RECORD OF SOCIETY OF ACTUARIES
1976 VOL. 2 NO. 4

INDIVIDUAL RETIREMENT ACCOUNTS

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1. Products and Marketing

2. Taxation

3. Reporting and Disclosure

4. Roll-overs

MR. HAROLD G. INGRAHAM, JR.: What has been the sales mix by type of product? What has been the lapse or "not-taken" rate of IRA business? Has policy persistency been adversely affected by Form 5498 disclosure?

MR. G. THOMAS MITCHELL: I think the sales mix depends very heavily on the products and marketing of each company. In 1975, the sales mix ran anywhere from 50 to 1 in favor of annuities up to 2 to 1 in favor of insurance with the Met and the Pru. In my own company in 1975, we sold about 60% on an endowment form and 40% annuities but in 1976, it is almost exactly reversed, that is, 41% to 59% in favor of insurance. We have taken a look at the persistency of this business to date and obviously the exposure period and the numbers involved are not too great. Our first 18 months in the business has found us losing 13% of our insurance IRA's. We're estimating based on the kind of mode and how many months the business has been in force that we will have a 16% 13 month lapse rate. The annuities are quite another story because we presently have 98% of what we have written still on the books. We're looking forward to about a 95% 13 month retention rate on that. I think the cash values shown on the Form 5498's have caused some problems, especially in the insurance area with the persistency. With the numbers we are seeing so far it obviously hasn't caused too much problem.

MR. BRUCE E. NICKERSON: I was talking with a couple of companies the other day. One of them, if I understood them correctly indicated that they thought they had done a particularly careful job on disclosure which had impacted their "not-taken" rate. Consequently, the 5498 didn't seem to shock people very much.

MR. INGRAHAM: The IRA product mix at New England Life for the first six months of 1976 was as follows: 66% of our sales were flexible retirement annuities (a fixed dollar annuity), 18% were retirement income contracts, 11% were variable annuities, and 5% were mutual funds. About 30% of the retirement incomes were sold to lives under age 30, and 50% to lives under age 35. 54% of the retirement incomes were issued with waiver coverage, but only 20% in the case of fixed and variable annuities.

MR. CHRISTOPHER H. WAIN: As a supplement to Mr. Ingraham's comment, the evidence from our own experience is that the markets being served by annuities and insurance are completely different. 90% of our issues over age 50 are on an annuity form. It's almost a complete reversal under age 30.

MR. INGRAHAM: How have companies coped with bank competition? What competitive advantages do insurance company IRA products have over bank sponsored products?

MR. WAIN: First of all, we're providing service. We are fitting the person's needs against his available income to find the best way to do the job right to take care of both retirement and the immediate needs of the family. We are selling products. They are similar to those sold every day in the market place on a nonqualified basis. They are necessarily better products than the ones that are not available on an IRA basis. For instance, our income endowments throw out a yield to maturity about 1% higher for a number of reasons than the nonqualified income endowments. So that if there is something wrong with the endowments as a tool, it is really something wrong with the industry and should be looked at in terms of that total framework and not just in the IRA market. Now we are fitting needs. We are providing benefits which are not available from the banks such as waiver benefits and the life insurance benefits. We are also furnishing through these products participation in the long-term investment portfolios of the insurer. I believe it is a fair statement that the insurance companies by virtue of being long-term investors are able to produce both somewhat more stable yields and on the whole somewhat higher gross yields than the banks do. It is in essence the marketing and the traditional advantages of our long-term operations in the face of competition from predominantly short-term operations.

MR. INGRAHAM: Should a prospect who works for a 501(c)(3) organization be advised to purchase an IRA contract or a tax sheltered annuity?

MR. MITCHELL: It depends on the particular circumstances. But I think the Law weighs generally very heavily in favor of the tax sheltered annuity because: 1. it would generally produce a greater amount of possible contribution, 2. if the employer (or the employee for that matter) gets involved in any other qualified plan that is not a tax deferred annuity, the TSA is not poisoned by that but the amount contributable may be reduced. In such a case the IRA is lost entirely. Also, the taxation is better because there is not a 10% penalty. All that I have to say in favor of the IRA in that situation is that there is no employer participation required. Obviously, you do not have to go through a salary reduction and the payroll mechanics associated with it. This gives the participant the opportunity to have additional responsibility in terms of the timing and the amount of the contribution.

MR. INGRAHAM: Another argument in favor of the tax sheltered annuity route would be the treatment of past service where under a TSA you can take advantage of past service with the same employer to obtain a much greater deductible contribution than is possible under an IRA. In addition, an eligible individual can participate in a TSA and also participate in any other type of retirement program provided by the employer (i.e., the school teacher covered under a state's teacher retirement system).

MR. NICKERSON: Also, the school teacher who earns a little bit of money consulting on the side could establish his own HR10.

MR. INGRAHAM: The next question is for me. What is the market potential of employer-sponsored IRA's? Are group annuities being sold here? In order for a group annuity to properly qualify as a funding vehicle, what conditions must be met?

MR. INGRAHAM: First of all, it is probably well to review the Labor Department release in 1975 which exempted employer IRA plans from reporting requirements providing certain conditions are met. The contributions had to result from a salary deduction agreement between the employer and employee and no employer contributions could be made. Participation had to be completely voluntary. The employer could not endorse the program but he could publicize it, collect contributions through payroll deduction and remit them to the insurer or broker dealer. Also, the employer could not receive any consideration in the form of cash or otherwise, other than reasonable compensation for services rendered in connection with the payroll deductions.

In the spring of 1976, IRS Technical Release #1451 announced that final regulations for individual retirement accounts would clarify the situation relative to group annuity contracts. The final regulations would provide that a participation certificate in a group contract would be treated as an individual retirement annuity if it met certain requirements (the ones of paragraphs 1 through 5 of section 408(b)). In addition, there would have to be separate accounting of the benefit allocable to each participant owner and the group contract would have to be for the exclusive benefit of the participant owners and the beneficiaries.

