



SOCIETY OF  
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2019 **ANNUAL  
MEETING**  
& EXHIBIT

October 27-30  
Toronto, Canada

## Session 194: Product Taxation for In-Force Products

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# Session 194

## Product taxation for in-force products

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# SOCIETY OF ACTUARIES

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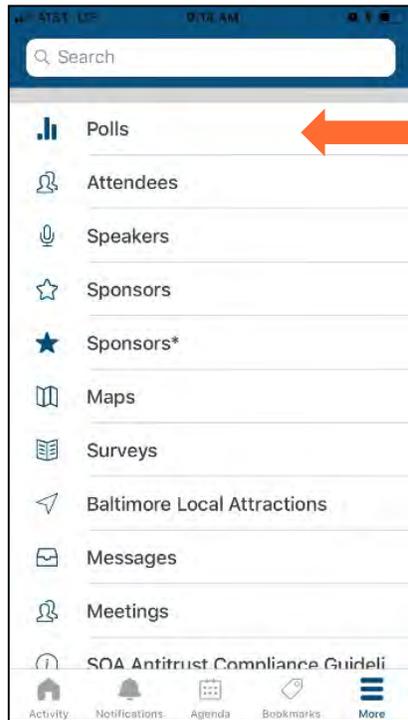
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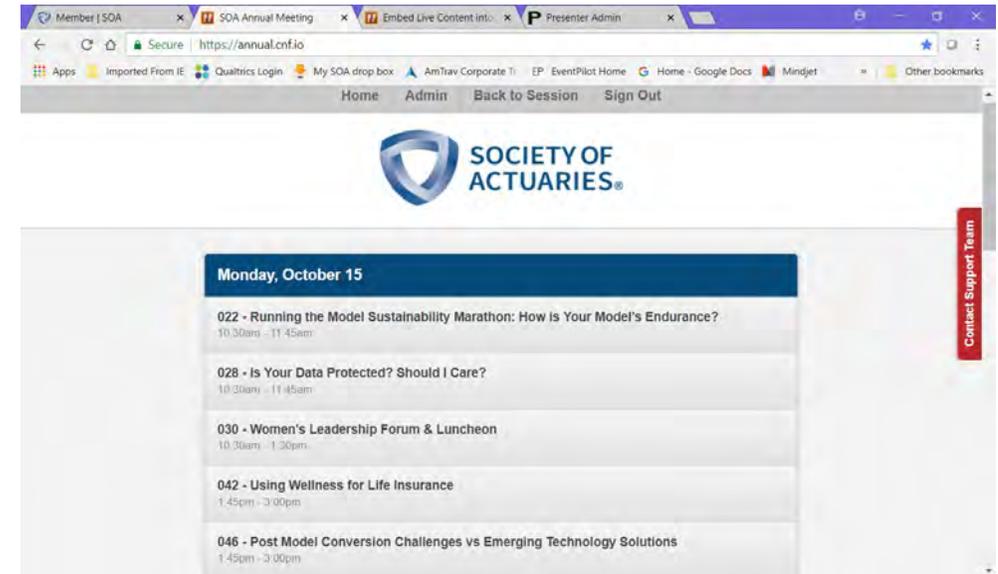
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# Poll

Where do you work?

1. Insurance company
2. Consulting firm
3. Regulator
4. Other

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**Poll: Where do you work?**

# Poll

What's your level of product tax experience?

1. DEFRA is my BFF
2. I've computed a 7-pay in my day
3. What's a guideline premium?

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**Poll: What's your level of product tax expertise?**

# Introduction



# Case study

## ABC Life Insurance Company (ABCLI)

- Launched a new product portfolio in 2002:
  - Variable universal life (Best VUL):
    - Designed to accommodate either an accumulation or death benefit focus
  - Traditional whole life (Best WL):
    - Fixed premium and death benefit with option to purchase paid-up additions
- Sold from 2002 to 2009, when the 2001 Commissioners Standard Ordinary (CSO) mortality table went into effect

