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RETIREMENT PLANS

(INDIVIDUAL AND GROUP)

Keogh Act—Treasury Regulations

What is the present stage of development of the regulations? What are the most important points which are still under discussion between Treasury officials and interested business and professional groups? What are the most likely solutions for presently unresolved questions?

MR. ALBERT PIKE, JR.: When the impending Treasury regulations under the Keogh Act were put on this program, it was anticipated that at least some of the tentative regulations would have appeared by now. This has not proved to be the case, and, even when the regulations appear, they will probably be only the first of two or more instalments. Furthermore, after all the instalments eventually appear this year, not all the matters of importance to the life insurance business are expected to be dealt with. The Treasury Department does not customarily put all its tax-law interpretations into formula regulations but instead leaves a number of matters to individual rulings of various subordinate grades of importance and generality.

From the taxpayer's point of view, this delay does not really matter, because, if he starts his program by the end of this year, the tax effect will be virtually the same as if he were to act now. However, from the point of view of life insurance companies, there are business reasons why it may be desirable to move ahead immediately with sales plans. Competition is the most obvious of these reasons. To move ahead at once is not so dangerous as it might at first appear, provided conservative decisions are made as to how the various provisions of the act will probably be interpreted. But, if unconservative decisions are made, there may be serious embarrassment with customers later on when it becomes clear that the wrong advice was given.

The Life Insurance Association and the American Life Convention have committees which are studying the various problems involved for life insurance and annuity media, and some of their conclusions have been sent by bulletin to member companies. Some of the most important unresolved issues are:

1. *Use of existing life insurance policies.*—At the October Quebec meeting of the Society, I called attention to several roadblocks to the use of existing life insurance policies to fund new pension plans benefiting the self-employed. At that time I said that even if a way could be found around these difficulties, mostly legal ones, there would still be a question

as to whether the use of outstanding policies will be found practical. About the only reason for going ahead under such circumstances is the desire to minimize policy replacements.

Unfortunately, the prospects are that this very important question of the permissible use of outstanding policies will be one of the last to be answered, certainly not in the immediately forthcoming regulations. Meanwhile, the problem involved is this. If the whole of an outstanding policy with substantial cash values is put into a pension plan for an owner-employee, how do you conform to the limit of 10 per cent of earned income, or $2,500 if greater, for contributions by an owner-employee for any one year? How, also, do you avoid the "prohibited transactions" provisions of Section 503(j), which say that an owner-employee may not even sell property to a trust which benefits him, much less buy property from the trust?

Various suggestions have been made to get around these difficulties, all of which seem to involve the idea of splitting the values of an outstanding policy into a part attributed to premiums already paid and a part attributed to premiums yet to be paid. One way suggested is to transfer the outstanding policy to a Keogh Act trustee under two guises—one to the trustee in his capacity as agent for the policyholder with respect to values which have accumulated up to the point of transfer (which presumably would mean the values which would thereafter obtain if a paid-up nonforfeiture option were elected) and the other with respect to the trustee with his trustee hat on with respect to the balance of policy values.

Unless some plan such as this is worked out, not only will there be a question as to whether the "prohibited transactions" section of the law is violated by using outstanding policies, but there will also be a question as to whether Section 805(d) of the Life Insurance Company Income Tax Act is still applicable, since that section speaks only of reserves on policies under pension plans and trusts in being at the time the contracts were entered into. And to go one step further, unless some such split as this is made of values of outstanding policies, there may be fundamental objections on the part of the Treasury Department to the commingling of life insurance policy values which are subject to Keogh Act tax treatment with policy values which are not subject to such tax treatment.

2. *Application of the usual nondiscrimination rules.*—As you know, the Keogh law provides that pension plans benefiting the self-employed must be subject to the same general nondiscrimination rules as are now applicable to corporate pension plans, plus certain additional requirements. This poses several problems, particularly two.

One of these is how to apply antidiscrimination rules between owner-employees and regular employees when the proposed pension plan for regular employees is of the unit-purchase type. If the maximum pension is being purchased for an owner-employee, his benefit will obviously be of the money-purchase type, since the statutory limitations are on what is paid for his pension, not on how much pension is bought for him. How, then, do you combine this money-purchase principle for the owner with a unit-purchase principle, if you want to use one, for regular employees and still observe the nondiscrimination principle? A possible solution, if the Treasury ultimately agrees, is first to apply the unit-purchase nondiscrimination principles between individual regular employees according to the usual rules for unit purchases and then to test the total cost of their pensions for discrimination against the cost of the pensions for owner-employees.

A somewhat less important phase of this discrimination problem concerns eligibility. If the owner-employee is himself in business for less than three years, can he deny coverage to his stenographer on the grounds that she has been with him for only the same, less than three years, time?

3. *"Incidental" life insurance benefits.*—Two principal questions arise. First, can "incidental" life insurance benefits be included as supplements to annuity contracts, which are probably not subject to the same trustee or custodian requirements as are life insurance policies used to fund qualified pension plans, or must the outward form of a life insurance contract be used even though it is actuarially mostly an annuity. No one yet knows, but the probable answer is "No."

Second, if "incidental" life insurance benefits are included up to the present guide-line limits of one hundred times the monthly pension, are these limits exceeded if the so-called side funds, designed primarily to convert whole life or nearly whole life policies to maturing endowments, provide extra benefits on death because of required vesting?

4. *Mimeograph 5717.*—This tax ruling provides different, and more stringent, nondiscrimination rules with respect to pension plans which are wound up within ten years of their start than for pension plans as they are initiated. The rationale of these extra requirements seems not to hold when pensions are all vested, as the Keogh Act requires, except possibly when unfunded past service benefits are involved. Nevertheless, it would be the better part of wisdom to assume the applicability of this tax ruling to Keogh Act situations until it is clear that this is not required. If the opposite is assumed, it may be that some embarrassing company-customer confrontations will ensue if and when positive holdings to the contrary are made by tax officials.

5. *Definition of "earned income."*—What an owner-employee, and for that matter other specially defined employees, can contribute depends upon his "earned income." When investment capital is deemed to be a "material income-producing factor," special limitations apply as to how much of the total Income is for personal services.

There are tax rulings outstanding which say that the office equipment of physicians, dentists, and attorneys is not "material income-producing factors," so that the limitations on what may be placed in an H.R. 10 pension plan can be equated without reduction to the individual's total income from his business or profession. However, in other cases, notably that of farmers, the opposite must be true. Therefore, companies moving ahead in the field of providing coverage for self-employed persons must take this complication into account. They would probably be well advised to await the actual regulations before giving advice which they might have to retract on what constitutes "earned income."

6. *Nontransferability of annuities.*—The Keogh law provides that annuities used to fund pension plans, including presently outstanding group annuities for corporate pension plans, must be nontransferable. Somewhere along the line we must learn what this means. Does it mean that loan and surrender values are prohibited, or only that transfers to third-party owners are prohibited? We do not know, but the answer to this question is obviously important.

An associated question is whether the exercise of a premium loan privilege in a life insurance policy qualified under a Keogh Act pension plan, without a cash outlay, constitutes a distribution subject to tax penalties.

These are a few of the issues, and a few of the problems. I wish all the regulations were out so that we would know at least some of the answers. But they are not out, and probably will not be in their entirety for some time, so in the meantime life insurance company tax lawyers will have to do the best they can in interpreting the Keogh Act on their own, and life insurance company officials will have to decide how far they can go now, without being absolutely sure of many important points.