New England Life has been marketing a group IRA contract for over a year in employer sponsored situations but not aggressively until this TIR came out. We have sold about a dozen of them. The average contribution per case is in the $70,000 to $75,000 range. We are cautiously enthusiastic about the marketing potential here. We are using a product which we also use in essentially the same form for profit sharing plans. It has a characteristic group load structure, an 8 1/2% current rate of interest accumulation, and a typical group commission scale.

MR. INGRAHAM: A number of Mutual companies recently moved in the direction of developing IRA flexible retirement annuity dividend classes, featuring new money interest credits for current issues. How can equity among old and new classes of annuity contract holders be maintained under this approach?

MR. NICKERSON: That is a very difficult question. I don't think we really have the time here, other than to get into the general discussion of using new money rates on individual products. Certainly, questions have been raised by a number of people as to the compatibility of a new money interest approach with guaranteed cash values and guarantees against asset depreciation. Another item, of course - perhaps a little off your topic of flexible annuities - is that many companies have traditionally based the interest element of their dividend formula on the reserve. If you're using new money rates, I think you would have to base it on the asset share rather than the reserve. That could produce some interesting effects on an endowment policy, for example, if your early asset share is negative. With respect to the IRA flexible annuity, of course, one of your major problems is a sort of rollover that can occur. If you withdraw money out of an IRA flexible annuity and then put it back in, does it come at the new money rate or do you return the money at the original basis upon which it was withdrawn? Do you go LIFO, do you go FIFO, or do you go what I like to call highest interest first out? Then, of course, there is still the basic problem of equity if your new money rate goes below your current portfolio rate. I'm not that old, and I can remember the days when new money rates were back in the 2 1/2 - 3% rate. I wasn't paying that much attention to life insurance then, but I can still remember what I got on my own nickel-dime savings account. The problem there,

of course, is not theoretical, but it is the practical problem of what you do in the marketing situation. I won't say flatly it can't be done, but I see very serious difficulties.

MR. WAIN: There is certainly no way you can offer a new money annuity and a portfolio annuity concurrently. We've moved into the new money annuity flexible approach and discontinued the old type completely. We recognize the problem of equity but on the other hand, the new money approach eventually is going to grade into a portfolio average. You have to be a very good guesser of future trends to know whether the old money qualified annuity, over any extended span of time, is going to be much better or much worse than the new money product. We are giving the existing qualified annuities a chance to come over at the current money rate. It is an operating problem, but it is a transition to a necessary feature of life. As far as the new money endowment goes, it would certainly be a complete nightmare.

MR. MITCHELL: With respect to flexible annuities, there is the question of whether you are going to have good equity between classes of policyholders or whether you are going to have perfect equity between your average portfolio customers and some non-existent flexible annuity average portfolio customers. We are really in a bind. People are offering new money flexible annuities. If you want to be competitive, you must have a new money flexible annuity.

MR. WAIN: ....So if you wanted to keep the money in your company, you've got to do it?

MR. INGRAHAM: No, I don't think you do. At least we are hanging tough on the portfolio approach. We are using a portfolio rate for our tax-qualified flexible annuity policy class which embraces such policies offered by New England Life for the past ten years. This portfolio rate is the rate allocable, to the tax qualified individual annuity line. It is not as competitive as some of the new money rates currently being made available by some companies, but our flexible annuities have other attractive features that we promote which we think offset our current competitive disadvantage on interest rates. We are convinced that within a few years the portfolio rate will inevitably converge with the applicable new money rate.

One practical problem, regarding the use of new money rates in this situation, relates to the interest to be credited to deposits made on existing contracts. If such rates are lower than new money rates, the existing contractholders can direct their employers or plan trustees to rollover the policy proceeds into a new flexible annuity to obtain the benefit of the new interest credits. In this situation, a company would properly have to impose some sort of market value adjustment on the rolled-over proceeds which would lead to a considerable amount of client misunderstandings.

MR. NICKERSON: Harold, I believe that New England has a companion fixed annuity and variable annuity which allows the owner, essentially on a no-load basis, to transfer monies back and forth. Your variable annuity, of course, is inherently on a new money basis.

MR. INGRAHAM: It is interesting that virtually all of this kind of switching is one-way now--from the variable to the fixed annuity. That is essentially what has been happening at my company the last year. There has been a significant disenchantment of our customers with variable annuity performance.

MR. INGRAHAM: How are companies handling the problem of IRA contractholders who become ineligible for IRA coverage during a year? Are the year's contributions refunded with commission charge-backs or is merely the cash value of such contributions refunded, however small?

MR. WAIN: Rather than my trying to say what the companies do, it would be better to put the question to the audience. I will ask for a show of hands. How many will return premiums and recapture commissions when a person becomes ineligible? How many allow only the cash value? It looks like a slight majority favor the cash value approach.

MR. MITCHELL: The regulations call for returning the excess contributions. I think they say "plus earnings thereon". Are you saying "plus or minus"?

MR. WAIN: Of course.

MR. INGRAHAM: The NAIC is now considering substantial revisions in the valuation and non-forfeiture laws. (A) What proposals would have a particular impact on IRA products? (B) How might these proposals affect product design, marketability, and profitability?

MR. NICKERSON: The change that is closest to being adopted by the NAIC (it still takes a while after that for States to act) is a non-forfeiture law for deferred annuities. Basically, this law would require about a 60-65% maximum first year load and renewal loads in the range of 85-90%. I'm being general because there has not been official action and the details are still under debate. However, there would also be some divorcement between the interest assumption for valuation purposes and the interest assumption for non-forfeiture purposes. The non-forfeiture values could drop below the reserves but they would have to come back up to the reserves by maturity, giving margin for potential investment anti-selection in the intervening years. There is at least a reasonable chance that the NAIC will act upon the proposal at its December meeting.

