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INDIVIDUAL LIFE PRODUCTS IN THE EMPLOYEE MARKET

Moderator: HAROLD G. INGRAHAM, JR. Panelists: JACK S. COUZENS, WALTER N. MILLER, EUGENE L. NOTKIN***

1. The current status of the Section 79 market.

2. The "Retired Life Reserve" concept.

3. Trends in deferred compensation products.

4. Recent activity in "key person" and split dollar markets.

MR. HAROLD G. INGRAHAM, JR.: One particular marketing area in which the Society of Actuaries' formal education has been singularly deficient is the area known as advanced sales or advanced underwriting. Yet, this is the field where a company's most complex and sophisticated sales are made. It is where a blend of skills is required that brings together tax law, computer systems support, and product development and pricing. Clearly the more we as actuaries, working with our company's marketing people, agents or estate planning lawyers understand the intricacies of these very specialized markets, then the more creative and responsive our design of suitable products is going to be to meet the market needs.

On February 3, 1978, the IRS issued a proposed regulation which, in effect, would prevent tax deferral under a non-qualified deferred compensation arrangement in situations where the payment of compensation is deferred at an individual's election. The proposed regulation represents a dramatic reversal of a long-standing IRS position that has permitted such tax deferrals and gave no rationale for the proposed change. What is the intent of this proposed regulation and what will be the impact of it?

MR. JACK S. COUZENS: I really don't want you to worry too much about a proposed regulation. I won't make you experts on how the IRS works but a proposed regulation in this area is something that can be tackled in many ways, first of all at its inception. It is very possible this proposed regulation won't even receive final approval. I think we can most easily address this concept by thinking about a doctor. In fact, I want to bring up a case that I don't think is very good law but it will serve to illustrate what we are talking about.

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It is called the Goldsmith case which was decided in March of this year. The doctor was earning X number of dollars working for a small hospital in Youngstown, Ohio. He decided that he was paying income tax on too much money. He therefore determined that prior to the actual earning of the money, he would agree with the hospital to put that money aside for him to be paid out at a later date. The thought was that he would not pay income tax currently on that money. At a time when he had retired from the hospital, the payout to him would not have as much of a tax effect because his tax bracket would be much lower. The IRS in that case argued as they are arguing in this proposed regulation, that this doctor had rights to that money. In other words, he constructively received that money by having it be set aside for him in the non-qualified deferred compensation plan. In this case, the doctor agreed to put that money into an endowment contract. The IRS argued that he constructively received the premiums placed into the endowment contract and wanted to currently tax him on that money. The taxpayer argued that he deferred the income prior to actually having immediate rights to it. Because the funding vehicle was going to be owned by the hospital, it was an asset to the hospital, not his, he should not be taxed on the income. The IRS retorted, "Well, there is a 30 day right of cancellation on both your part and the hospital's part so the doctor could say after next month 'I want my money'." That is the constructive receipt argument that the government had.

As the case wound up, the Court said that the money was not constructively received by the doctor. However, because the death benefit that was going to be paid under the contract should he die prior to retirement was far in excess of what he would have received had he retired two years after being into the contract, the Court said, "We are going to tax you on the economic benefit given to you via the death benefit." What was really strange here was the method of measure which was not by the PS-58 table, which would have made some sense, but it was by looking at the premium attributable to the accidental death benefit portion of the policy. To me, that doesn't make any sense at all. If we follow through that theory, it would be great because you could design products to which you would attribute accidental death benefit for a very small premium. If that is true, and the employee is currently taxed on that, shouldn't the death benefit be income tax free as well? That would be fantastic. That is why I say I don't think the case is very good law. What is interesting is that in the case the Court said that this will have no bearing on any proposed regulation without specifically talking about the proposed regulation which is now outstanding.

I have heard many people say the proposed regulation is going to be the end of deferred compensation, but I don't believe it. Most deferred compensation is "in addition to" rather than "in lieu of" compensation. If you will reflect on the fact that the average corporate life of all corporations in the United States is a grand total of eight years, you will realize that most employees are not very thrilled by relying on an "in lieu of" kind of contract. In other words, the corporation is going to pay me $120,000, $20,000 of which will sit in the coffers to be paid out to me later at retirement, but if I am the super salesman that is making that corporation go, I am not going to be really thrilled about letting the corporation hold that $20,000 in its coffers year after year with the assets being subject to the claims of creditors. I want, if I want anything, an inducement, an "in addition to", deferred compensation and the proposed regulation is not attacking the "in addition to" kind of benefit. I think you should know about it, but I don't think it is going to have a tremendous effect on the non-qualified deferred compensation market. I think, we are going to see more non-qualified deferred compensation in the future in light of ERISA requirements.

MR. EUGENE L. NOTKIN: We are talking about two different things which both seem to be called deferred compensation. In the business of designing and selling these plans, I have stopped using that phrase because "non-qualified" deferred compensation has the implication that the compensation is less than as good as it could be because it is not qualified. I call them non-ERISA pension plans which is exactly what they are. It is not an option on whether you want it now or later; the option is that you want it later or not at all. It really has the same effect as the pension plan and there is no "now or later" option. The whole thing that Jack was talking about really comes down to is something that is already in the law, "constructive receipt", isn't in the plan. It is something for later. I think that if there is one message I want to get across to you today, it is that I think the non-ERISA pension plans are the hottest thing going and they are going to be very important in the future. In the design of products by life insurance companies, it is essential that the companies take into consideration the concept of deferred payment pension plans and pre and post retirement death benefits.