MR. HARRY WALKER: Stuart McCarthy, of my company, a member of the task force working with the LIAA on H.R. 10, approached me and said that actuaries of companies represented on the task force were being asked to suggest a formula to be incorporated in the regulations that would substitute an equivalent level premium charge for the one-year term costs now prescribed. Varying insurance costs are highly undesirable under H.R. 10 because of the provision in the law that, as long as the first year's premium under the annuity contract complies with the maximum

contribution requirement based on the earnings of the three prior years, that premium may continue to be paid without violating the maximum contribution limit.

I have suggested an alternative formula that the LIAA task force may wish to recommend to the Treasury Department. The formula is quite similar to that adopted in Canada in connection with the regulations dealing with registered retirement savings plans there. Briefly, in the case of a straight endowment form you proceed as follows:

1. Compute the net level annual premium required to provide (*a*) the death benefits under the policy to the earlier of the maturity date or the policy anniversary nearest the insured's seventieth birthday, plus (*b*) the cash value of the policy at the earlier of the maturity date or the policy anniversary nearest the insured's seventieth birthday. This computation shall be based on "Table 38, U.S. Life Tables and Actuarial Tables, and $2\frac{1}{2}\%$ Interest."

2. Compute the net level annual premium at $2\frac{1}{2}\%$ interest for a sinking fund which will accumulate to the cash value of the policy at the earlier of the maturity date or the policy anniversary nearest the insured's seventieth birthday.

3. The portion of the premium allocable each year to the insurance protection element of the policy may be taken as the excess of (1) over (2) above.

In the case of the Retirement Endowment Form you go through the same procedure, using, however, as the maturity date the first duration at which the cash value exceeds the face amount. The insurance protection element so calculated would then be commuted and redistributed over the premium-paying period from issue to the earlier of the maturity date or the policy anniversary nearest the insured's seventieth birthday.

Now whether this method would be acceptable to the Treasury is somewhat doubtful because it will by and large result in a lower tax take for the government in the early policy years, offset by a higher tax in the later policy years. I had a computation made comparing the first-year insurance cost under the present regulations with that brought out by this proposal, using the Equitable Retirement Endowment Form. At age 25, under the proposed method, the level insurance cost would be $1.72. The present regulation provides for $1.90. At age 45, the level cost would be $3.54, compared with $5.99. At age 55, under the current regulations the first-year insurance cost would be $12.02; the cost reduces each year thereafter, being $5.27 in the fifth year and zero in the tenth year. These would be leveled off at $5.20 under the proposed method.

Keogh Act—Development of Pension Business

A. Contracts and Forms. What plans of insurance and annuities will be appropriate for use under Keogh Act plans? Are any special new policies, individual or group, being designed? Have special policy provisions or riders been developed for use with existing policy forms? Has progress been made in the development of short-form trust agreements and plan documents?
B. Sales and Underwriting. What volume of new insurance and annuity business has developed as a result of the new legislation? What problems have arisen? Are there likely to be any serious problems of replacement of existing business? What has been the Canadian experience under similar legislation during the past five years?
C. Banks, Trust Companies, etc. What arrangements are banks, trust companies, and investment companies planning to make available for the funding of Keogh Act plans? What has been the scope of activity of consulting actuaries in the development of self-administered or noninsured Keogh Act plans? Do significant opportunities exist for co-operation between insurance companies and bank trust departments in the development of pension arrangements for either individuals or groups of professionals?

MR. JOHN F. RYAN: On December 31, 1962, New York Life introduced a program for self-employed individuals' retirement plans. In general, the program involves the use of the same policies as are available for pension trust business: (1) retirement income and retirement annuity policies for fully insured plans; (2) whole life policies with a pension option for combination or split-funded plans and profit-sharing plans; and (3) retirement annuity policies for direct purchase on a nontransferable basis. Some sort of trust agreement or pension plan document is required in all situations.

Our initial program concentrates on the plans involving a trust agreement or the nontransferable annuity approach rather than the custodial account approach. Frankly, we do not see how a bank custodial account arrangement would be any easier to set up and handle than a plan involving a trust agreement or the direct purchase of nontransferable annuities.

We feel that our field force would be reluctant to get involved in dealings with banks under a custodial arrangement unless substantial cost savings or conveniences are possible. In addition, the custodial account approach is new, and thus far there is very little precise information available as to how it will work. So we have proceeded slowly and have not prepared any specimen custodial agreement forms.

If the custodial account approach is wanted, we have told our field force that a copy of the custodial account agreement and any separate plan document must be submitted to the home office before any applications may be taken.

With all the uncertainties surrounding the Keogh Act, we have not attempted to develop new policies especially designed for Keogh business. We did develop for general use new annual premium and single premium retirement annuity policies which contain an "accumulative option" permitting the owner to purchase additional single premium annuities after issue. The basis for such supplementary annuities purchased during the first five policy years is guaranteed in the policy. This kind of flexibility with respect to premiums is particularly suitable under Keogh because the contributions and tax deductions permitted vary directly with the self-employed person's income.

We have prepared several special riders or endorsements for use with regular policy forms on Keogh business. First, we have prepared an endorsement for use with retirement annuity policies which would make them "nontransferable." This is a simple policy endorsement stating that the policy is "nontransferable" in accordance with the law. We have developed an appropriate plan document, spelling out the terms of the retirement plan, restrictions regarding owner-employees, etc.

We also developed pension options for use with combination, or split-funded, plans and profit-sharing plans where less than five lives are involved. These follow our usual pension option riders but call for higher charges for the exercise of the option at retirement. Our usual pension option charges of 103 per cent of the lump sum required for the first $10 of monthly income per thousand, and 105 per cent of the payment required for monthly income in excess of $10 were not sufficient to cover the anti-selection involved in small cases. The charges for the pension option in the rider used where less than five lives are involved are 105 per cent and 107 per cent instead of 103 per cent and 105 per cent.

The usual practice in setting up split-funded and profit-sharing plans is to use a whole life policy with a pension option under which only a small part of the desired monthly income is provided by the guaranteed cash values in the policy. We felt that the professional and small businessmen who might be interested in setting up such plans under the Keogh Act might be interested in having a larger part of the monthly income guaranteed by the policy's cash value rather than relying on the side funding for the large majority of the income. So we developed a special pension option to be used with retirement income policies and which gives the policy owner the right to increase the monthly income from the guaranteed $10 per $1,000 to up to $30 per $1,000 by making an appropriate lump-sum payment. This approach has the advantage of giving the insurance company a larger share of the total contributions each year under split-funded and profit-sharing plans.

The special trust agreements we have prepared for Keogh cases are considerably shorter than our agreements for use with corporate pension trust plans. They are eight pages instead of twenty pages. But they are still quite formidable documents and probably cannot really be called "short-form" agreements. The specimen plan document for use in connection with the direct purchase of nontransferable annuities is a seven-page form and is quite similar to the specimen trust agreement.

With all the uncertainty surrounding H.R. 10 until IRS regulations are issued, new business has naturally been slow to develop. Thus far, we have received applications for about thirteen Keogh plans covering seventeen lives. Eight of these cases involving nine lives were for the direct purchase of nontransferable annuities; five cases involving eight lives were fully insured plans involving retirement income policies.

We require an initial minimum premium of $1,000 for trusteed and bank custodial cases involving less than five lives, but for nontransferable annuities we apply our usual minimum premium rules for individual annuities. This may be why the majority of our cases to date have been on the nontransferable annuity basis.