The impact of this on some companies would be negligible; that is, those companies which have basically a level or low-load contract. There are other contracts being sold which have very substantial first year loads and which obviously will have to be redesigned. Another problem contract would be the type of contract which has its load percentages based on accumulative deposits: X percent on the first $2,000, Y percent on the next $5,000, etc. They would either have to drop that type of approach or would have to set some sort of issue limits to insure that they wouldn't violate the loading percentage limit in the second year.

Other activity in the NAIC area includes consideration of again increasing the interest rates for valuation and non-forfeiture purposes, both for annual premium and single premium business. A lot of thought is being given to the question of the very high interest rate guarantees offered on some contracts in the individual area and, particularly in the group area. If they take too hard-nosed an approach on some of these high guarantees, they simply cut the insurance company out of the business by throwing up ridiculous surplus strains or deficiency reserves. They don't want to achieve that result. They also don't want (and neither do the insurance companies want because of guarantee laws) the situation of companies guaranteeing themselves to offering guarantees which might lead to insolvency.

In terms of product design and marketing, the likely result of all this will be that individual annuities will become more competitive, particularly as compared to individual endowment contracts. I also think that the valuation law changes will improve somewhat the attractiveness of individual annuities as compared to group products, because of the higher interest rates allowed on individual products and, undoubtedly, additional controls on the group products.

MR. INGRAHAM: What are the principal features of the 1976 Tax Reform Act affecting IRA's? What types of policy changes should be made available to existing IRA contractholders who wish to take advantage of the increased limits provided under the 1976 Tax Reform Act?

MR. MITCHELL: Two things affected IRA's. It adopted an accrual principle for the end of the year which will mean that IRA contributors will have 45 days after the end of their tax year to make up a contribution. When we talk about Form 5498's, this is going to have maybe a positive, maybe a negative impact on administration. But that is a nice change. Military reservists who have not served more than 90 days of active duty and volunteer firemen who are not going to get more than $150 a month pension for their volunteer fire work, will no longer be prohibited from having an IRA. This will increase the market by many hundreds of thousands of people. The thing that has had the most comment has been the provision for the spouse's annuity. Basically, unlike in the Senate bill, there was no change in the actual definition of what an IRA annuity or account or bond is. And for that reason I don't think that any actual changes in policy forms are going to be required. They renumbered the old section 220 to become 219, which is the same old $1500, 15% rule. There is a new section 220 which says that if a) the spouse has no earned income, b) neither spouse is covered under any qualified plan (except for army reserve and volunteer firemen), and c) they do not take their regular section 219 IRA deduction, then each year the family unit can decide whether they want to take a section 220 deduction or section 219 deduction.

What can you take under the new spouse's deduction? There is still the 15% of income limit. The maximum amount is $1750 which is $250 extra. The final requirement is that the amounts contributed for each spouse are to be equal. The law states that the deduction is twice the amount of the lesser of the amounts contributed for either spouse. This means in effect that you can contribute, as a maximum, $875 for the wife and $875 for the husband. My opinion is that for some people this will be a nice little added benefit, but that for quite a few people they are not going to be either eligible for it or it is not going to be worth the extra trouble.

MR. INGRAHAM: I might also make a comment on the estate tax part of the act. The act extended the availability of the estate tax exclusion for distributions on death from a qualified plan to self-employed persons under HR10 plans and also to participants who have established IRA accounts or annuities, including IRA plans for roll-over contributions. However, to qualify, such a distribution from an IRA of any kind must be in the form of an annuity providing for a series of substantially equal periodic payments for life or for a period of at least 36 months from the decedent's death. In addition, in order for a distribution on death to qualify for the estate tax exclusion from a qualified plan or an HR10 plan, the distribution must be in a form other than a lump sum distribution. Consequently, a lump sum distribution payable on the death of a plan participant from an HR10, IRA, a corporate pension, or a profit

sharing plan will not qualify for the estate tax exclusion under Code section 2039C. The gift tax exclusion continues to apply to death proceeds payable to a beneficiary from a qualified plan and it has been extended to now also cover HR10's and IRA's (of all types). Now the impact of this extension of the estate and gift tax exemptions to HR10 plans and all IRA plans is a positive and significant feature with good marketing implications. For qualified corporate plans and HR10 plans, it would appear that the death proceeds can be payable in any form other than a lump sum while still retaining the estate tax exemption. The requirement that applies to IRA plans, that death proceeds are payable in the form of an annuity payable for life or for a period over 36 months, does not apply to distributions from qualified corporate plans and HR10 plans.

MR. INGRAHAM: My next question is one for the audience. At the June 19, 1976 MDRT meeting, a marketing scheme was unveiled by an agent, involving the use of a capital transfer and application of the tax-free dividend on a participating whole life policy to fund an IRA account. Under this scheme: an individual buys $100,000 of whole life coverage and, in this example, the premium is about $2500 a year. He also puts $1500 into an IRA. If he is in a 40% tax bracket, the $1500 put into the IRA eventually produces a $600 tax refund. So to pay the $1500 IRA premium, he deposits $600 which he later gets back as a tax refund, he puts in the whole life tax-free dividend (let's say it is in an early policy year) of about $150, and he puts in $750 from capital transferred allegedly from other investments, although the primary source of this capital might come from maximum loans in the whole life policy. The agent asserted that this scheme was superior to selling term plus an IRA and waxed eloquently about its sales potential. Has any company seen any evidence of this marketing approach?