MR. INGRAHAM: Would you explain the impact of the maximum tax limitation on pay-out of deferred compensation to a retired employee?

MR. COUZENS: The answer to this question is going to further reinforce, I hope, the interest in non-qualified deferred compensation as well as qualified pension and profit sharing plans. I will continue to talk about non-qualfied. I heard a discussion recently where some people like to call it selective compensation rather than non-qualified deferred compensation. It is not always that non-qualified or the word "non" is so bad. Many of my clients are becoming very much upset with the ERISA requirements for pension and profit sharing plans and they are very happy to have a non-qualified plan. Let's talk about a change in the law, the Tax Reform Act of 1976 which reinforces both non-qualified deferred compensation and pension and profit sharing plans. As many of you know, recently the law has stated that there will be a maximum tax rate of 50% of earned income. Therefore the salaries that you and I make are subject to a top bracket of 50%. Income that doesn't fall into that category can be taxed as high as 70%. Under Tax Reform Act of 1976, Section 1314, non-qualified deferred compensation as well as pension and profit sharing pay-out to the retired employee, is going to be subject to the 50% maximum tax. That makes those plans much more advantageous to the person receiving that money if he has a lot of outside investments. He knows that the non-qualified deferred compensation or the pension and profit sharing will only be taxed overall at a maximum rate of 50%.

MR. INGRAHAM: On December 30, 1977, the IRS filed proposed regs in the Federal Register dealing with the treatment of "Combination Term and Permanent Insurance Arrangements under Section 79." Essentially, the proposed regs provide that the term element in such a combination arrangement may qualify as "Group Term Life Insurance" for purposes of Section 79 provided that certain conditions, including the availability of pure term insurance protection are met. The proposed regs go on to specify the formula for computing the costs of the permanent insurance. What are the principal features of this reg applicable to the Section 79 plans, what is the industry's reaction to these proposed regs and what is the current status?

MR. WALTER N. MILLER: The industry reaction probably ranged from horror to outrage. At the outset, let's remember that there would be very little talk about Section 79 plans if it weren't for some tax leverage. This derives from the fact that under a properly qualified Section 79 plan, the employer can deduct his actual cost of providing group-term life insurance coverage, while the employee has to include in his taxable income only the cost of any amount of this group-term life insurance, in excess of $50,000 according to Table I provided by the IRS.

In January, the Internal Revenue Service issued proposed new regulations concerning group-term life insurance provided to employees under Section 79 of the Internal Revenue Code. The proposed regulations described the conditions under which group-term life insurance may be provided to employees through policies which also provide permanent benefits.

The proposed regulation reviews the conditions under which life insurance qualifies as group-term life insurance for the purposes of Section 79. It then states that group-term life insurance may be provided under a policy that provides a permanent benefit if the following four conditions are met:

1. The policy specifies the part of the death benefit provided to each employee that is group-term life insurance

2. The part of the death benefit that is provided to an employee and designated as the group-term life insurance benefit for any policy year is not less than the difference between the total death benefit provided under the policy and the paid-up death benefit that would be provided if the policy were not renewed at the end of the year

3. Employees may elect to decline or drop the permanent benefits

4. The amount of group-term life insurance provided to an employee is identical whether the employee accepts, declines or later drops the permanent benefit.

These rules would seem to require that companies offer policies which provide pure term insurance out to at least the same attained age for which there is group-term life insurance under the allocation of a permanent policy. In addition, the amount of pure term coverage in the separate policy which qualifies as group-term life insurance may have to decrease in exactly the same manner as the group-term life coverage in the permanent plan. Thus, a company which does not offer YRT renewable to age 100 may have difficulties with this requirement.

If a policy providing group-term life insurance to an employee also provides him with permanent benefits, the proposed regulation requires that the cost of permanent benefits, reduced by the amount paid for permanent benefits by the employee, must be included in the employee's taxable income. The regulation specifies that the 1958 CSO Table and 4% interest must be used in applying the formula which gives the cost of permanent benefits to the employee specified in the proposed regulation.

The proposed regulation also specifies how dividends are to be treated. The basic rule is that if the employee pays nothing for the permanent benefits, all dividends under the policy actually or constructively received by the employee are includible in his income. This provision makes the tax leverage of a non-participating policy more attractive than that of a participating policy as dividends become significant. Of course, when evaluating a Section 79 plan, one should look at the benefits and actual costs of the policy, in addition to tax leverage.

The effects of these rules are as follows: First, the very favorable first year tax leverage which was present under the old allocation formula if there was no cash value at the end of the first year, is gone. Second, over four or five years, the total tax leverage is pretty close to what it used to be. For non-par policies, significant tax leverage continues for later years. For a participating policy, though, including dividends in the employee's income begins to wipe out the tax leverage.