MR. CHARLES A. YARDLEY: We have seen no volume of new business develop as a result of the enactment of this legislation. Actually, one case has come in and is in the process of being put on the books. This covers a sole proprietor (doctor) and is in all respects completely regular, using a retirement income policy and the specimen retirement income trust which we prepared. This does not mean, however, that there will not be a considerable volume of new business once the regulations and requirements become clarified. We have had numerous questions from all over the country relating to association plans, groups of independent practitioners, etc. If all the inquiries which we have had should produce new business, there could be in excess of three thousand entities to be covered. For new business under the Keogh Act we have recommended that no permanent policies be purchased until after the execution of a proper trust agreement, and in the meantime we have recommended the use of temporary term insurance running to the latter part of 1963 in order to permit the parties concerned to develop a complete and orderly approach.

We, of course, have no way of knowing the extent to which existing business will be replaced. Of all the companies, the New England Life is, as far as I know, the only company which has attempted to develop forms and procedures to utilize existing insurance. The success of this approach will depend upon the decisions of the Internal Revenue Service, but at least initially they were receptive to the use of existing insurance, provid-

ed that it could be used without creating "excess contributions," even though the Internal Revenue Service did not take a similar view toward the contribution of existing securities or other types of property. Part of the submission which the ALC-LIAA Joint Legislative Committee made to the Internal Revenue Service was the form which we designed for use with previously existing insurance.

MR. ROBERT C. DOWSETT: Section 79B of the Income Tax Act of Canada became effective in April, 1957. It authorizes income-tax exemptions for certain deposits made on registered retirement savings plans on a much less restrictive basis than the Keogh Act basis. A good description of the 79B basis is given in *TSA* IX, 424–29.

Under the Canadian scheme, a self-employed person does not have to set up a pension arrangement for any of his employees before he can claim income-tax exemptions for himself. Also, 100 per cent, not just 50 per cent, of contributions to a registered retirement savings plan, up to a maximum of $2,500, or 10 per cent of earned income, can be claimed as income-tax exemptions each year by any person who is not a participant in a registered pension plan set up by his employer. For a person who is a participant in a registered pension plan, and is normally getting an income-tax exemption for his employee contributions to his pension plan, the $2,500, or 10 per cent, maximum for 79B purposes is reduced to $1,500, or 10 per cent.

Despite the attractiveness of the 79B law, it has not generated a great amount of enthusiasm among Canadians. Individual life insurance contracts have not been sold widely for registration purposes. Comments were made in the discussion of this same subject at the April, 1958, Society meeting regarding reluctance of individuals to "lock in" savings. These comments seem to have remained quite valid through the intervening five years.

In the Crown Life the number of individual life insurance policies registered in the years 1957 to 1962 inclusive was as follows:

Year	Number
1957	726
1958	367
1959	224
1960	218
1961	239
1962	252
Total	2,026

In these years the total number of individual life and annuity contracts sold by the Crown Life in Canada ranged from 14,000 per year to well over 15,000 per year. Thus approximately $1\frac{1}{2}$ per cent of new policies in recent years were registered.

Of the 2,026 policies that were registered in the six-year period, only 1,526 remained in force as registered policies on January 18, 1963. Five hundred had been de-registered in one way or another.

Administration of policies registered under Section 79B has been costly considering the relatively small numbers of policies sold for registration. Special premium receipts covering the savings portions of registered policy premiums must be sent annually to policyholders for filing with income-tax returns, and tax must be withheld on payments made from policies after de-registration. Work in the policy change area has been costly, as the normal policy conditions must be amended drastically on registration.

MR. FREDERIC P. CHAPMAN: In considering what sort of a contract would be most desirable to serve the market created by the enactment of H.R. 10, we at Metropolitan limited ourselves to annuities. We have not in the past engaged in pension-trust business and are not presently inclined to do so in the future.

We considered what features of our current retirement deferred annuity might be changed for this purpose. The most obvious need was for an annuity which would permit the purchaser to vary the purchase payments from year to year as needed. This arises, of course, from the fact that the contributions permitted by law for both employers and employees are determined at least in part by earned income which varies from time to time. We did not want to rely solely on the three-year average rule, under which the maximum payments with respect to employers are related to the average earned income during the three years preceding the issuance of the contract. While this avoids any excess payment problem under a level consideration contract, no provision would be made for increasing contributions where earned income increases. We did not like covering such increases in earned income through the issuance of small additional contracts, since this is not very satisfactory or flexible and might result in a whole series of contracts being issued, mostly of small size with their attendant higher expenses.

The other features in our retirement deferred annuity which needed modification were those relating to nontransferable and various other requirements of the law. This included making the contract nonassignable and putting certain restrictions on cash surrender, early retirement, and settlement options.

The solution we arrived at was to prepare a single contract composed basically of a series of single-premium deferred annuities. Thus the purchaser could pay in any year any amount he sees fit. If he desires, he can skip payments entirely in any year, resuming them at his own convenience. No reinstatement procedure is needed. Where a payment is made, we did put in a minimum and a maximum, although the latter is rather flexible. Each payment purchases an annuity on the basis of guaranteed rates shown in the contract.

While the contract may be written at any time during a taxable year, future additional purchase payment dates would generally be one month before the end of the taxable year. For most people on a calendar taxable year, the additional purchase payment date would therefore be December 1. This date corresponds to the contract anniversary in the usual type of deferred annuity contract and is used to determine the contract age, annuity rates, retirement dates, etc.

Annuities purchased in the first year directly reflect the additional first-year expenses expected. Annuities purchased in all years reflect a discount for size determined on a policy fee principle.

The contract provides only for annual purchase payments. We are now considering the possibility of developing some sort of deposit account to permit the annuitant to make payments at more frequent intervals, which would be accumulated and used as a single purchase payment each year on the annual additional purchase date.

Since developing this contract, we have been considering ways and means of adding a life insurance and a disability waiver benefit. We feel we can furnish life insurance by issuing a separate uniform annual decreasing term policy for any amounts and period desired within reason. The amounts and period of term insurance may be so selected as to produce a total result very similar to a retirement income contract.

As to the disability waiver benefit, the variable purchase payment principle introduces serious complications. Our present thinking is to develop a benefit under which, if a person becomes disabled after the first five years, we would credit as paid toward the annuity the average of the last five years' purchase payments, such credit being made yearly as long as disability persists. Special measures would be taken to provide an adequate benefit for disability occurring during the first five years. The charge for this benefit would be a single premium payment each year, with rates depending on the attained age of the annuitant and the amount of the purchase payment made in the particular year.

We feel that this annuity contract may be issued without a trust or custodial account, since the only life insurance involved is in a completely

separate contract. The employer will, of course, have to adopt a formal plan, which presumably will have to be approved by the Internal Revenue Service. Our lawyers have been working on various proposed plans, but no final form can be developed until regulations come out.

The annuity contract was filed with the various states last fall and to date has been approved (where approval is needed) in all but two states, one of which has not indicated any objection but just has not gotten to it yet. This contract has not as yet been put on the market, and we do not expect to do so at least until we receive preliminary IRS regulations.

MR. PETER M. TOMPA: We, at Guardian Life, use our pension-trust series individual policies for Keogh Act type business. So far all business issued is of the income endowment type. The more flexible "Life with Auxiliary Fund" type has to await suitable arrangements with banks, of which we may hear more in one of the later sections.

Whether it is possible to avoid the need for a bank trustee by accepting the auxiliary fund ourselves (similar to what many companies do in connection with conventional pension trust cases), possibly by means of a rider to be attached to the policy, is still unresolved. So far we have not succeeded in drafting a rider which is acceptable to the New York Insurance Department.

We started to publicize the sales opportunities under the Keogh Act before the ink had dried on the release of the conference version which resulted in the act. Consequently, our sales force started selling such plans almost immediately after October 1 of last year, based on the income endowment type of pension trust policies. To date, we have sold forty-three policies for a total amount of $915,130 and one annuity contract. We expect a large increase as soon as regulations are released.

