanted to "fix" the proposed retrospective deposit method so that it would give

Continued on page 2 column 2

The Canadian Tax Proposals

By Robin B. Leckie

(Ed. note: On June 18, 1987, the Canadian federal Department of Finance released a tax reform paper containing proposals for discussion over the ensuing months. The Actuary *asked Robin Leckie, who chairs the Task Force on Tax Policy of the Canadian Life and Health Insurance Association (CLHIA), for comment.)*

The CLHIA Task Force has been meeting for several years in analyzing the taxation of Canadian insurance. More recently the Task Force has worked with Department of Finance officials in overcoming some of the deficiencies in the current corporate tax formula, which has led to rather minimal taxation from the life insurance industry in Canada. Thus, although the June 18, 1987, Tax Reform proposals from Finance are sweeping (along the lines of the changes in the United States last year), a specific objective was that the life industry should hereafter bear its fair share of tax. The initial reaction to the general tax reform proposals has been reasonably favorable; the initial reaction to the life insurance proposals has been "overkill."

Summary of Existing Taxation

Life companies operating in Canada, whether Canadian or foreign, are taxed on their Canadian income. For multi-nationals Canadian income is defined through the use of a Canadian Investment Fund (CIF) and the income from assets designated to fill the CIF. One of the reasons for the lack of significant taxable income has been deficiencies in the CIF calculations. Another reason is that bond and mortgage gains and losses have been taxable at regular corporate rates. Until recently these have been mainly losses. Another reason has been the full integration (i.e., pass through) of dividends, common and preferred, from Canadian corporations. The deduction for actuarial reserve increases has been based on one-year preliminary term reserves calculated using pricing assumptions.

Taxation of individuals depends on whether the policies are exempt or not. An exempt policy is one in which the reserve is less than a 20-year endowment at 85. The gain on exempt policies is taxable on termination of the policy by other than death. On non-exempt policies the reserve interest increment is taxed annually (or electively every 3 years) at the individual's personal rates. Variable policies and mutual funds are also taxed on an annual flow-through basis.

Continued on page 2 column 3

In this issue:

THE
Actuary

The Newsletter of the
Society of Actuaries

VOLUME 21, NO. 7
SEPTEMBER 1987

Correspondence should be addressed
The Actuary
P.O. Box 105006
Atlanta, GA 30348-5006
Tel: (404) 980-5644

Published monthly (except July and August) by the SOCIETY OF ACTUARIES, 500 Park Boulevard, Itasca, IL 60143. Harold G. Ingraham, Jr., President; Richard V. Minck, Secretary; Michael J. Crowell, Treasurer; Anthony T. Spano, Director of Publications. Non-member subscriptions: students, $5.50; others, $6.50.

FASB Hearing cont.

results they considered more rational and those who urged the adoption of a single, comprehensive accounting model for all life insurance products. Most who favored the latter approach suggested that existing accounting guidance for life insurance products under the Board's Statement No. 60 could be fine-tuned to cover universal life as well as traditional products. Most insurers seem to believe that the retrospective deposit method proposed by the Board could be fixed, by changing the method of amortizing deferred acquisition costs, so that the reported earnings would be less sensitive to product design and more in accord with the insurer's view of an appropriately recognized earnings stream.

Similarly, there was general agreement that something needed to be done to improve the guidance with respect to single or limited premium products. While few thought that the Board's proposal to recognize earnings in proportion to insurance in force for all limited premium products was the answer, the solutions proposed ranged from an exception to special rules for products of more than five years' premiums to an exception only for products of more than 20 years' premiums.

The Board will now review the comments received with its staff to identify the areas that should be reviewed and reconsidered. This process, if substantial agreement can be reached among the Board members, is scheduled to take place over the summer and fall of 1987, culminating in a final Statement of Financial Accounting Standards before year-end.

William J. Schreiner is an Actuary with the American Council of Life Insurance. He serves on the Council of the Life Insurance Company Financial Reporting Section.

Mail Alert

Members should have received the following material from the Society in recent mailings:

- The *Record*, Volume 12 Nos. 1, 2 and 3
- Preliminary Program and registration materials for the 1987 Montreal annual meeting
- Exposure Draft on Life Insurance Company Valuation Principles

Canadian Tax Proposals cont.

Tax Reform Proposal

The June 18, 1987, Tax Reform proposal can be summarized under three headings:

1) *Company Tax*

The Corporate tax proposals for life insurance are significant. Tax rates for corporations are reduced, but not as much as they were in the United States. The combined federal-provincial rate in Ontario will be approximately 44%. The rules for defining and applying the CIF have been corrected. In fact, they may have been overcorrected, particularly as they may affect Canadian equity income and real estate. Actuarial reserve deductions will hereafter be based on one-and-a-half-year preliminary term and pricing assumptions. The dividend reserve has been reduced to the dividends accrued to the end of the year (correcting a deficiency in the former tax law). There are no longer formula deductions for investment reserves, but actual bad debts and specific provisions for potential debts can be taken. Dividends to policyholders remain fully deductible for both stock and mutual companies.

The issues in the proposed changes are:

i) The use of one-and-a-half-year preliminary term and the lack of any deductions for contingency reserves could, on average, increase the taxable income base above the reportable income base.
ii) There is no recognition of the large overhang of accumulated capital gains on real estate, bonds and mortgages presently on the books.
iii) The proposal for the determination of Canadian taxable income for banks would appear to have a number of deficiencies. This could result in a non-level playing field for insurance companies and other financial institutions versus the banks.