The result is that after a certain number of years, generally between 5 and 10, an ordinary bonus type plan, where the employer buys the policy for the employee by paying the premium less the dividend each year, becomes more attractive than a Section 79 arrangement. Somewhat paradoxically, the "better" the policy is, in terms of higher dividends and cash values, the lower the tax leverage.

The proposed regulation also gives "effective date" provisions. If the insurance program for the employees was in effect on or before November 4, 1976, the regulation generally applies to taxable years beginning or after January 1, 1978. For plans not in effect until after November 4, 1976, the regulations generally applies to taxable years beginning on or after January 1, 1977.

Quite apart from the highlights I've summarized, there are some very important areas that are quite cloudy in the proposed regulation. Thus, some of the most important aspects of this regulation relate to what it doesn't say. For example, although not specified, it may be that the IRS intends to specify that a Section 79 plan covering part of a group of employees may not be superimposed on a plan covering the entire group unless the same insurance company writes both plans. The proposed regulations do not make it at all clear what the underwriting rules are if such a superimposed group consists of less than 10 lives. Also, lurking behind all of this is the Administration's general proposal to very sharply limit the ability to vary benefits from one employee to another without having the plan deemed to be discriminatory.

Obviously, there are several requirements in the proposed regulation which the industry could easily do without. An attempt was made in preliminary discussions with the IRS to allow some of the dividends to be used to offset the cost of permanent benefits to the employee, but it was made clear that the writers of the regulation were insistent on the dividend provision as given.

On April 27, formal hearings were held, where various representatives of the industry raised other objections.

William Gibb, chief counsel for the ACLI, suggested raising the interest rate in the formula for determining the cost of permanent benefits to 5% from 4%, so that the interest rate would be more in line with those contained in the new Model Standard Nonforfeiture and Standard Valuation Laws adopted by the NAIC. He also raised serious objections to the requirement that the employee always have the option of having the term coverage without any permanent benefits. This requirement could lead to severe anti-selection problems.

Also, other speakers pointed out that this requirement would totally undermine group paid-up plans, where the employee pays for part of the cost of group paid-up insurance while the employer provides group-term life insurance in addition.

Other objections were raised against the "effective date" provisions. It was felt that plans sold before November 4, 1976, under the then-existing regulations should not have their tax provisions changed in midstream. And for plans sold after that date, the proposed effective date for the new regulation of January 1977 is totally unrealistic since tax returns for that year have all already been filed.

Also, it was strongly suggested that where a superimposed plan covers less than 10 lives but the basic group is more than 10 lives, the basic ground rules covering the larger sized group - and generally permitting regular underwriting - should control. Finally, there's the $64 question of what the IRS' reaction was to these comments, and what the final regulations will be and when they will come out. You can construct almost any possible answer to these questions and I can tell you honestly that I've heard a rumor on "strong authority" that this is what's going to happen. It therefore seems like a good time to stop talking about this subject.

MR. INGRAHAM: Based on the proposed Section 79 regs, how attractive from the marketing standpoint do you feel Section 79 plans are versus split dollar plans? If a Section 79 Plan is in combination with an uninsured pension plan, how would it look versus an individual policy pension trust plan?

MR. NOTKIN: I am not that comfortable with the proposed regs on Section 79. They are like the previous ones,unrealistic. Harold Ingraham gave me some figures and I see in that the figures for a term allocation at age 45 for $100,000 of insurance of $1,312. That's $13.12 a thousand. The PS-58 table only calls for $6.30 a thousand. I don't think that is realistic, and I am really surprised that the government would go along with that. I know the regs of a couple of years ago were much more generous than that, but, these are still unrealistic. I do feel comfortable with split dollar because I feel comfortable that the PS-58 tables are realistic values of one year term insurance.

These figures evaluate the Section 79 from the employee's point of view. In order to consider the corporate point of view as well and that in order to do it fairly, you have to examine from the total point of view. That includes what it costs to create a particular amount of death benefit.

In this case, I am talking about two $100,000 policies, one is a form of split dollàr policy, one of the kinds, that I design to provide death benfits for employees versus the more traditional Section 79 (the way Section 79 is usually used). The end result that is accomplished for the total cost to the corporation as well as to the individual depends upon when the individual dies. So, take a 45 year old male at 3 points of time, 10 years down the road, 20 years down the road when he is 65 and at age 80, 35 years later. Understand that in the outlays for both the corporation and the participant in the plan, I have added a reasonable interest factor to the outlays because money tied up costs money.

Let's take a look at 10 years. I will go through the details the first time around to show you how the figures were arrived at. The corporate after tax cost is the corporate part of the premium plus the after tax costs of the bonus to the employee for him to pay the PS-58 plus interest on the total of the two, in this case compounded at 3.8% which is 8% (valued by the policy loan rate), adjusted for 52-1/2% tax saving. I feel that this is quite realistic. If the employee dies in 10 years, under the split dollar plan, the corporation will have laid out almost $44,000, but it would get back $39,000 in cash value (whether you look at that it has already credited it to their books or it gets it back in cash in the event of death is unimportant). So, it cost the corporation $4,625. The after tax cost of the PS-58 assuming a 50% tax bracket of the participant compounded at 4% (8% minus 50%) is $4,671 for the total cost to create a death benefit, which at that point is a little over $72,000, is about $9,300.