MR. RODNEY R. ROHDA: I have been told that a computer software firm operating out of New York City has computerized this great capital transfer approach and I have also been led to believe that it is getting a fair amount of usage right now. One of the things that struck me from this MDRT presentation, the words were so carefully chosen with regard to the use of capital transfer, that you really had to sit down and look at the illustrations to figure out if its a good minimum deposit approach. I don't think the word loan appeared once in the whole presentation and there was no such thing as loan interest. But I now personally am quite concerned with this approach of minimum depositing a full life contract, and using an IRA. Also, you can get an even more specious type of approach by selling Section 79 Permanent Insurance, borrowing and applying the money to an IRA. I worry that we're about to see a lot more of these schemes.

MR. INGRAHAM: I too, Ron, and that is why I asked the question because I wondered if my fears were well grounded. I heard about this scheme from some of our agents who went to that meeting and then I saw the write-up in the National Underwriter a few weeks later. But I have not actually seen much evidence in my own company of this.

QUESTION FROM AUDIENCE: Recently, the "New York Times" had an article concerning criticism directed at the insurance industry because of the high front end loads associated with life insurance policies versus flexible purchase annuities. Has any company seriously considered withdrawing or curtailing life endowment sales because of such negative criticism?

MR. GREGORY S. STRONG: When IRA came out, Western Life withdrew its non-par retirement income policies from its rate book and we are not allowing our pre-retirement policies to be sold in the IRA market. The only product we have available is a flexible fixed interest and variable annuity combination, much like Northwestern Mutual's combination fixed variable.

MR. INGRAHAM: I know there are a few companies that never did make available retirement income policies in the IRA market. Connecticut Mutual comes to mind as one company. Anybody else wish to speak on this subject?

MR. ELLIS D. FLINN: One of my major clients has withdrawn from the retirement income market. And they were about 2/3 retirement income and 1/3 annuity. They just recently withdrew from it primarily because of the problems that came from disclosure of the small cash value, or lack of cash value in the first year.

MR. WAIN: The "Times" criticism and some other criticisms come from some well-meaning people who perhaps can be accused of concentrating on the hole rather than the doughnut. There, of course, are endowments that have poor early year results but on the other hand, systematic actuarial implementation of these poor results in the first year leads to relatively favorable long term results. The adjustment of the system that tends to produce more cash values in the early years will lead to poor long term results, all other things being equal. It is also questionable if with any type of commission related to life insurance practice there could be high enough endowment values to take care of the criticism, no matter what. This is one thread. Another thread is that whatever should be the practice for the future, there are now several hundred thousand endowments that have these characteristics that were issued under the current law. They cannot be continued for reasons beyond the control of the individual. That is, the law permits a long-term product. The Congress presumably knew what the structure of the insurance business was or had that information available to it. It enacted a law that precluded the continuation of a long term product. It seems to me that there is room for a rather strong case that some adjustments in the law should be made and could be made without revenue loss to the government.

MR. INGRAHAM: How does the tax treatment of pre-retirement death benefits under an IRA differ from the treatment of such benefits under a non-qualified individual policy?

MR. NICKERSON: The essential difference, of course, is that the death benefit under an IRA constitutes taxable income to the beneficiary. This is not a very pleasant result, and it does not occur with individual insurance or annuity products. Under many circumstances, with proper estate planning, the non-qualified benefits do not come under the estate tax either. The implication, then, is that from a tax viewpoint it would be desirable to avoid pre-retirement death benefits under an IRA. This question leads to speculating whether a different product (although complex) might not produce significantly better financial results for the customer. Consider the combination of an annuity which accumulates with benefit of survivorship and a companion decreasing term insurance product to provide a death benefit. The annuity would provide nonforfeiture benefits, but cash values would be available only with evidence of insurability. Surrender of the term policy, however, would constitute sufficient evidence of insurability to permit a cash surrender of the IRA annuity. This would remove the pre-retirement death benefit from the IRA and, at the same time, would increase the retirement benefit per dollar of IRA contribution.

MR. INGRAHAM: What's the proper tax and reporting treatment of waived IRA premiums (e.g., premiums credited under a waiver rider on behalf of a disabled participant)?

MR. MITCHELL: There isn't any book written on this yet. So this is just my opinion as to how it would be treated. The actual premium for the disability waiver rider originally paid for this coverage is tax deductible. We need to look at the fact that this is a premium which is waived. It may very well be the practice in nearly every company to actually book the premium and maybe even pay commissions on it and so forth, and treat it as a premium paid. But as far as the contract is concerned, it is the waiver of a premium. This is not treated as a distribution of a premium to the annuitant plus the annuitant making a cash contribution back in the same amount. This would give you terribly mixed-up taxation results. If someone becomes disabled and the premium is waived then we are talking about an extra increase in the cash value (without any contribution being made). At such time as the cash value is paid out in benefits there is taxable income at that point (but not until then).

We were talking this morning about quite a few interesting things concerning disability premium waiver. One example is as follows: Suppose that somebody is disabled for part of a year, we waive part of the premiums, then the person (either before or after disability) has some earned income in the same year and wants to make his contributions. Premiums of more than $1,500 might be made for the year. Quite a few odd things can begin to happen.

MR. NICKERSON: Consider the reverse side of this. If, for example, you have a traditional type of waiver benefit with a six-month waiting period, and if the individual is contributing on a 15% of income basis, becomes disabled and doesn't have income during that waiting period, this can cause substantial problems, since the policy must lapse. Now consider what happens if the insured recovers at the end of five months instead of six--I'm not quite sure what this would do to your recovery rates. We also mentioned some of the systems problems in terms of having to pull the policy out of your normal processing system for producing 5498's. It just appears that an awful lot more thought needs to be given to some of the administrative and contract language ends of the waiver and IRA problem situations.

MR. INGRAHAM: Under the proposed regulations, what are the particular features of the required disclosure statement and what practical problems would result from their adoption?