In lieu of a complete plan and trust agreement, we have each insured sign a declaration of intent, under which he declares that he plans to set up a trust and to nominate a designated person (oftentimes himself) as the trustee. We plan to ask for a complete trust agreement as soon as we hear further as to the results of the attempt of the LIAA Committee to have a standard plan and trust approved preliminarily by the Internal Revenue Service.

Among the cases sold there are four where a self-employed individual included one qualified employee each under the plan.

MR. RICHARD B. MARX: Mutual of New York made a new rider available on the first of the year—the retirement income purchase option (RIPO). It was designed particularly for use in accordance with the

provisions of the Keogh Act and on each policy anniversary permits a single premium purchase of additional deferred retirement income.

The rider is available for issue with our retirement endowment and retirement annuity policies—the policies which we believe are most appropriate for use under the Keogh Act. This does not mean that we have ruled out the appropriateness of a whole life policy issued with the RIPO rider or some rider which allows a conversion at maturity to a retirement annuity. Rather, we have chosen initially to avoid the additional complexities inherent in such an approach to qualifying policies under the Keogh Act.

The insured can vary the amount of income purchased under the rider on each anniversary and can thus vary his contributions as his earnings fluctuate from one year to another. The mortality and interest bases for the income are the same as those underlying our current settlement option guarantees, except that a 2 per cent loading has been added to account for further mortality improvement. Prior to the commencement of the income an interest-only accumulation is assumed. There is a small annual premium charge for the rider during the period prior to the commencement of the income.

We have also drafted a custodial annuity plan and are negotiating with several national banks to serve as custodian under the plan. Our efforts along these lines are designed, of course, to facilitate the sale of our Keogh products. Two areas where we feel the custodian can perform useful functions for us are in fulfilling Treasury Department reporting requirements and in affording the policyholder the maximum flexibility with respect to payment of contributions in accordance with the plan. Mutual of New York will be a party to the plan, agreeing to act as insurer, to deliver contracts to the custodian, and to classify such contracts for dividend purposes as Keogh Act contracts.

The plan is adaptable for use by a single proprietor without any employees, by a partnership, or by an establishment with employees. The plan has been informally reviewed by the Treasury Task Force charged with the responsibility of drafting Keogh regulations; their reaction was most favorable. A submission to the local district office of Internal Revenue requesting a favorable determination letter has, in fact, been made by a taxpayer who adopted the plan. However, the Treasury's temporary moratorium has, up to now, delayed an official determination.

As expected, new business consisting of policies intended to qualify under the Keogh Act has thus far been quite limited. Self-employed individuals in the United States have been cautioned from many quarters that perhaps the best course of action is to wait until the Treasury regulations

have been promulgated before they decide on any purchase of a vehicle to qualify as a Keogh Act retirement plan. The full tax deduction for the year 1963 can be obtained as long as contributions are made prior to the end of that year. Incidentally, our in-force records indicate that we have fewer than fifty existing policies qualified as Canadian registered retirement savings plans.

Policy forms approval problems in connection with our new rider were virtually nonexistent. The rider was filed almost three years ago and, once approved, was put on the shelf to await the enactment of the Keogh Act.

We have provided our sales force with an H.R.-10 training manual. Of course, selling policies for qualification under the Keogh Act involves the agent in the intracacies of selling pension trusts, and it may be difficult for those not acquainted with this area to merchandise Keogh Act policies without a certain amount of advance preparation.

MR. JEAN M. LINDBERG: As many of you know, H.R. 10 provides for several methods of funding. The ingredients are life insurance policies, annuity contracts, mutual funds, investments, and so forth, and a number of these require the services of a bank. For example, if the owner-employee wishes to use general investments or securities, a trust must be employed and the trustee must be a bank. On the other hand, if he wishes to pay premiums on endowment or life insurance contracts, the trustee need not be a bank.

A custodial account with a bank as custodian must be used in the event one wishes solely to invest in mutual funds; and a custodial account can also be used for holding annuity, life insurance, or other forms of insurance contracts.

Now the banks generally throughout the country have ranged from cold or lukewarm to passive to aggressive in their approach to H.R. 10. Chase Manhattan has taken the attitude of aggressiveness, partly motivated by the fact that the act required the services of banks, and we therefore felt it a responsibility of the banking profession to provide this service. I think with this in mind a number of others that may have been a little bit passive will be coming along.

In our opinion the trust is the most flexible vehicle for any of the methods of financing. One can use any or all of the permitted forms of investment in any combination and the combination can be altered from time to time. Contributions need not be made on a set date and the method of distribution can be changed as conditions change. Also, the situs of the trust can be changed.

A bank such as ours offers facilities to the trustee to pay premiums on

insurance or annuity contracts, to make investments on our own full discretion or at the direction of the participating employer, using securities, mutual funds or, perhaps, pooled funds that we would set up for this purpose.

Since relatively small amounts are involved, we feel that the most economical method under the investment approach is to use pooled funds and to do our bookkeeping mechanically. Otherwise we do not see how we could have an economical fee basis. If the individual wishes to go into directing investments or have his own investment program, even at our discretion, a higher fee schedule would be applicable.

We have worked out some specimen forms for the individual alone and for the individual with employees but have limited their availability to owner-employees who are interested in this as prospective clients of the bank, and we actually have given them only to their attorneys for a reason which I will come to later.

We have been selected as the central bank for some custodial account arrangements using insurance and annuity policies. As well as being economical it is also very useful to the home office as a sales tool, since its representatives then have in effect a specimen form already prepared, a bank that will accept this form, and a schedule of fees that can be discussed. Notwithstanding this, any agent or prospective client of the agent may use the facilities of a local bank if this particular document is acceptable to them.

Some insurance companies have as part of their marketing program a split-funding arrangement whereby there will be a set premium for a life insurance policy or an annuity contract and a money purchase side fund where a portion of the total available would go into investments. It is the portion going into the side fund that would be flexible and vary with income.

I can tell you that a number of the mutual funds have also been looking at this field, and they, too, are attempting to work out central custodial arrangements. In many instances they go to the bank that is the transfer agent for the mutual fund in order to economize on fees by having the bank, as part of its transfer duties, do some of the record-keeping that a custodian or a trustee would otherwise do.

We have had a number of actuaries and consultants talk with us and we find that their inquiries arise in two ways. Friends or attorneys who have worked with them on cases and know that they are knowledgeable in the pension field want to know how to go about qualifying for H.R. 10 or what they think of certain aspects of the law. More commonly, however, my inquiries come from actuarial firms that have been retained by

associations to advise them generally regarding the best approach to take; and specifically regarding the various proposals that so many of these associations are receiving.

Under a money-purchase approach, the technical ability of the actuary will not be used to any great extent, but if the regulations permit a unit benefit type of program, or one using both unit benefit and money purchase, there should be considerable work for actuaries.

We have made our fees modest, not only because they must be in relation to contributions, but also to avoid pricing ourselves out of the market. We hold life insurance contracts at an annual figure of $6.00 or $9.00 a person, depending upon whether we receive the premium or whether the premium goes directly to the insurance company.

The problems that we have encountered in our marketing approach arise from the lack of regulations, the danger of unauthorized practice of law, and the attitude of the SEC toward pooled funds. As I mentioned earlier, we have specimen forms and to avoid any question of unauthorized practice of law we have been careful to limit distribution of this material to the attorney of an interested client. The problem with the SEC comes about because this agency has taken the position that any advertising of a pooled fund is tantamount to making a public offering. Negotiations are taking place, and it is hoped that a satisfactory solution will be found.