Under Section 79, using the same calculation, except there is no cash value coming back to the corporation, it would have cost the corporation $18,422, the participant $11,400, a total of $29,823. It would have cost under Section 79, 3.2 times as much, yet the death benefit is only 1.4 times as much. The "superior efficiency factor" that I would attribute then to the split dollar is better than two to one.

The same thing happens if the employee dies in 20 years at age 65. You have a total cost under split dollar between the corporation and the participant of a little over $11,000; under Section 79 it is almost $68,000, six times as much, The death benefit is $100,000 under Section 79 versus $36,000 under split dollar, less than 3 times as much, so you have still have a better than 2 to 1 "efficiency factor".

Now, let's give the guy a break and let him die of old age at 80, 35 years down the road. Here is where Section 79 really does poorly. It will have cost to provide $100,000 in this man's estate (between the corporation and the participant) almost $150,000. The split dollar would cost a total of $1,400. Section 79 costs 105 times as much. Now, in this particular split dollar plan, there is no insurance for the individual after retirement. What he gets is a salary continuation. A salary continuation, of 2 years to the widow, would have been a little over $61,000. Arbitrarily reducing that by 40% for income taxes leaves about $37,000 net. That the Section 79 in this case would have given 2.7 times as much insurance net dollars to the widow for 105 times as much cost makes a pretty good case for split dollar over Section 79.

Now, let's measure Section 79 against individual policy pension funding. The basic plan here is a defined contribution pension plan or a profit sharing plan. I don't get involved in the actuarial calculations of how much insurance you require, but look at this on the basis of it being an optional thing on the part of the employee. The premium for the $100,000 of insurance (male, age 45) invested at 8% interest by age 65, would be worth $116,000. The cash value of the life insurance policy would have been $44,000. So, to put $100,000 of death benefit in the plan would have cost him in retirement funds a pretax $72,000. I think that is a rather expensive price to pay for the life insurance coverage. I feel that there are more efficient ways to buy life insurance, and Section 79 is one of them. Although, I would make a better case for split dollar over this method of buying life insurance, here I am just comparing Section 79.

In this particular Section 79 plan, I am having the corporation pay the term allocation premium and the balance is paid by the individual. So, if the corporation is paying that term premium, to make the comparisons comparable, I reduce the corporate contributions to the profit sharing or pension plan by that same amount. The reduction in contributions, at 8% interest, will come to $68,000 by the time he is age 65, so, in the whole movement of the insurance from inside the qualified plan to Section 79 the net gain pretax to the individual is $4,000 at retirement. But, that is not really where it counts.

Look at the individual and how it affected him. To measure the value of the cash value build-up to him in the Section 79 policy, take his share of the premium plus his Table I cost minus what he would have had to pay in tax under the PS-58 with the qualified plan (that would be insurance in the plan) minus the plan dividends, and he ends up at age 65 with about $54,000 of cash value, for his after tax outlay of $10,000, compounding that at 4%, comes to $21,000. So, the $4,000 of additonal amount that he ends up with in his profit sharing or pension account is insignificant here. He has recovered his after tax outlay, plus interest, (a total of $21,000) and made a $32,000 after tax gain in the Section 79 policy.

Now to reduce the employee's pay or bonus by the amount that the corporation is contributing to the Section 79. That is where the differential between what they pay and what he has to accept of taxable income becomes rather effective. Now, the corporation can contribute the same amount to the profit sharing plan as before the Section 79 plan was instituted and it is just not buying any insurance. At that point of time, there is $72,000 more in his profit sharing account than would have been.

Now, measure how it affects the employee on the Section 79 because he is putting out more money. In addition to what I indicated before, I am adding to that the after tax cost to him of his loss of bonus plus interest. So, the cash value at his age 65 is $54,000, the original cost was $21,000 for the loss of bonus compounded plus another $23,000 for a total of $44,000. He is still $9,000 ahead in the Section 79 plus he has $72,000 more in his profit sharing account. I think it makes a pretty good case for the fact that there are more efficient ways of buying life insurance than in a qualified plan.

MR. INGRAHAM: Last June, the Department of Labor released a class exemption, 77-9, from the prohibited transaction provisions of ERISA with respect to agents, brokers and registered representatives. They also issued regulations relating to the provision of multiple services. In particular, this prohibited transaction exemption allows the sale of an insurance product to an employee benefit plan, if the agent discloses his status as an agent. Disclosure is required whenever the sale is to an employee benefit plan and either the agent is a fiduciary or the company is a party in interest. As a practical matter, nearly all companies have a requirement that preprinted forms setting forth commission percentages on the product sold with respect to the plans be given to the plan sponsor, signed by the plan sponsor and then returned to the company as a condition to issuing the policy. Do you think that these same disclosure procedures apply in the case of split dollar plans?

MR. COUZENS: I want to do something nasty first to Gene. I want to make a point that I would like you to consider Gene's point about the Estate Tax implications of insurance in the qualified plan very seriously. I want you to consider the losing of the death benefit from the qualified plan after retirement. I also want you to consider the tax impact of the new Tax Reform Act, of 1976, or the extra money that you made from the savings invested in a piece of real estate. When you die and your family sells that real estate, there is going to be a new capital gains tax. Just consider those things.