MR. WAIN: I'd like to answer this in terms of the types of comments that were made at the public hearing on the regulations that were held by the Internal Revenue Service. These proposed regulations have been out for six months so that most of those interested have probably seen them at least once. One of the most troublesome points was the elimination of the seven day free look that had been permitted under the preliminary regulations in favor of the requirement that, in most cases, there had to be a complete seven day advance disclosure before any action was taken to establish the account. At the public hearing the banks, the mutual funds, and the insurance industry spoke out with united opposition to this. The one contrary comment came from a consumer advocate who said that a person also feels conned, in effect, by a single sale and would be reluctant to try and unwind it since it is too embarrassing to admit a mistake. So a person has to be protected from himself or herself by this required waiting period. It is rather hard to say how the IRS would come out on this issue. All we can do is hope at this point. There is a require-

ment in the regulations for disclosure of commissions. It turned out that the consumer advocate, as well as the Federal Trade Commission and seemingly the Internal Revenue Service, felt that the insurance industry was like the stockbrokerage business or the mutual fund industry in that the payment less what was taken away from the total payment in commissions equalled what was credited to a person's account. They had thought that commissions equalled the loading in the insurance operations. They did not know the things we have such as paying different commissions on the same contract without any effect on the financial results to the individual. The fact that there was a misconception augers favorably for some relief from this requirement. As a guess I'd say that there is maybe a chance of 60/40 we could get a little relief there. There was a requirement of a disclosure system based on how much of the first dollar of a person's payment and how much of each additional dollar on a level basis would go to developing values. Here all participants, including consumerists, said this wasn't workable or was not desirable. It would be better to have the results for some simple amount such as a thousand dollars. With this development we could be very hopeful that we'll come out with a simpler requirement and one that is also mathematically workable. There absolutely has to be a change because what they proposed was not mathematically workable for the insurance industry anyway, and we may get a change to something that would be understandable.

MR. NICKERSON: One other minor item, but perhaps of more interest to actuaries than to the world at large is the proposed regulation on required projections of dividend scales. The suggestion was made that illustrations might be more appropriate and would better conform to the requirements of the laws of some States.

MR. INGRAHAM: There will be numerous discrepancies between the amount of IRA contributions reported on Form 5498 as having been received during the year by an insurance company as opposed to the amount claimed as a deduction on Form 5329 by the participant. What has been proposed by the ACLI to the IRS to alleviate this problem?

MR. WAIN: The basic proposal of the ACLI was that the IRS should recognize that the books or records of an insurer and the books or records of an individual holder of an IRA will not necessarily agree and that the IRS should provide for ways to reconcile the two on the Form 5329 individual return form. It is hard to say whether this will actually happen, but the Tax Reform Act of 1976 should virtually eliminate this problem. The basic problem up to now has been that a remittance mailed on December 31st or December 25th may not get into an insurance company's books until the 5th or 10th of January. If the insurance company uses the 1st, 2nd or even 5th as a cut off date. The resulting difference between the insurer's books and the insured's tax objectives for policy holders is very troublesome.

MR. MITCHELL: Under the cash rule prior to the 1976 tax reform act we were talking about picking through post marks. Now under the accrual rule, we are talking about mindreading.

MR. INGRAHAM: The current requirement that Form 5498 include actual earnings, including negative earnings, if applicable, for the 1976 reporting period will likely result in adverse reactions by some participants, especially those who have purchased endowment or retirement income contracts. Won't a large number of complaints to the IRS result in a re-examination of the question of whether fully-insured contracts should be permitted as IRA funding vehicles?

MR. WAIN: I have the theory that the Form 5498's for payments made in 1976 are not going to generate as many complaints as we got last year because by now all of the sales will have been made with the use of disclosure information which should have been showing financial results in a clear enough way so as to avoid the worst complaints. However, there are still going to be some complaints on these cash values, and there is the Achilles heel, which we went into at length, that the industry is selling a long term contract without its being possible for it to be continued long term. Either we make the sale that the concept the Law imposes is wrong and the distribution system is really doing a job for the public or either the IRS or the Congress will start down the track, and put some regulations under us. At the moment I would be inclined to bet that something more might come out of Congress and with a little more speed than out of the Internal Revenue Service.

MR. NICKERSON: From the point of view of what might cause political pressure and re-examination, I would like to emphasize my agreement with Chris that the greater danger is not a number shown in a box on Form 5498. Rather it is a number shown on a statement when the purchaser cannot continue an IRA, has put in 2 years worth of premiums and ends up with a second year cash value of $400 or something of that sort. That would make much better political hay.

MR. INGRAHAM: Chris, didn't you tell me about some situation where a state insurance department was questioning the amount that was going to be payable to an IRA participant and wanted to know what was in his contract and was concerned because it was so much less than the amount put in?

MR. WAIN: Yes, we've had at least one complaint that went to an insurance department. The person handling the matter indicated that the whole idea of an endowment sale should be carefully re-examined and the justification for offering this contract, even though duly approved in that particular state, should be relooked at. Fortunately, this person had a poor case since a woman was implying that she only made about $4000 a year although she was a full time operator of a business. That one was resolved to our favor, but it shows a great potential for competitive regulatory pressures developing in an area which is complex enough with primarily just federal regulations.

MR. INGRAHAM: What is the roll-over market? What particular product features are needed to be competitive? What are the requirements for an IRA roll-over to be available?

MR. MITCHELL: Roll-overs arise from two main sources. A lump sum distribution to a plan participant upon termination of employment or upon an entire plan termination. To qualify as a roll-over, the amount rolled over has to be the entire amount of the lump sum distribution excluding any employee contributions included in it. This is very important. You cannot pick and choose how much of it you want to roll-over. It has to be the whole thing. The next requirement is that it does not include money derived from self-employment. The third requirement which is the one that causes the most practical difficulty is that the money is to be rolled over within 60 days of receipt of the money. We receive a lot of phone calls and correspondence asking what can be done if the 60 days have expired. The answer is nothing can be done. The final requirement is that the roll-over has to be made either in cash or in the same property in which the distribution was made with such property valued at its fair market value. I'm not sure exactly how this works. For instance, if you've got mutual fund shares worth $10,000 which you haven't cashed in yet and you want to roll them over as mutual fund

shares and they've gone down to $9,000 in value, you have to come up with $1,000 in cash. I don't know what happens if the mutual fund shares went up. What makes for a competitive roll-over product? First, you need a reasonably low load on the money (it is single premium money). Secondly, you need a nice high new money interest rate.