Separate Accounts—Investment Year Method

A. Separate Accounts. What problems arise in writing separate account group annuity contracts with respect to:
   1. Investment,
   2. Insurance department filings,
   3. SEC regulation,
   4. Annual Statement accounting,
   5. Federal income tax?

B. Investment Year Method. What practical problems have been encountered by companies which are applying the method? Are companies which are offering separate accounts also using the investment year method of allocation of investment income for the general account?

MR. JAMES A. ATTWOOD: In regard to item 1, there appear to be many interesting and challenging investment problems with respect to separate accounts. Some of them are:

1. To what extent should investment officers participate in the sale and servicing of separate account contracts?
2. To what extent should policyholders be allowed, or even encouraged, to participate in investment decisions? (These may range from the decision on how a given contribution should be split between the company's conventional account and one or more separate accounts to the decision on investment policy or selection of the investment portfolio of a certain separate account.)
3. What type of separate accounts should be established? Should the emphasis be on pooled accounts or individual employer accounts? Where pooled accounts are used, should these be set up on a diversified or a specialized basis?
4. To what extent should a company be willing to advise or recommend the use of separate accounts (say, those involving common-stock investments) in contrast to use of the conventional investment account?

Without answering these questions specifically, it does appear in general that the investment officers of our companies must become more involved in the product development, sales, and administrative phases of the group annuity business. Similarly, those of us in the group annuity business must become involved in the area of flexible and variable investment policies and practice.

With respect to item 2, insurance department filings, I should like to report the results of a survey made recently as to the general status of separate account filings in various states by several life insurance companies. Of the companies studied, filings of one or more separate account contracts have been made in thirty-six states. The general results break down as follows:

Approved contracts	21 states
Disapproved contracts	3 states
Delayed action	4 states
Unclear situation	8 states

Several of the large and populous states, such as Illinois, Ohio, Pennsylvania, Michigan, Texas and New Jersey, fall into one of the latter three categories. In certain of these and other states, legislation has been introduced or will be introduced this year. The situation is far from crystallized throughout the country, and it may take a year or more before separate accounts can be written on a widespread basis throughout the United States.

With respect to item 3, SEC regulations, it can be reported that in January of this year the Securities and Exchange Commission issued Rule 3C-3, which exempts certain separate account contracts from regulations under the Investment Company Act of 1940. The scope of this rule closely parallels the New York separate-accounts statute but contains no criteria for investment of separate-account funds. Throughout their discussions with the SEC, the insurance companies asserted their belief that group annuity contracts involving separate accounts were not, as a matter of law, subject to the Federal Securities law. Nevertheless, while reserving this legal position, they welcomed the Commission's exemptive rule as a constructive step in clarifying the status of these contracts and in avoiding an overlap of state and federal regulations in this field.

In regard to item 4, the annual statement accounting requirements with respect to separate accounts have not yet been finally resolved. For 1962, a special separate account blank was stipulated by the NAIC. The industry has taken issue with many aspects of this action, but chiefly has objected to the requirement that information about operations during the year be shown for *each* individual separate account and that investments for *each* such account be listed separately. In addition to the onerous and expensive procedures this will entail, this additional reporting may adversely affect the relationship between insurance companies and their clients.

Finally, in regard to item 5, changes in the Life Insurance Company Income Tax Act of 1959 enacted last year by Congress would appear to remove tax problems with respect to separate-account operations. Now, both investment income and capital gains with respect to separate accounts for qualified plans are free of tax.

MR. DANIEL F. McGINN: I would like to comment briefly on what *appear* to be investment problems.

1. *Valuation.*—Several companies have established separate classes for

common stocks, bonds, and mortgages. Establishing a common-stock class seems to involve the least problems, but bonds and mortgages seem to create real problems. In recent years most of our bond investments have been on a "private-placement" basis. Since these securities do not have established market values, it seems that the only way to establish their value is to have an accredited banking facility periodically establish their value. If the valuation of private placement bonds is a problem, it seems that the valuation of real estate mortgages is a far greater problem.

2. *Reinvestment.*—It seems that there can be very serious problems in the reinvestment of dividends, coupons, and mortgage repayments unless a substantial cash-flow situation exists. A substantial subsidy from the general account surplus for each investment class probably could eliminate reinvestment problems.

3. *Types of investment operations.*—Do companies intend to make the same type of investments as they do for the general accounts or will the philosophy of investment change somewhat? For example, the diversification in the investments for the general accounts will not be possible for separate account classes until the separate funds build up to substantial size. Lack of substantial funds to invest might lead initially to a relatively conservative investment policy.

4. *Experience of the general accounts versus separate accounts:*—If a company uses the investment year method of allocating investment income, you expect that the bond and mortgage separate-account experience may not differ substantially from the general-account experience. The real differences appear to be the federal income-tax treatment, capital gains or losses, investment expenses, and the fund withdrawal provisions of the group contract. It could be somewhat embarrassing and difficult to explain if the bond and mortgage separate-account experience were not as favorable as that of the general account.

MR. JOHN B. STEARNS: So far the Prudential has sold only one equity funding contract, and it is our intention to offer just one portfolio of assets, which we call our investment fund.

Our first problem was to establish an investment policy for running this fund. Some of the main points of the policy are as follows: First, there is an over-all statement that the composition of the portfolio shall be determined from the long-range view of a prudent investor concerned primarily with the preservation of his capital and with the growth of his capital in relation to the growth of the economy and the changing value of the dollar. The investment policy gives the management freedom to make such changes in the portfolio as are necessary, but for investment

purposes, not trading purposes. It is stated that we expect to have usually a diversified portfolio of equities, primarily common stocks. The policy gives the management freedom under appropriate circumstances to place a higher percentage of the fund in fixed-dollar investment, or up to 10 per cent in real estate, or up to 10 per cent in direct placements. No more than 5 per cent of the fund can go with any one issuer. This restriction does not apply to U.S. Governments and it applies only to 75 per cent of the assets of the fund. There is also a statement that no investment shall be made for the purpose of control, and we are not allowed to invest more than 3 per cent in one investment company. There is no investment in commodities, no borrowed monies, no loans to individuals, and no margin purchases or short sales.

In starting off our own portfolio and trying to comply with this policy we had some difficulty getting a diversified portfolio and still keeping brokerage charges within reason. However, it has worked out all right, and we have found that our investment results have followed the Standard and Poor's average very closely. Our investment policy so far has been quite conservative. We have picked the larger and more successful companies in their industries.

As to insurance department filings, we have gotten sixteen approvals and eight disapprovals with quite a few still pending. Some states disapproved on the grounds that they could not accept a variable annuity, so we had to go back and explain that this was not a variable annuity. Several states indicated that they felt that they had to have special legislation, as there was no provision in the statutes which would permit us to do this business. This was a surprise to me, as I had thought you should be able to do something unless the law said that you could not.

The Prudential applied to the SEC, claiming that it should be completely exempt from the regulatory provisions of the Investment Company Act of 1940, but this application was turned down in January of this year. How this applies to certain areas of the group business is still in doubt, and we have just recently appealed this application. This, of course, does not shut us out of the separate account business where only fixed-dollar annuities are involved.

MR. WALTER L. GRACE: The Massachusetts Mutual is planning to set up a separate investment account for use with qualified pension plans. Our procedure will be to establish a separate pooled account, and funds will be invested primarily in common stocks. We have had contract language on one specific sizable pension fund approved by the employer several months ago and are merely awaiting approval by the state insurance

department for execution of the contract. Our contract provides that up to 50 per cent of the total funds held under the contract may be allocated to the separate account and contains provisions for transfer between the separate account and the general investment account of the company.