The prohibited transaction exemption is really an outgrowth of ERISA. I would say that we are seeing people either into the pension market or we are seeing people getting completely out of the pension market. Then we have those few lost souls who say, "Gee, I can make a big sale here, and I will dangle dangerously around the qualified plan area." I would say that the effect of the prohibited transaction exemption is in the mind of the agent. I think it is how the agent views the client, the purchaser, viewing what the agent makes on the product. If the agent explains to the client what he is delivering or what he is making, I think it will not be a problem.

I don't think it is a big problem for those people who are committed to the qualified plan market. We see a lot of people running scared of the qualified plan market, but I don't think it is necessary if there is a positive approach taken.

MR. NOTKIN: I think that problem is mostly created in the mind of the agent. The agent, and I will include myself in that group, who feels he is doing a really good job for his client is not the least bit ashamed of what he is making by way of commission. Either the plan is good for the client or proposed client or it isn't. What I make on it is really irrelevant and none of his business, but if he wants to know it is nothing of which I am ashamed.

MR. COUZENS: Let's get out of the qualified plan area for a minute, and let's get into the area of the split dollar which I would like to call a welfare plan. The way the question was posed is very important. Should insurance companies require similar commission disclosure in connection with insurance sold to fund the benefits offered under a split dollar plan? Let's substitute for split dollar, disability income, one man pensions, or informal, non-qualified pensions. Some companies are taking the position that it is not their problem. It is the agent's problem because the penalty is going to be assessed against the agent. There is a 5% excise tax against the agent and if it's determined to be a prohibited transaction and if it is not cured within a certain period of time, there is a 100% of the fund penalty. That is a pretty steep penalty. Many companies are saying, "That's not our problem." We are going to explain the law to our agents. ERISA, however, is complex, and the explanatory words about it are going to come out in regulations which will take decades. If you think I am joking, there was a regulation just issued from the 1954 code last month. Many companies are saying, "This is the law, agent. You decide whether you are going to disclose your commission on a split dollar plan or on a disability income sale." Because the company is saying, "Gee, when you sold that disability insurance, we didn't know if it was going to be a corporate paid-for plan or not. That is your problem to worry about. We are not going to have to pay the excise tax, you are."

MR. MILLER: This is a very good example of Walt Miller's third law of corporate organization which is that no large corporation can function effectively without a clearly defined scapegoat. This approach says, "O. K. agent, you're going to be the scapegoat; you are the party that gets into trouble and we are all right". But you are right, a lot of people are taking that approach.

MR. COUZENS: Then, there is the other side of the coin. A very conservative company that I know of is taking the approach that on a split dollar sale, if split dollar is mentioned, there is a disclosure form required by the Home Office. The theory there is that split dollar is a funded welfare plan. The only exception in the eyes of this particular company is a nonfunded, non-qualified deferred compensation plan. It is not funded in that the asset is a general asset, a life insurance policy, held by the company and it is non-qualified so we don't have to worry about the severe requirements of ERISA in terms of reporting. I understand there is an opposite view on split dollar and I would invite your position here.

MR. INGRAHAM: My company's lawyers say that agents are not as apt to be fiduciaries because (1) split dollar plans, by their very nature, don't require comprehensive plan administration, and (2) split dollar plans can't be funded with a broad range of funding vehicles (e. g. stocks and bonds), nor are the plans provided substantial on-going advice by the agents, making it more difficult to argue that the normal sales activity of an agent makes him an "investment advisor fiduciary". Also, we feel the insurance company is not likely to be a party in interest because, although the company services the policies which fund the split dollar plan, the company doesn't generally provide administrative services to the plan. In some cases, split dollar plans are not "employee benefit plans". The 5% penalty or excise tax, can be imposed only in the discretion of the Secretary of Labor. The Department of Labor hasn't specifically addressed the need for an exemption in connection with sales to split dollar plans. Keep in mind that split dollar plans run the gamut all the way from a simple sale to the sole owner of a corporation to a very large scale plan covering all the executives of a large, publicly held company. There is no one neat category to fit split dollar into.

How can keyman life insurance be used to enhance the keyman's retirement? And, there was a recent technical advice memorandum that came out of the IRS regarding keyman insurance that was rather unpleasant to sellers in this market. Can you tell us a little about that technical advice memorandum?

MR. NOTKIN: There are many companies whose future success would be impaired by the loss of the keyman. So, let's presume a situation where there is truly a need for keyman life insurance. Let's take the life insurance now and divide into its component parts as you would with Section 79, but I use the split dollar approach. It really makes for better understanding. Obviously, the cash values of a life insurance contract are not keyman insurance in any sense. They are just monies that belong to the corporation and they are in the form of cash value rather than some other cash asset. So, we split the policy into its component parts which are the pure risk comparable to term insurance and the cash value. The decreasing amount of pure death benefit's value is measured by the PS-58 table. Remaining is the balance of premium that manifests itself in the cash value.