MR. INGRAHAM: A recent ERISA amendment permits a roll-over after a lump sum distribution resulting from termination of a qualified plan, provided certain conditions are met. First, what are these conditions and second, must an employee under a terminated plan fulfill a minimum period of service in the plan of five or more taxable years in order to qualify for a roll-over?

MR. NICKERSON: The basic condition is that the distribution must be made within one year of the plan termination or the discontinuance of contributions to the plan. This presents certain problems. In the case of a defined benefit plan, the date of plan termination would be determined by the Pension Benefit Guaranty Corporation. In the case of some types of defined contribution plans you could probably determine reasonably closely what the date of discontinuance of contributions was: If, for example, contributions had been paid monthly and were stopped. However, there could be some very real problems in determining just when this one year roll-over period starts. The other problem is that this section of the law does not refer to such a roll-over as involving a lump sum distribution. So it would appear that the five year participation requirement, which is required for other types of roll-overs, would not apply in the case of the plan termination roll-over. The information I get from one of our lawyers is that he doesn't believe that the IRS imposes, or is trying to impose, the five year requirement in this case. Harold, I think you had a contrary report on this.

MR. INGRAHAM: In the 1976 summer issue of the "Pension and Profit Sharing Tax Journal", there's an article entitled "New Problems Raised by New Law and Roll-Overs" by Seymour Goldberg. Let me just read a small excerpt which comes up with an opinion contrary to that of the lawyers. It says in part "a tax free roll-over treatment applies for lump sum distributions made upon separation from service conditioned on participation in the plan by the employee for five taxable years prior to the year of distribution". Though it would seem the same five year participation rule would also apply to the roll-over distributions on terminations under the new law, there is nothing in the statute that indicates it. In fact, the statute does not refer to the termination distribution as a lump sum distribution but instead speaks in terms of the balance paid within one taxable year of the employee, but then it says, "the IRS officials have unofficially taken the position that the five year rule of plan participation still applies in the absence of a national office directive to the contrary. In addition, tax counsel to the House Ways and Means Committee has indicated that there was no intent to change the existing law on lump sum distributions". So I guess we don't know yet.

MR. INGRAHAM: Still on the same topic is a question I'll try to answer myself. What special tax adjustment rules apply if a former participant received a distribution from a terminated qualified plan in 1974 or 1975 and included the entire proceeds in taxable income?

MR. INGRAHAM: If a former participant received a distribution from a qualified plan on or after July 4, 1974, and before April 16, 1976, and he included the entire proceeds in taxable income for 1974 or 1975, those amounts may be rolled over to an IRA before the end of the year 1976. Such a former participant

should roll over the proceeds received from the plan unless the income tax has been paid on those amounts before the end of this year. Form 1040X should be filed for the year in which the proceeds received were included as taxable income along with (1) the copy of the Form 1099 that was received in the year of the distribution, and (2) some evidence that an IRA has been established to accept roll-over contributions. Then the former participant must roll over amounts received as a tax credit within 30 days after the credit is allowed to the same IRA even though this may occur after December 31, 1976. Consequently, a roll-over which normally must be made in one lump sum can be accomplished in two stages only if the distribution meets the requirements which I just recited.

MR. INGRAHAM: Consider a participant about to terminate from a split-funded individual policy pension trust plan. He needs the life insurance for family protection. However, a life insurance policy is not an allowable investment to an IRA roll-over account. But can he keep the whole life policy in force with after-tax dollars and roll-over the cash portion of the qualified plan distribution to an IRA?

MR. WAIN: Under the present law and lack of regulations, it looks as though the answer has to be "no" because the law speaks of transferring the entire property into the IRA. I had a discussion with one of our lawyers on this theme. I asked why can't the policyholder get a statement from the insurance company as to what the cash surrender value was on the day of distribution and pay that amount into the roll-over. This was a good progressive lawyer. So I gave his negative opinion particular weight. He said he thought it would probably be possible for the IRS to issue a regulation under current law that permitted that result. In the absence of such a regulation it was impossible to safely leave the shell of the policy around in any form.

MR. MITCHELL: Well there is another way to do it. The plan could distribute the cash value in cash and then have the participant buy the policy for its cash value. I assume that is not a prohibited transaction. Then he has a distribution in cash to roll over.

MR. NICKERSON: That, of course, is a different question and with a different answer. The IRS in its review of prototypes seems to do everything possible to discourage the continuance of life insurance. If the plan did not distribute the policy and distributed the cash instead, there's a possibility that your suggestion might work. However, in many cases, unless the policy is terminated at the end of a policy year, the maximum loan value will be less than the cash surrender value, because of provision for interest at the policy loan rate to the end of the policy year. If you take the approach that Tom has in mind, you may have difficulty in getting an entire distribution of the value.

MR. INGRAHAM: It is widely assumed that a roll-over from a qualified plan to an IRA with a subsequent roll-over to a second qualified plan will result in a complete restoration of the tax advantages originally available in the roll-over amounts under the first qualified plan. There is nothing in the proposed regulations or statute which specifically addresses this question. What is your feeling on this?

MR. NICKERSON: If you assume that the money in the original qualified plan was employer contribution, I have great difficulty in seeing how you can get it rolled into an IRA and then get it rolled back into the plan of a second

employer and have it treated as if it were employer contribution. My reaction is that it would tend to be more in the nature of a voluntary contribution which is supplementary to this second pension plan. From the point of view of that pension plan, it would be money which the employee legally put in, but I just do not see how it could regain its status as employer contributions.