# Case study

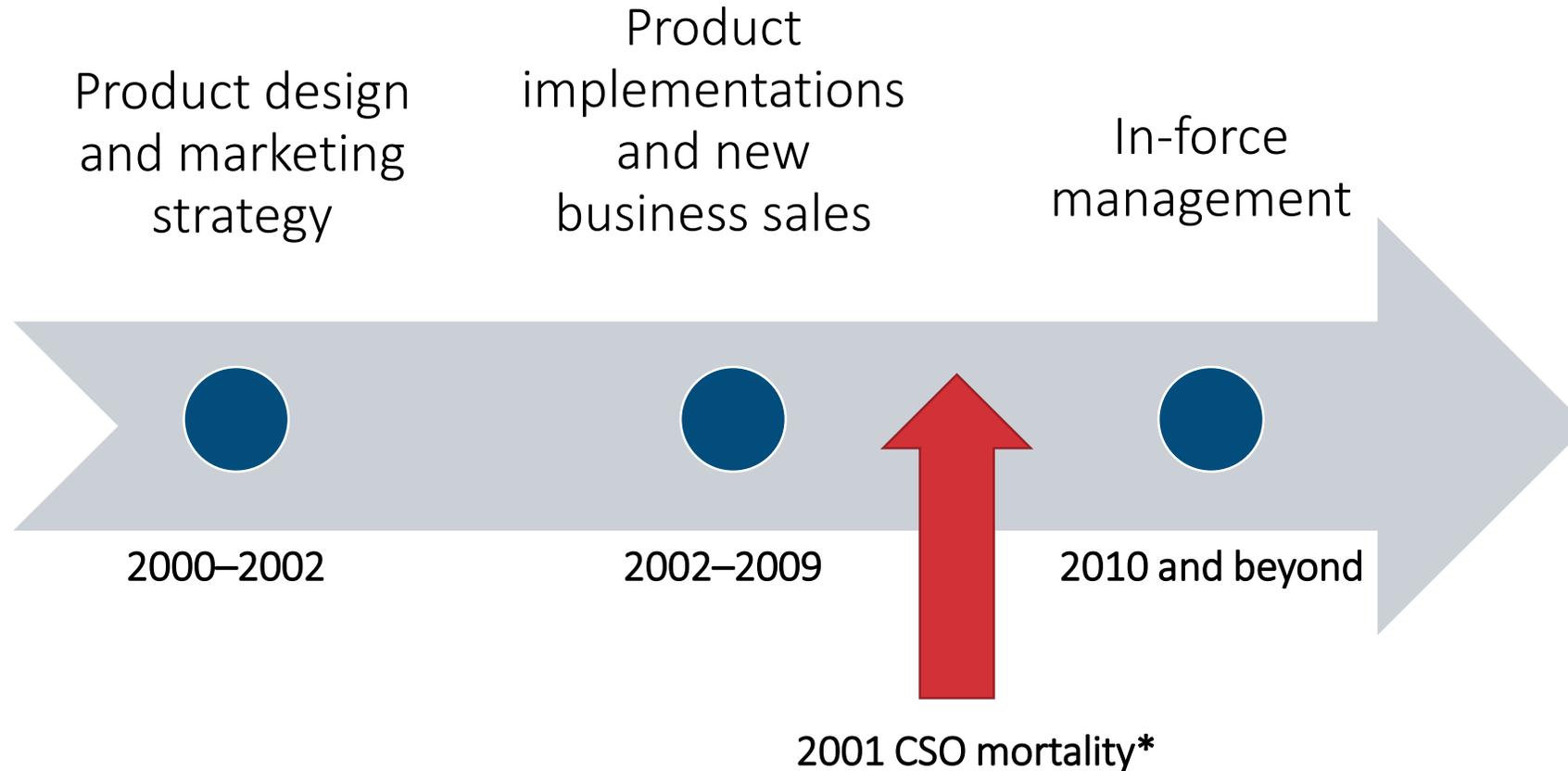
- We will explore the product tax compliance (PTC) issues that ABCLI faced during the product life cycle phases, which include:
  1. Product design and marketing strategy
  2. Product implementation and new business
  3. In-force management
- Our focus will be on issues that surfaced during the in-force management phase.