MR. A. CHARLES HOWELL: In 1959 the John Hancock formally adopted an investment year method for allocating investment income within the group annuity line to group annuity asset shares as part of our group annuity dividend formula. Effective January 1, 1962, we adopted an investment year method for allocating investment income among lines of business within our general account. Also on January 1, 1962, we began to receive money in our separate-accounts lines in accordance with legislation enacted in Massachusetts in 1960 authorizing the establishment of separate accounts for pension plans.

In the separate account new contract holders "buy into" separate-account pooled funds at market values prevailing at the time contributions are received. Their initial participation value is thereafter adjusted at regular intervals to reflect changes in the value of the pooled fund, and investment income is distributed as a percentage of market value. In our general account, on the other hand, our investment year method essentially partitions our assets into a number of discrete investment year blocks. Dollars received in a particular investment year participate in the subsequent investment history of the block with which they are associated on a pro rata basis.

There have been a number of practical problems of an accounting nature a few of which are as follows:

A. Problems arising from differences in methods between separate accounts and the general account.
   1. Do the methods applied in the two types of accounts yield identical results? Theoretically these results could be quite different, but for practical purposes they yield essentially equivalent results.
   2. Having agreed that the two methods may yield different results, it has been necessary to justify the use of both methods rather than one or the other.

B. Problems in using the investment year method of allocating income among lines of business.
   1. In first applying the method a choice must be made between (*a*) a prospective basis, applying only with respect to future contributions; (*b*) a retrospective basis, determining the amount of income that would be allocated currently if the system had always been in effect; or (*c*) a retroactive basis, determining prior credits as though the system had always been in effect. We adopted a retrospective approach and, having made

this decision, then had to decide whether to maintain separate records for each prior investment year or whether this separation should be cut off after some period of time. Our decision was to maintain separation for a twenty-five–year period.

2. Should allocations by line be through a determination of yield rates or through a percentage share approach? These two methods yield the same result but from a practical point of view one or the other of the methods is more appealing, depending on whether you are dealing with a large or small number of allocations. We use a percentage-share approach among lines of business but a yield-rate approach for group annuity asset shares.
3. In setting up a retrospective system, it was necessary to develop extensive historical records.
4. In the development of the historical investment records a good deal of investment data was for the first time organized on a tape basis for computor processing. This required a good deal of rethinking.
5. In developing the historical investment shares for the various lines of business, problems were encountered where the method of allocating certain items or classes of reserves in the annual statement had been changed in the course of time.
6. Should investment expenses be separated by investment year and, if so, how? A separation of investment expenses by class of investment by year of acquisition for the investment may be needed.
7. Specific decisions are needed with respect to the following classes of assets:
   a) Cash—is it an asset of the most recent investment year block, transferable at the end of the year to the next block? We finally took the stand that, to the extent that the amount of cash on hand is a normal operating requirement, all investment years should hold a share of it. Cash in addition to this is treated as being associated with the most recent investment year.
   b) Short-term securities—commitment fees are a special problem.
   c) Exchange of bonds—decisions have to be made concerning the investment year with which the new and old securities will be associated in the future.
   d) The treatment of fixed and frozen assets—our practice is to treat the dollars put into a fixed or frozen asset in a particular year as a single investment at the average yield rate on the nonfixed investments. The income is then spread across our total portfolio.
   e) Allocation of federal income taxes—this is a very difficult problem.

C. Problems associated with the investment year method of allocating income within the group annuity line of business.
   1. Policyholder relationships—it is necessary to distinguish between investment year interest rates and portfolio-average rates. Graphic illustrations have been helpful. Problems may arise with policyholders whose interest rates are lower than under the average method, although this has not

been a major problem because the changes were made in a period of rising interest rates. Also, it may be necessary to develop yield rates for allocation which can be understood by the policyholder.

2. IPG contracts may require special treatment—the language must be reviewed carefully to be sure that the changes contemplated can be extended to this class of contract.
3. Relationship of investment generation methods and rates, reserves and dividends.
4. How should transfer of business from one line of business to another be treated for allocation purposes?
5. The use of the method may require a review of funding assumptions for deposit administration or IPG where dividend levels are changed markedly.
6. Reconciliation of yield rates used in the dividend formula under investment generation with rates quoted in the company's financial report.
7. Dividend calculations—particular problems arise where contracts are split off or combined.
8. Consideration of the effect of investment generation on fund transfer provisions and charges.

In conclusion, I think it is desirable in working with an investment year method to have subsidiary interest rates which will enable you to test allocation results for reasonableness. For example, information could be kept separately for each class of investment, such as bonds, mortgages, real estate, and common stock. The results for each of these should be subdivided between gross investment income, investment expenses, and net investment income. By use of these subdivisions for each investment year, a historical picture can be developed. By putting these results together in the varying proportions in which these classes of investments enter into our portfolio in different years, we can establish the reasonableness of our over-all allocation.

MR. WILLIAM H. CROSSON: To provide some background for my discussion, I shall first describe in general terms the Equitable's system for the allocation of investment results by line of business. We use a "prospective" system under which all investments made before January 1, 1962, are merged and treated as a single investment class. Investments made subsequently are maintained under separate identities depending on the year of investment. Four broad classes of investments are used.

1. The first, and by far the largest, class consists of mortgages, transportation equipment carried for investment purposes, and securities (including bonds, preferred and common stocks, but excluding short-term investments). For this class the assets and investment results are deter-

mined and maintained separately by year of investment. The assets for each investment year are allocated in proportion to the relative contribution of each line of business to the funds available for new investment in that year, and the investment results for each year of investment are allocated in proportion to such assets identified with that year of investment.

2. The second consists of policy loans, whose assets and investment results are allocated exclusively to the line of business giving rise thereto, the ordinary life insurance lines.

3. The third consists of real estate, including properties occupied by the company, real estate acquired in satisfaction of debts, and investment real estate. We do not include mortgage loans in the class of real estate. Decreases in the real estate asset account are allocated by line of business in proportion to the share of each line in the existing real estate asset account. Increases due to foreclosures are allocated in the same way as the mortgages that were foreclosed had been allocated. New investments are allocated by line in proportion to the funds available, in each line, for new investment. Investment results are allocated in proportion to amounts invested in real estate, without regard to the year of investment.

4. The last class consists of cash, bank deposits, short-term investments, and diverse miscellaneous assets not otherwise allocated. Assets for this class are allocated by line of business in proportion to all other assets of the various lines. Investment results are allocated by line in proportion to these assets.

All of the line of business allocations which I have mentioned are carried out by the application of distribution ratios, which represent the ratio of the amount of the distribution base for the line to the total distribution base for the entire company. For allocation within the group annuity line, the results to that line are translated into rates of investment income and realized capital gain or loss.

I shall now describe a few of the problems which we encountered at the Equitable, since I feel that some of these are of importance to every company in the industry. One of the problems that we encountered very early in the design of our system was the problem of allocating capital gains and losses. Quite often a capital loss is realized on an existing low-yield investment in order to obtain funds to invest at a higher yield. Also, an investment, such as in common stocks, may be made on the expectation of low current yields with the hope that increased investment return, including capital gains, will ultimately be so realized as to more than offset any current interest loss. In both of these situations it is obvious that, to maintain equity as between investment generations, the distribu-

tion of realized capital gains should be based on the year of investment.

Another problem here is how to determine capital gains and losses. The Equitable allocates by contract only the gains or losses from sales, maturities, and changes in ledger asset values. Some companies could also allocate the changes in the difference between admitted and ledger values. Another possibility is to allocate by contract the changes in the mandatory securities valuation reserve arising from capital gains and losses.