Perhaps you could get some advantages on any future gains on that money, but that is as far as I see it going.

MR. WAIN: If that is true, why couldn't the money that originally came from an HR10 plan be transferred in a roll-over to a corporate plan?

MR. NICKERSON: I'm not aware of a provision that permits you to roll over money from an HR10 into a corporate plan, but this is a little further out of the actuarial area than I generally wander.

MR. INGRAHAM: Is there an alternative to an IRA roll-over which will accomplish the same purpose of deferred taxation?

MR. MITCHELL: A non-transferable paid-up deferred annuity.

MR. INGRAHAM: What are the pros and cons of that option compared to a roll-over?

MR. MITCHELL: In a non-transferable paid-up deferred annuity, you are tied up with one insurance company. With the IRA roll-over, the taxation isn't quite as favorable. You may or may not have the opportunity to roll-over into another employer plan later on. The IRA roll-over has more flexibility. Certainly, every three years you could change your investment medium.

MR. NICKERSON: In view of some of the things that are being done, I'm a little bit puzzled. I'm aware of companies which offer both fixed dollar and variable accumulation products and allow you to switch back and forth. This provides some flexibility. From talking with people in various companies, it appears that a reasonable amount of IRA roll-over money is going into an existing IRA and therefore can never be rolled back out. I don't quite see what the great advantage to this is, as opposed to the deferred annuity option. But it is being done a fair amount.

MR. MITCHELL: You would lose the possibility of rolling back to an employer plan. When you have a non-transferable deferred paid-up annuity, you are pretty well stuck with that document or instrument. If you mingled an IRA with some other money (which my company doesn't do), you would lose the possibility of rolling it back but you would still have the possibility of changing carriers. My company's rates might be very fine this year, but thirty years from now our rates might be uncompetitive and somebody would really wish they could get away from us.

MR. NICKERSON: That is what puzzles me, in view of our (shall I put it in quotes) "greed" at getting all these commissions. Why do we want to make provision for somebody to transfer to another carrier or bank? There is, at least, an inconsistency if those critics are charging us with always acting clearly in our own selfish interest.

MR. INGRAHAM: What do you think should be a proper load structure for a non-transferable deferred annuity to make it competitive? Let's get back into

this question of new money versus something other than new money. Can you justify a new money rate on a non-transferable annuity anymore than you might be able to justify it on a flexible retirement annuity?

MR. MITCHELL: The new money concept portfolio is a whole "house of mirrors". Part of our difficulty with new money rates is that we really need to look at the whole competition, not just the insurance industry. I think some of these arguments would take on a different aspect if only insurance companies were involved and the banks would disappear from the face of the earth. Banks for the most part pay current rates for these funds. It's pretty hard for me to see the possibility of not having the new money rate on roll-overs and attracting very much of it. Again, we can have equity at the price of not selling anything.

MR. INGRAHAM: For companies marketing an IRA and fixed variable annuity as companion contracts, are transfers between one or the other regarded as roll-overs?

MR. INGRAHAM: At New England Life, we were concerned about that question because we have such companion contracts. They are each priced using very comparable loading patterns and field compensation. We use a level load pricing approach, and we also use a "fronted" commission scale. We have designed our commission system to treat a fixed-dollar annuity and a variable annuity issued to an individual as one contract for commission purposes.

Now with that as background, we were concerned that the three year limitation on roll-overs might be applied here. We make available no-load transfer privilege between these two contracts. A recent IRS Private Letter Ruling seems to address this point. It stated, in part, "Direct transfer between annuities consistent with established positions bearing in the operation of plans qualified under Code section 401A, is not considered to be a distribution to the participant and is not deemed to be a roll-over transaction. Thus the three year limitation of roll-overs would not apply to transactions of this type".

MR. NICKERSON: Let me say before someone takes it out of context that the IRS was talking about companion contracts in that letter. That paragraph does say annuities. It doesn't qualify it.

MR. INGRAHAM: But the question would not come up in a combined contract.

MR. NICKERSON: No. What I meant is that, if you just read that sentence, it says transfers between annuities. They are talking about companion contracts.

MR. INGRAHAM: We've now explored the four areas involving IRA's and now in the time remaining, I'd like to invite questions from the floor on any of these areas. Who would like to be the first?

MR. CHRISTOPHER CHAPMAN: I would like to make a quick comment about the question that was raised earlier about the appropriateness of marketing endowment retirement income contracts as IRA's. One of the advantages of working for a Canadian company and selling products in the IRA market as we do, is that we've had the RSP experience to draw on in Canada. And for those of you who are not familiar with the RSP, it is really the Canadian equivalent to the IRA. It has been around for quite a long time. The limits are much

higher in Canada and they were just raised the last year. But nevertheless, when it comes to RSP time at the end of the year (we've got an extension to the end of February in Canada), the first thing that you see is advertising on the radio, television and in the press, saying RSP is a great thing but for goodness sake stay away from your life insurance agent. When the insurance companies in Canada first got into the RSP business, they did exactly what I see happening in the U.S. now. They offered retirement income contracts and heavily loaded annuities for retirement. Most people looked on the RSP as a deferred taxation savings vehicle to defer income tax, not primarily as a retirement income vehicle. As a consequence, they began to cash them out after a few years and found they had received a poor savings deal. This came to the attention of the Canadian Department of Insurance and many of the Provincial departments and there has been, as a result of that, a lot of very bad press for the Canadian life insurance industry. Our company, for example, withdrew all but low load flexible income retirement annuities from the U.S. IRA market because of this and I think that companies selling IRA's in the States should take a look at the Canadian situation.