# Case study

The case study will explore these issues from the viewpoint of three main roles within ABCLI, and their respective priorities during the product life cycle.

- Product actuary:
  - Designs products with a focus on company profitability
- Marketing officer:
  - Goes to market with products that fit desired marketing strategies and are attractive to producers and clients
- Tax compliance officer:
  - Focuses on PTC and mitigation of potential risk in the future

# Product life cycle



\* The 2001 CSO mortality table was required for all policies issued beginning January 1, 2009.

# Phase 1 Product development



# Phase 1 – overview

During the product development phase, ABCLI needed to do the following two main things:

1. Design products with features to accommodate the anticipated marketing strategies
2. Develop contracts, prospectuses and other disclosures needed for each product

# Product design and marketing strategy

## Push and pull from the three roles

- Complicated product designs may help fit a marketing niche, but do they take into account potential issues down the road?
- ABCLI developed complex features for both the Best VUL and the Best WL products without fully considering the impact on implementation (systems) or PTC.
  - A marketing strategy for the Best VUL product was illustrated with a large withdrawal and concurrent face amount reduction to save on the cost of insurance (COI) charges.
  - The Best WL product has complicated riders to allow for the purchase of both term insurance and paid-up additions.
- Do the marketing strategies align with the product features and the pricing for profitability, and were the designs reviewed appropriately?
  - The Best WL cash values were developed assuming an interest rate of 3.5%, which does not align with the 4.0% statutory minimum for the calculation of the net single premiums.

# Contracts, prospectuses and other disclosures

Was language reviewed by all appropriate parties?

- The Best VUL contract and prospectus were developed by different teams within ABCLI and used inconsistent language to describe the same product features and key PTC terms.
- The Best WL contract was not reviewed for potential PTC issues, which could have identified the product design issue wherein cash values were developed based on a 3.5% interest rate.
- The modified endowment contract (MEC) disclosures were limited to illustrations and did not require client signatures.

# Phase 1 – potential risk mitigation strategies

PTC risk mitigation strategies ABCLI could have implemented

- Institute a formal review and sign-off procedure that includes PTC subject-matter experts to:
  - Review product features for profitability, fit to market and PTC
  - Review marketing and illustrative strategies for potential conflict with PTC
  - Review contracts, prospectuses, marketing materials and illustrations for:
    - Consistency of terms
    - Accuracy of descriptions
    - Understandability by client

# Phase 2

## Product implementation and new business



# Phase 2 – overview

The Best WL and Best VUL products were developed and marketing strategies were finalized for each. ABCLI now needed to get ready to sell business by:

1. Implementing and testing the products on illustration and administration systems
2. Establishing underwriting and new business procedures
3. Training staff about products and procedures

# Product and system implementation

Did PTC-related items receive adequate attention during the product implementations?

- Two concurrent product implementations, tight timelines and inadequate oversight all led to pushing off many features to a “day two” status, and instituting manual procedures as a temporary “bridge.”
- Testing procedures (testing tools, test plans and regression testing) were not fully developed and reviewed.
  - An existing product was inadvertently affected by the new product implementation.
  - Product features and transaction scenarios were not adequately tested for PTC.
  - There were inconsistencies between illustrations and administration.
  - Checks and balances for the administration system were not implemented.

# New business procedures and staff training

Were administrative procedures adequately documented, and were new business staff trained on procedures, product features and potential PTC issues?

- Manual procedures were implemented as a bridge until automated procedures could be implemented. Many of these procedures were not formally documented, and staff received inadequate training.
- ABCLI's staff was not adequately trained on the procedures to follow when a contract was issued as a MEC. Combined with inconsistent MEC indicators between the illustration and administration systems, this led to some clients not being informed of the MEC status.
- Staff members were able to override a MEC flag in the administration system and issue contracts without providing the proper MEC disclosures to policyholders.