Quite often an existing investment is refinanced, frequently with some additional investment being made. Usually the interest rate on the resulting total investment represents a compromise between the existing rate on the existing investment and the rate obtainable on a comparable completely new investment. A problem arises, under current conditions, about how to handle this situation so as to avoid diluting the investment income rate on new money because of the low yield on such additional investment. It is desirable to adjust the asset and income distribution in some way in order to reflect the situation that would have occurred if the amount of additional investment, if any, had instead been invested without restriction in new investments then currently available.

In allocating investment results by contract, a company must decide whether to reflect investment repayments by a "fixed-index system" or a "declining-index system." In a fixed-index system, investment repayments and the resulting re-investments are retained under the original investment year classification, and changes in investment rates upon re-investment are reflected by adjustments in the rates at which investment results are credited to such original investment year. In a declining-index system these repayments are transferred from the original year of investment to the current year of investment, and the rates applicable to a given generation of investments should not change very much from year to year. Whatever changes occur will be due to changes, due to repayments, in the distribution of investments remaining after repayments. Under either system substantially the same results should be experienced unless separate investment generations are prematurely merged.

"Diversification" is a watchword in the design of a sound investment program. A problem that an investment-year-method company must face is how to attain the proper degree of investment diversification. It is obvious that traditional concepts of what constitutes a proper diversification of investments should be modified to some extent when a company embarks on the investment year method.

In conclusion, in comparing investment results as between different

companies using the investment year method certain comments are warranted. The following considerations must be borne in mind:

Even if the numbers shown as investment return rates and investment repayment rates should differ, these differences may result from their method of application, and a particular contract may experience essentially identical financial results under either company despite these differences. The fixed-index system will produce numbers different from the declining-index system, but the financial results should be unaffected.

There may be differences in the incidence by calendar year of capital gains and losses, due to one company's reflecting only realized gains and losses, while another also recognizes unrealized gains and losses. There may be differences in the degree of recognition of the mandatory securities valuation reserve.

There may be differences in the allocation by contract of the United States income tax. There may be a difference in the method of allocating the results on common stocks. One company may recognize the year of investment in this category, while another may disregard the investment year.

There are various possible methods of allocating the results on real estate, cash, bank deposits, and short-term investments, which will produce an effect on the rates. There are certain difficulties in the determination of the investment-income rate for investments of the current year that might result in invalid comparisons as between companies. There may be substantial differences in the quality of investments made by various companies. The higher-quality, lower-rate investments will receive no credit for such higher quality in a comparison of rates.

MR. RAYMOND A. BIERSCHBACH: The Occidental is adopting the investment generation method effective in 1963 and will be treating everything prior to this year as a closed block. We plan to employ the technique in allocating investment income to the various lines of business. We have run into a fair number of practical problems, as I am sure every other company applying the method has.

In the area of assets there are five questions. (1) Are other companies going to use book value for bonds and stocks as we are planning to do? (2) How are others handling the home-office real estate asset? At Occidental we have an additional Annual Statement line of business which receives investment income and pays some federal income tax. This is the corporate account, and it is made up of the investment earnings on capital and surplus funds. We are tentatively planning to assign the home-office real estate asset and income from it to that line. (3) In addition to the

direct assignment of the home-office real estate asset, we will be assigning the policy-loan asset to the ordinary insurance line. (4) We plan to treat short term bonds in the manner that cash is handled. (5) We plan to make an adjustment in our allocation to recognize the fact that re-investments do not occur uniformly over the year. This will be done by analyzing turnover quarterly.

There are a couple of rather thorny problems under the heading of income. Has anyone devised a method of preventing the deflation of the income rate on current years' investments that results from stock dividends being on a cash basis? This becomes a problem when a large portion of new investments is made in stocks—especially late in the year. How refined must one be in splitting incurred investment expenses in order to get incurred investment income broken by year of acquisition of assets producing the income? Our functional cost figures are not available early enough to be used in allocating the investment income at year-end and even when received, they do not now go into anything approaching a year of acquisition expense.

Concerning capital gains, about all I can do is ask questions. So far we have no answers. If realized capital gains are allocated, how is this accomplished in the statement or is it being done outside of the statement? Is any distinction made between short-term and long-term gains and losses? Is any adjustment made for the fact that at year-end capital gains or losses may be taken solely for the purpose of producing a desired result in the federal income-tax picture? Are unrealized gains and losses allocated?

Just one miscellaneous question in closing. What is being used as a control figure for the sum of all the funds of all lines? We will be using invested assets, *i.e.*, the excess of liabilities and surplus over such non-invested assets as deferred and uncollected premiums.

MR. JOHN BIGGS: Several practical problems are unique to a medium-sized insurer adopting an investment year formula. First, one of the important prerequisites to a successful formula is a satisfactory diversification of investments in each investment year period. This may be difficult to obtain for companies other than the giants. There are several possible solutions. One would be to include two, three, or more calendar years in each investment period. This is, in effect, a compromise sliding farther along the scale toward the portfolio-average method. The amount of investments needed for proper diversification would determine the number of years. Another possibility would be that of determining quotas for certain sensitive security types. A company also could use a less respon-

sive, less exact formula on some smoothed basis. All these solutions except the first make the interline allocation rather difficult.

Another problem results for companies with a small percentage of liabilities as pension reserves. Investments with tax advantages may be good for the total company but not for the pension or deposit accounts. Some adjustment should be made in the line allocation of taxes or of investment income. The best way to solve this is to find a way to segregate such investments for the nonpension, nondeposit lines.

The above point plus the fact that investment year interest rates currently are higher than portfolio rates gives a certain tax incentive to establishing separate accounts, even if a company has already adopted an investment year allocation formula. Because of the operation of the pension-deduction formula, some tax is incurred in adding blocks of assets at high interest rates—correspondingly, the total company taxes are reduced by adding pension business at rates which are lower than portfolio average. Because of this there is currently an advantage in using a separate account for which the full interest earned is deductible.

Impact on Pension Business of Other Legislation or Rulings

A. Ontario Bill 165

What would be the probable impact of the proposed compulsory "portable-pension" legislation on private pension plans, both new and existing?

B. Prefunding Post-Retirement Medical Benefits (P.L. 87-863)

How are insured and noninsured pension plans being adapted to accommodate prefunding of such benefits?

C. Disability Pensions under Rev. Ruling 62-152

Many employers have established long-term disability benefits which are not part of their qualified pension plans. Will the new ruling make it desirable to bring these benefits within the scope of the qualified plan?

MR. LAURENCE E. COWARD: Ontario bill 165 is dead but its successor, which is bill 110, probably will be enacted very shortly, and other provinces are expected to follow with similar "portable-pension" legislation. Briefly, this act will compel employers to establish and maintain pension plans up to certain minimum standards. It will also require that vested rights in the minimum and supplementary pension be granted to employees who leave their jobs.

The act, which is to be in full force on January 1, 1965, requires all employers with fifteen or more full-time employees in Ontario to provide pension benefits after January 1, 1965, for service after age 30. The mandatory pensions must be not less than one of three minimum levels, or the actuarial equivalent thereof. The three alternative "standard plans" provide single life pensions commencing at age 70 as follows: (1) A monthly pension of ½ of 1 per cent of the first $400 of monthly earnings for each year of employment; (2) A monthly pension purchased by the accumulation of the following contributions on the first $400 of earnings;

Age 30 to age 44.......	1½%
Age 45 to age 54.......	2
Age 55 and over........	3

(3) A monthly pension of $2.00 for each year of employment.