Let me just stop a minute and look at the situation of the retiring key executive who had a substantial amount of group insurance who now is going to lose essentially all of it. He still needs it. There is little difference between the day before he retired and the day after he retired for his life insurance needs. The need really doesn't change dramatically. Certainly not as dramatically as the group insurance changes, usually from a substantial amount down to zero or a token amount. His response to this sudden void created by the loss of the group insurance is usually to buy death protection. And the way he buys it is instead of taking a maximum payout on his pension plan, as a life annuity, he takes some form of joint annuity. What he is doing, literally, is buying death protection. For example, take the 45 year old key executive whose anticipated pension is $50,000 and presume reasonably that if he takes a joint annuity instead of that life annuity, he'll get $40,000 a year.

The company now takes out $500,000 of keyman life insurance on him. They do that because the increase in cash value will pay for that part of the premium and interest thereon and leave a gain on top of that. Obviously, if he dies relatively prematurely anytime before 65, the company does well. It was a very wise financial move on their part. If we take the non-PS-58 premiums, and compound them at 3.8% interest (8% minus 52-1/2%), by the time he is age 65, there is about a $90,000 gain.

That, incidentally, is just about what it has cost them for the PS-58 premium so they have had the protection on the keyman all those years and they have made enough gain in the nonpure insurance part of the policy to pay for the protection. If we allow the keyman to join that great Society of Actuaries in the sky when he is an old man of 80, let us take a look at what happens then. The corporation has made enough to cover all of their premiums and all of the interest and I have excluded from consideration here the pure risk beyond age 65. So, if they can come out whole with the cash value if he dies at age 80 or age 65 for that matter, then they can afford to be generous with that pure risk beyond age 65. If they have $150,000 of pure risk at age 65 and he dies at that point of time, they can pay out over $300,000 with the tax saving making up the differential.

Even if he dies at age 80, there will be a substantial amount of salary continuation paid to his widow. Therefore, he is in the position at age 65 of instead of a $40,000 retirement benefit to protect his wife, because his wife will be protected with the post-retirement death benefit in what was keyman insurance, he can afford to take the $50,000 life annuity and not worry what happens if he dies the next day. That's the equivalent of getting a 25% increase in his pension.

Let me make some comments on this IRS technical memo on keyman insurance. It is reasonable to assume that the rationale behind Section 2042 is the Internal Revenue Code is to require a policyholder to completely give away life insurance that he wishes to exclude from his estate. There is no in between. One must conclude that the IRS is legislating rather than interpreting.

In the case on which the technical memo is based, the decedent did not have any control over the policy during his lifetime, not in any real sense. What he had was a possibility of gaining control at such time as the corporate owner (the policyholder) chose alone and in all events to relinquish control of the insurance.

The obvious motive in this case was to allow the insured to buy the policy from the corporation if, and only if, the corporation decided, absent any control by the insured, to discontinue the policy. The motive, obviously, would be that they did not want the policy any more, but if the insured wanted the insurance, to allow him to pick it up because it would be much more economical for him to buy that policy than go out into the marketplace and buy a new policy if, in fact, he could buy one. It is interesting to note that if the policy had a Business Exchange Agreement, the right to substitute another insured, and the company retained the policy, this problem would have never come up. Before the corporation would have allowed the insured to take over the policy (it being on an attractive basis, the costs already out of the way and paid for once), they would have determined if there were any other key executives in the company to whom they could have transferred the policy. In these circumstances, I suspect the whole agreement would have been worded a lot differently. In any event, I just don't see the IRS prevailing in this.

MR. INGRAHAM: With respect to the "Retired Life Reserve" concept, (1) what are the important legal, tax and regulatory issues, (2) what types of product packages are being developed and (3) are there any special pricing problems, underwriting questions, or administrative considerations involved? What might be the impact of the Retired Life Reserve concept on inforce Section 79 plans?

MR. MILLER: Under many group-term life insurance plans, the insurance coverage provided after normal retirement age either decreases substantially or vanishes entirely. Many employees then discover that their post-retirement life insurance coverage is not sufficient to meet their needs, especially with regard to estate planning. The Retired Lives Reserve concept is an attempt to alleviate this problem.

The basic idea underlying Retired Lives Reserve is simple. A Retired Lives Reserve is a fund established and maintained by an employer over the working life of an employee which will be used to provide continuing group-term life insurance for retired employees. Thus the Retired Lives

Reserve concept provides a method by which the cost of post-retirement group-term life insurance may be allocated over the employee's active life. In this sense it is somewhat analogous to pension funding.

A properly designed Retired Lives Reserve plan offers the following advantages:

1. The employer may deduct contributions to the Retired Lives Reserve fund in the year paid.

2. Contributions to the Retired Lives Reserve fund on behalf of an employee do not represent taxable income to the employee so long as the contributions or earnings of the fund are not made available to him.

3. Group term life insurance on the life of an employee who has attained normal retirement age and whose employment has terminated does not result in taxable income to the insured employee.

Deductibility of Contributions

In order for contributions to a Retired Lives Reserve to be deductible to the employer, the Internal Revenue Service in its Revenue Rulings has laid down several requirements which the Retired Lives Reserve must meet:

1. The balance in the reserve fund must be held solely for the purpose of providing life insurance coverage for active or retired persons so long as any active or retired employee remains alive.