MR. WAIN: This seems like a very worthwhile comment and we certainly should have it in mind. There are a couple of other differences that might give us a slightly better chance of surviving than the industry in Canada. One is, as I understand it, that the original registration deals allowed any kind of permanent insurance policy to be registered in Canada, whereas in the United States, we have been limited to endowments maturing at ages not higher than 70 1/2. The other is that the Canadian companies, in general, have been operating on an even lower cash value basis than the American companies have, perhaps because of their having had higher interest earnings than we generally have had.

MR. MICHAEL WINTERFIELD: There was some mention of some relatively low cash surrender rates on IRA's, especially on the annuity side. I think the figure was about 5% for the first thirteen months. Has anyone had any measurement of the suspension rate of premiums? I recognize that the 10% tax penalty is a substantial deterrent but I have a lot of concern with the suspension rate.

MR. NICKERSON: I was present at a meeting of LOMA's Equity Products Administration Committee a week ago. They were interested in seeing what they could do about studies of persistency on flexible premium variable annuities. They concluded that very few companies had systems which would even allow them to identify this information. All they could really tell was whether the contract was still in force and, in some cases, when they last got some money, but not very easily. I have no real reason to believe that the systems are that markedly different in fixed benefit areas.

MR. MITCHELL: I have one other statistic to throw at you from our fairly small experience. In the persistency statistics I gave you earlier, we count anything that has gone on to a paid-up status as a termination. Of those policies that have terminated, approximately 2/3 of them are on a reduced paid up status right now.

MR. NICKERSON: I have a question for the other members of the panel or the audience. With respect to fixed premium products, the reinstatement provisions normally call for paying some interest or back premium to reinstate a policy. How does this fit in under the 15%-$1500 limits in those companies which have been selling such contracts?

MR. RODNEY R. RHODA: Could I ask an associated question? You have a $1500 annual premium IRA which changes to some mode other than annual. You apply a modal factor to produce, for example, a semi-annual premium on which is 51% of the annual premium. This puts them over $1500. What do you do then?

MR. MITCHELL: We have established a procedure so that we caution the person who is going to do this that he'll get involved with an excess contribution. If he still wishes to make the contribution, the alternative available for him is to make a trivial policy change to reduce the premium amounts.

MR. NICKERSON: Harold, I have a question for you. You spoke earlier about your employer sponsored IRA which was set up on a group basis in such a way that it was an employee pension benefit plan for Title I purposes. That, of course, results in the employer being a fiduciary with respect to a plan. Does the employer as fiduciary have any problems that you can foresee in such plans?

MR. INGRAHAM: He certainly has problems to the extent that he has that fiduciary obligation. All you avoid when you go the route I was describing is that, by meeting those conditions, you can avoid reporting requirements but obviously not the fiduciary responsibilities. I think this in the minds of many people restricts somewhat the marketability of employer sponsored IRA's. We developed our product because it was a relatively simple modification of an already existing product being used for larger-sized defined contribution plans.

MR. RICHARD JOHNSON*: You mentioned waiver of premium on a flexible premium annuity. I was wondering if there is any consensus on how that benefit can be determined; and if you are using just a recent experience period, for example, the last 36 months, how you are reserving for the possible fluctuations in the amounts that can be contributed, especially if ultimately the amount of contributions can exceed $1500 a year?

MR. MITCHELL: I think almost every company that has a disability waiver on flexible contracts is using some sort of averaging concept. We use the last 36 months average premium paid, but not to exceed (if disability is in the first year) the initial premium rate.

MR. INGRAHAM: My company markets a disability agreement which is not the traditional waiver of premium disability rider. We developed it when we introduced the variable annuity. Basically, it provides a disability benefit which is directly tied to the often varying level of contributions. The benefit is the lesser of the amount of contributions made 1) on the average in the last three years; or 2) on the average since inception of the contract. The premium is a percentage of the payment made for the annuity. This percentage varies by issue age, varying between 2% and 5%. At least three other companies market similar waiver coverage for flexible annuity products. We developed this vehicle at the time we introduced our variable annuity in 1971. The conventional form of waiver of premium disability rider is not suitable for use with flexible annuities. We discovered this the hard way. Prior to 1971 when my company was marketing a fixed-dollar flexible annuity product with a relatively high front-end load and corresponding high first year commission for use primarily in HR10 cases, many agents were selling this annuity with a disability waiver benefit covering, say, the $2500 HR10 contribution

*MR. RICHARD JOHNSON, not a member of the Society of Actuaries, works for the Michigan Insurance Bureau.

to the annuity. However, we discovered that after the first policy year, only a minimal deposit would be made to the annuity, the full waiver premium covering the $2500 would be paid, and the balance of the HR10 deposit would be invested outside in a mutual fund. This left us with an empty shell of a contract and a loss.

Thus, in restructuring our flexible annuity in 1971 we also developed the new disability benefit agreement and it has been reasonably popular. For all of the tax qualified annuities we sell, we are getting an 18% waiver coverage option election rate. As I mentioned earlier, it is about 20% for IRA's.

MR. MITCHELL: Let me get back to the reserving question and tell you our approach. In pricing the product we looked at different patterns of flexibility in the premiums and chose something that is not the worst possible case but is relatively close to it and simple. We assumed the original premium level remains in effect for five years and then doubles in amount. From that we derived the net premiums that we wanted to charge. The reserving is also based on that assumption.

MR. NICKERSON: This raises an interesting question: Does any stock company have a comparable product? If so, how do they GAAP it?

MR. INGRAHAM: No takers.

MR. NICKERSON: Another question involves the provisions in the IRA which potentially can make individuals stop contributing, even though they would like to continue. If a disqualification occurs during the year, many companies have procedures for refunding monies as of the beginning of the year. Have any companies decided to reflect this by using different persistency assumptions and amortization schedules for acquisition expenses in their GAAP valuations of IRA's?