The act places on the employer the responsibility to provide the standard plan benefits but permits him to reduce his costs through requiring employee contributions. The maximum employee contribution is approximately one-half the cost.

The act requires that the standard benefits be fully vested in the employee and that, in the event of his termination of employment prior to retirement, such pension benefit cannot be forfeited. Employee contributions toward such benefits cannot be refunded in cash but must be "locked in." The benefit must be provided him through the purchase of

an annuity contract, the issuance of a contractual undertaking by the employer, the transfer of the funds to a subsequent employer's plans, or through transfer to the Central Pension Agency or to a retirement savings plan.

All pension benefits in excess of the minimum requirements are called "supplementary benefits," and must be fully vested in the employee upon his attainment of age 45 and completion of ten years of service. Once the vesting of supplementary benefits has taken place, any contributions which the employee may have been required to make (other than additional voluntary contributions) toward the cost of such benefits must be "locked in"—with the exception that the plan may permit the refunding of an amount not in excess of 25 per cent of the commuted value of such supplementary benefits. The balance of the supplementary benefits must be provided in the form of pension benefits.

The act also requires that each plan must meet requirements of solvency which will be governed by regulation. Existing plans will require a certificate on January 1, 1965, of the amount of unfunded liability. Any such liability must be funded over a period not in excess of twenty-five years. The current service cost of all benefits provided after January 1, 1965, must be paid currently. Thus pay-as-you-go and terminal funding will not be allowed.

Several thousand new pension plans will have to be established for mandatory groups. Employers who already have plans in effect may find that their plans have to be amended in some or all of the following respects: Membership provisions may need to be brought in line with the requirements of the act. Pension benefits may need to be revised, particularly in plans providing reduced benefits after age 70. Vesting provisions may need amendment both concerning the standard benefits and concerning supplementary benefits. Provisions dealing with the refund of employee contributions on termination may need revision. It is my opinion that in future years the minimum will be raised and supervision intensified. This act is the beginning, not the end.

MR. JOSEPH B. CRIMMINS: The direct answer to this question of prefunding past-retirement medical benefits—at least as far as we in the Metropolitan are concerned—is that there is apparently little interest among employers in using the pension plan as a mechanism for prepaying the cost of medical-care coverage on retired employees. This is despite the fact that we have a significant and growing volume of group business where the coverage is being continued under the group policy, and that

we find a growing interest among employers in arrangements for paying the cost during the working lifetime of the employee.

For the employer who wants to adopt a prepayment program, we have available the same type of contractual arrangement under the group policy that we have used widely to accommodate the prepayment of group life insurance costs for retired employees. This seems to us to be the more direct and suitable approach. It permits much more flexibility than would be the case if the pension-plan mechanism were used. Only one group policy is necessary, covering both active and retired employees, whereas the pension plan method would seem to require a separate policy for the retired employees. Eligibility and benefit provisions can be changed from time to time as required, without the delays involved in making a formal submission to the Internal Revenue Service each time a change is made. A very significant advantage is that under the group insurance approach the financial experience of the coverage on both active and retired employees can be considered as a single entity for rate-making and dividend purposes. At the moment it is not at all clear that this can be done under the pension plan method.

Based on these considerations, we feel that the group insurance mechanism, rather than the pension plan, will prove to be more satisfactory for prepaying the cost of medical-care benefits for retired employees.

MR. JOHN K. DYER, JR.: Revenue Ruling 62-152, released by the Internal Revenue Service last September, announces the rules under which integrated pension or annuity plans will be considered as qualified plans if they contain disability benefits, with special reference to the conditions under which such disability benefits will be considered to be properly integrated with the social security disability benefits.

In setting up the requirements for integration of normal retirement benefits, which the Internal Revenue Service first did nearly twenty years ago, the only real problem was to find a reasonable and acceptable formula which would apply in all cases, on the presumption that all employees reaching age 65 would in fact receive a social security pension. In the case of disability, however, there is not the corresponding certainty that an employee whom the employer considers eligible for disability pension will be similarly considered by the social security administrators. After thinking about this problem since disability benefits came into the social security picture in 1956, the Internal Revenue people finally came up with the idea that integration of disability benefits had to be qualitative as well as quantitative. Revenue Ruling 62-152 says that a disability benefit formula designed to supplement social security cannot be looked upon as properly integrated unless the employer's conditions for granting

a disability pension are at least as stringent as those applied under social security. Recognizing the subjectivity of disability-benefit administration, Internal Revenue advises that they will not grant advance approval of a plan involving integrated disability benefits unless it is provided that eligibility for social security disability benefits be made a condition precedent to the granting of disability benefits under the plan. We are already encountering cases where approval of plan changes unrelated to disability is being withheld by Internal Revenue agents until the requirements of Revenue Ruling 62-152 are also met.

Enforcement of the principle of qualitative integration in relation to disability benefits is in effect a requirement that the employer's objectives in providing disability pensions for his employees be closely identified with those of social security in providing similar benefits. This forces an unnatural and often impractical approach to the design of disability provisions in a private retirement plan. The employer's objective should be and generally is to facilitate the orderly retirement of employees who have become prematurely superannuated according to standards closely related to the nature of the employer's business and of the employee's responsibilities. Such an objective cannot adequately be fulfilled if disability retirement is permitted only in the presence of "inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or be of long continued and indefinite duration," to use the exact words of the Social Security Act.

The wide differences between employer and social security claim administration can be seen clearly by reviewing some of the court decisions that have been handed down in connection with claims for social security disability benefits. It seems obvious that most employers will find it difficult to live with a disability retirement plan which enforces as strict a definition of disability as the social security law requires. I have no criticism of the strictness of the social security administration; on the contrary, they have, as Congress insisted when the disability benefits were added, been effectively conserving the tax payer's money by limiting the payment of these benefits to those people whose disabilities have for all practical purposes deprived them of all earning power. Inability to continue as an effective employee, or risk of damage that might be involved in an employee's continuing activity, would have no place in a publicly supported system.

Thus the employer with a qualified plan including integrated disability benefits is faced with a dilemma. This could be resolved in a number of ways, none of which is really a satisfactory arrangement: (*a*) He could

eliminate the integration of disability benefits, modifying this part of the formula so that benefits are paid without regard to social security. This, of course, in many cases would result in the extravagance of duplication of benefits. Also it would run into conflict with an integrated formula for regular pensions, if it results in disabled employees receiving more liberal treatment than those who work through to regular retirement age. (*b*) He could provide that social security disability benefits will operate as a direct offset against a total disability pension defined under the plan. However, Revenue Ruling 62-152 does not permit a full offset; by some obscure actuarial arithmetic it concludes that the maximum offset permissible should be 64 per cent of the social security disability benefit actually received. Thus there will still be some duplication, and in any event many employers have found that offset-type plans are unsatisfactory from the administrative and the employee-relations standpoint. (*c*) He could drop the disability benefits completely from the approved plan, either providing such benefits under a separate unfunded arrangement, or perhaps eliminating any commitments to provide for prematurely disabled employees.

The last solution may well be the one to which many employers will be forced. There are certain advantages, in terms of control and flexibility, of disability benefits provided outside of the terms of a formal funded plan. It appears that in Revenue Ruling 62-152 the Internal Revenue Service has added another important advantage to separate unfunded disability plans.

It is interesting to speculate upon the possible reactions in case a number of prominent employers should eliminate the disability benefits from their approved plans, explaining to employees that it is no longer feasible to guarantee such benefits, because of a ruling of the Internal Revenue Service which requires that the employer be more strict in the interpretation of what constitutes qualifying disability than the employer would wish to be.