2. The amount added to the Retired Lives Reserve must be no greater than an amount needed to fairly allocate the cost of the insurance coverage over the working lives of the insured employees.

3. The trust fund may not revert to the employer so long as any active or retired employee remains alive, and if the employer does recapture a portion of the fund after this point, then there are significant income taxes payable by the employer.

4. To avoid distortions in the employers' taxable income, the contribution to the Retired Lives Reserve Fund must be actuarially determined and made on a level basis, if the benefits are level.

Another consideration which relates to the deductibility of employer contributions is that the IRS has rules that a Retired Lives Resrve Fund is an employee benefit plan and not a deferred compensation plan. Therefore, Retired Lives Reserve is exempt from the requirement that the plan be either a qualified retirement plan or that the contribution be included in the employee's taxable income.

Finally, there is the ubiquitous rule that any deduction by the employer be limited to ordinary and necessary business expenses.

The Employee's Side

We'll consider some other aspects of RLR as it affects the employer later. First, let's talk about RLR from the employee's viewpoint.

If the Retired Lives Reserve is used to provide group term life insurance for active employees before retirement, the current life insurance coverage would be treated as any other group-term life insurance. That is, the first $50,000 of coverage may be granted without any tax liability on the employee, and any excess would be taxed according to the Table I rates, even if the actual cost to the employer was higher than that given by Table I.

The contributions by the employer to the retired lives reserve fund which is used to prefund post-retirement group-term life insurance are not included in the employee's gross income, because Section 79 requires the employee to include in his gross income only the cost of group-term life insurance in excess of $50,000 for the current year.

Upon an employee's retirement, the employee still does not have any of his group-term life insurance included in his gross income because Section 79(b)(1) provides that the employer may provide group-term insurance to the employee without any adverse tax consequences if the employee's employment with respect to the employer has terminated and the employee has attained normal retirement age.

The preceding comments assume that the insurance coverage provided to the employee is group-term life insurance, as defined in Treas. Reg. §1.79.

As stated at the outset, the purpose of a Retired Lives Reserve fund is to accumulate monies to be used to provide group term life insurance for retired employees. Therefore, the fund must not be used for the purposes of providing insurance which is not group-term life insurance.

Furthermore, and this is important, any arrangement where the employees may receive monies contributed to the fund in any form will not qualify for the tax benefits enumerated above. The plan must provide that the employer may not recapture any part of the Retired Lives Reserve fund so long as any active or retired employee covered by the plan remains alive. After this point, the employer may recapture monies in the fund, but he will experience adverse tax consequences to the extent that he previously deducted his contributions to the fund.

Funding Vehicles

There are three possible vehicles for holding the Retired Lives Reserve fund. These are:

1. A fund held by an insurance company,

2. A tax-exempt trust, or

3. A taxable trust.

Under the first approach, the fund is held and accounted for separately by the insurance company. The interest credited to the fund does not constitute gross income to the employer. The fund may be employed as a source of premium payments for the employees, or, in cases with a large number of employees, the death benefits may be paid out of the fund directly.

The second approach using a tax-exempt trust, will not usually be appropriate for Retired Lives Reserve. For one thing, the criteria used to define the group of employees receiving benefits from a tax exempt trust may not limit membership to shareholders or higher compensated employees. Usually, the employer will want the benefits of the Retired Lives Reserve to be heavily weighted in favor of a select group of employees. Another problem is that upon dissolution of the trust, the employer would want any unused contributions to return to the corporation. But this constitutes an inurement, which disqualifies the trust from its tax-exempt status.

The third approach is using a non-exempt, or taxable, trust. This method provides the most flexibility in designating coverage and amount classifications. The question arises whether the trust must report the contributions it receives from the employer as gross income. In general, if funds are received solely in an intermediary capacity, for the purposes of forwarding such funds, the funds do not constitute gross income. Therefore, a non-exempt irrevocable trust whose only purpose is to use its receipts to pay premiums for group-term life insurance coverage for the employees will not have to report the employer contributions as gross income.

Any earnings of the fund would, technically, constitute gross income to the trust. However, to the extent that such earnings are used to pay premiums for the insurance coverage, they are deductible. Thus, if the trust arrangement and the funding pattern is defined carefully and properly, a non-exempt trust used for Retired Lives Reserve would ordinarily not have any gross taxable income.

Product Design

The next topic which I'll discuss is the area of product design. Most designs of a Retired Lives Reserve package currently marketed combine Yearly Renewable Term to 100 with another product used to accumulate the fund which will pay for the higher YRT cost at the older ages. This fund accumulation vehicle is either a deposit administration fund held by a life insurance company, or in some cases individual deferred annuity products. Usually, the package is designed so that monies in the fund are used to pay for group-term life insurance for active employees as well as for retired employees.

One thing that is very interesting is that most of the term/annuity combinations I've seen provide for agents compensation at rates approximately like those traditionally paid for permanent insurance.

MR. NOTKIN: It sounds like RLR was designed by an agent.