# Phase 2 – potential risk mitigation strategies

PTC risk mitigation strategies ABCLI could have implemented

- Develop system specs that align with ABCLI’s current PTC interpretations (not just what “old product” did)
- Develop testing tools and test plans that reflect input from tax compliance area, making sure appropriate level of tax focus is applied
- Perform regression testing with appropriate focus on PTC for existing products to make sure implementation does not “break” anything
- Implement testing plan across systems to make sure results are consistent between all systems
- Document procedures and train staff to:
  - Recognize potential issues related to product or PTC
  - Escalate potential issues following documented procedures
  - Understand MEC disclosures, Internal Revenue Code Section 1035 payments, reinsurance treaties, etc.

# Phase 3 In-force management



# Phase 3 – overview

The Best VUL and the Best WL have been developed and implemented, contracts have been issued and they are now in force. The PTC risk for these in-force contracts is influenced by a combination of the shortcomings in PTC oversight discussed previously, and the following items:

1. Market forces
2. Policyholder actions
3. Ongoing administration

# Market forces

ABCCLI is dealing with the following market forces that are affecting its in-force business:

- Low interest rates
- COI charges higher due to lower account values than anticipated:
  - If COI rate increase needed, would accelerate problem
- Non-guaranteed elements reviews
- Insureds living past 100
- Changes in loan rates and their impact on “overloan rider”

# Policyholder actions

The following policyholder actions have affected ABCLI's in-force management:

- Agent management of policies – requested changes in death benefits and withdrawal strategies
- Premiums paid via loan or other than illustrated
- Other policy change requests (e.g., risk class changes, add or drop rider)
- Lapse (and subsequent reinstatement) due to insufficient cash value or missed premium payments

Many of these can cause tax issues for the policy owner (or company).

# Policy administration

The following issues related to the administration of ABCLI's policies have led to increased PTC risk:

- Inadequate documentation of in-force procedures
- Reliance on manual intervention for day two items
- Lack of training for administrative personnel to handle requests from policyholders and agents
- Availability of system “overrides,” lack of oversight
- Legacy system shortcomings
- Administration system conversions

# Poll

Which of the following areas have led to challenging PTC-related issues for your in-force business? (Check all that apply.)

1. Complicated product design
2. Contract or prospectus issues
3. System implementation or conversion
4. Inadequate system testing
5. Legacy system issues
6. Administration system overrides
7. Lack of documented procedures
8. Reliance on manual intervention
9. Staff training
10. Other

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**Poll: Which of the following areas have led to challenging PTC-related issues for your in-force business? (Check all that apply.)**

# Potential exposure and costs of noncompliance

ABCLI's lack of attention to PTC throughout the product life cycle has led to substantial PTC risk exposure and remediation costs, including:

- Unanticipated system costs to:
  - Fix errors due to underestimating the effort to implement complicated product features
  - Correct the inadvertent impact on existing product during implementation of Best VUL and Best WL
  - Implement automated solutions for day two items previously handled using manual procedures
- Policyholder lawsuits due to lack of adequate disclosures regarding the tax status of contracts and tax liability from certain distributions from contracts
- Remediation of failed life insurance contracts and inadvertent MECs, including:
  - Toll charges payable to the Internal Revenue Service for remediation of noncompliant contracts
  - Costs of additional benefits provided to affected policyholders to bring contracts into compliance

# Conclusions

- Clearly there are many issues that organizations deal with related to PTC for their in-force contracts. We have discussed many of them in our case study, as well as some potential risk mitigation strategies.
- One way to avoid or mitigate many of the issues that ABCLI is dealing with is to set up an overall PTC governance program. Consider that:
  - A PTC team assumes the overall responsibility for assessing the PTC risk and making recommendations for mitigation of PTC risks across all phases of a product life cycle.
  - This will require a top-down mandate from leadership and buy-in from the functional areas of the company (e.g., product development and new business) to agree to work with the PTC team.

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