2) *Investment Tax*

Tax Reform introduces an investment tax on life insurance companies of 15% of the investment income on exempt policies. An exclusion has been given for fixed-premium policies issued prior to the end of 1987. The tax is proposed to be phased in over a 5-year period commencing in 1988, i.e., 3% in 1988, 6% in 1989, etc. In effect, this is a proxy tax on the

Continued on page 3 column 1

Canadian Tax Proposals cont.

company in lieu of an attempt to tax "directly" the inside build-up imputed to policyholders. The latter was attempted in November 1981, but the agent and policyholder lobby defeated the proposal for the exempt class of policies.

The issues are:

i) So far as I am aware, the inside build-up on regular annual-premium life insurance policies is not taxed in any country. There are sound reasons for not taxing the incidental forced savings in life insurance policies, and the proposed transfer of the tax to the company does not alter the logic. It is expected that this tax will be bitterly opposed.

ii) The expense deduction is limited to investment expenses. No allowance is provided for administrative and marketing expense, even though these expenses would serve to reduce taxable income on non-exempt policies and on savings through other institutions.

iii) It is, of course, anticipated that the companies would pass this tax through to the policyholders. However, because of the uncertainty of the passage of this proposal, the way in which it would operate, and the 5-year phase-in, there may be a lack of uniformity in making sales presentations of interest-sensitive products and dividend illustrations of participating products. Hopefully, the Canadian Institute of Actuaries and the CLHIA will act quickly to ensure reasonable integrity in the methodology for sales illustrations.

3) *Sales Tax*

The Tax Reform proposal includes a position paper on federal sales-tax reform, with probable implementation in 1989. The three alternate proposals for consideration are: (i) a sales tax without the use of invoices (i.e., a Business Transfer Tax or BTT); (ii) a sales tax with invoices (i.e., Value Added Tax or VAT); (iii) a combined federal-provincial sales tax, either BTT or VAT. The government favors the third alternative and prefers the BTT approach. However, if significant exemptions are required (for political purposes), it is quite possible they will revert to a VAT.

All three proposals are intended to include financial services. For a life insurance company the tax base would become (approximately) its Canadian taxable income plus compensation expense plus commissions. This would be a proxy for the value added for service rendered by the insurance company. The tax rate for a very broadly based sales tax would be approximately 8%.

The issues are:

i) Financial services are normally exempted from VAT. This could be a significant additional burden on the pricing of life insurance services.

ii) An initial review of the proposed formula would seem to indicate a slightly heavier burden on the life insurance industry than on other financial institutions. Hopefully, any lack of a level playing field will be rectified in a final formula.

iii) No consideration is given, at least at this time, to the premium tax already payable by life insurance companies to the provinces.

iv) The retaliatory provisions of state premium tax laws could conceivably come into effect.

Robin B. Leckie is Senior Vice President and Chief Actuary with Manufacturers Life Insurance Co. In addition to his duties with the CLHIA, he is a Past President of both the Society of Actuaries and the Canadian Institute of Actuaries.

E&E Committee Seeking Volunteers

The Flexible Education System (FES) has been implemented for Series 100 (formerly Parts 1-5) and is scheduled to be implemented for Series 200 and above (current Fellowship examinations) in November 1988. Because of normal turnover in the membership of examination committees, and the support needed to develop and implement FES while maintaining the current Fellowship examination structure for the next year, the E&E Committee is seeking volunteers. We especially need volunteers' help with the FES Fellowship tracks (Core, Individual Life and Annuities, Group Benefits, and Pensions), or the new Course 161, Mathematics of Demography.

If you are interested or would like further information, please contact Debra Walsdorf at the SOA office.

Valuation Actuary Symposium Schedule

By Arnold A. Dicke

The 1987 Valuation Actuary Symposium will be held on September 30 and October 1, 1987, at the Loew's Anatole Hotel in Dallas. The format is somewhat different from those of previous years. The first change is to be given over, largely, to a teaching session on cash-flow analysis and other techniques of interest to the valuation actuary. Each aspect of the process will be explored in depth, with comparisons of alternative procedures currently being used in practice. For example, the use of a fixed, validated set of interest rate scenarios will be contrasted to the use of transition probabilities. Lapse rate functions, assumptions about market credited rates and prepayment models will also be discussed. The topics will be covered in a way that is not specific to a particular legal or regulatory environment. The speakers for this session will be Doug Doll, Greg Jacobs, Donna Claire and Arnold Dicke.

The remainder of the meeting will be broken out into two, or occasionally three, tracks. Typically, sessions of interest to Canadian and U.S. actuaries will be held concurrently. The Canadian sessions will include discussions of the work being done on solvency requirements and current technique papers. The U.S. sessions will review the work of various committees on implementation of the valuation actuary approach, as well as implications for taxes, reinsurance, etc. A highlight will be an open forum in which three state regulators, John Montgomery, Robert Callahan and Ted Becker, will respond to pre-submitted questions.

Additional sessions will focus on applications to the property/casualty field and a review of current software that is available to aid the valuation actuary. Software vendors wishing to participate in the last-mentioned session should contact Arnold Dicke.

Arnold A. Dicke is Senior Vice President and Chief Actuary with Provident Mutual Life Insurance. He is organizing the 1987 Valuation Actuary Symposium and is Vice Chairperson of the Life Insurance Company Financial Reporting Section.