MR. MILLER: There is no sense in an actuary sitting down and trying to design any sort of product unless he thinks there is something in it that can motivate his field force to sell it. The funding patterns required of the employee can be done in several ways. The most straightforward method is for the employer to pay a level amount for the retired lives fund, plus the current YRT cost, which would mean a generally increasing contribution by the employer. Alternatively, the total cost to the employer each year may be made approximately level, either by using excess interest from the fund as an actuarial gain to offset the increasing YRT cost, or by having the contribution used to fund post-retirement death benefits decreasing at the same rate that the YRT cost for active employees is increasing. In addition, there is no need for funding to cease at normal retirement age. The funding pattern may be one consisting of level payments to some later age, such as 80, after which point the fund would be used to pay the entire YRT cost.

Another theoretical possibility in product design for RLR is the use of a permanent plan, but with the trust owning all permanent benefits. This, of course, gets us into the entire question of the proposed Section 79 Regulation, of allocating a permanent plan between group-term life insurance and permanent benefits. Until there are final regulations, it is impossible to make a clear evaluation of this possibility.

As far as underwriting goes, the situation would be the same as for any Section 79 plan. That is, in general, we would have a basic group of 10 or more lives being provided group-term life insurance and additional benefits for some of the employees are being superimposed through the Retired Lives Reserve plan. The specific requirements for the basic group, for the group being granted supplemental coverage, and for the situation where the group consists of under 10 lives are the same as those for any Section 79 plan.

As far as the impact of the RLR concept on inforce Section 79 plans, the key point to remember is that when the employer makes a contribution to a Retired Lives Reserve, that money is gone forever, except under unusual circumstances, and even then there are very unpleasant tax consequences. The fund may be used exclusively for the purpose of providing group term life insurance for the active and retired employees. There are no cash values or other benefits which go back to the employer. Similarly, the employee may get no benefit other than group-term life insurance coverage. Section 79 plans do provide cash values. It is unlikely that Retired Lives Reserve will affect any existing Section 79 plans if sold properly.

While RLR is limited in what it can provide, within these confines it can do the job very well. It's not a magic bullet cure-all, though. In this connection, let me quote from an excellent brochure on RLR prepared by the North American Life and Casualty Company.

"The accumulations of monies in a Retired Lives Reserve fund can only be used for payment of post-retirement premiums. The permanent insurance used under Section 79 and the resulting cash value accumulations very often offer advantages that cannot be met by the Retired Lives Reserve. Deferred Compensation, Split Dollar, Pension funding and other traditional marketing uses for cash value life insurance are sales that can be made with Section 79 individual permanent products. They are not, however, needs that can be solved with the Retired Lives Reserve. In other words, when cash values are important to solve a non-death benefit need, only cash value life insurance will do the job. The Retired Lives Reserve is not cash value life insurance."

MR. BRUCE E. NICKERSON: If a split dollar plan is an employee benefit plan under the Labor Department Sections of ERISA, and if a determination of whether a benefit is payable is made by the insurance company, doesn't the company face the same claims fiduciary problems as in group insurance areas which have received a lot of attention?

MR. COUZENS: At this stage of the law, I would agree with you. However, I want you to know that the multiple services questions in the fiduciary area have been basically postponed until January 1, 1979 with many proposals coming in from various life insurance groups. I think it is an area we have to keep our eyes on. The answer really is, I don't know. I think you are safe in offering as much information as you can. Comply with the rules. If you take a positive approach, you don't have to worry about it. Comply with those requirements, see what is going to happen in terms of definitions of what a fiduciary is in the splitting of the services issue. Dealing with the question has been postponed 3 times now. If they ever get around to dealing with it we might know the answer to that question.

MR. INGRAHAM: How might split dollar life insurance be used to fund a cross purchase buy/sell agreement, especially involving a group of shifting employees, and avoid the transfer for value issue?

MR. COUZENS: I want you people to solve the problem for me. Before I can tell you what I need from you, I have to explain the problem. Let's say that Gene and I own a corporation and Gene is my father. In that situation, assume the corporation purchases a policy on Gene's life and one on my life to fund a stock redemption agreement. That is a buy/sell agreement whereby if he or I die, the corporation will pull back the stock and give our respective widows cash. Because of our relationship, the IRS says that the money, which comes out from the corporation, in the form of proceeds received from the insurance to become corporate assets and then, to the widow will be taxed to her as a dividend. In other words, disaster. 70 cents of every dollar will be taxed as a dividend to the wife. So that is bad news. The way we avoid that in the buy/sell situation is to allow a cross purchase agreement to occur rather than having the corporation do the buying. So, a plan is set up whereby there is an agreement entered into between Gene and me where I buy a policy on his life, and he buys a policy on my life (cross purchase). When he dies or I die, the life insurance will flow to the survivor, the survivor takes the cash, exchanges it for the stock held by the estate of the deceased. Under the new law, there will be a capital gain, but it is not even close to the problem of the dividend issue under the redemption. That is the first problem.

Let's assume that I have lots of brothers and sisters and at this stage of the game, I don't know, nor does my dad know whether they are going to come into the business or whether they won't come into the business. But, we want to provide for the possibility. Now, if I own the policy and I decide I have had enough of it with dad, who started the business, and I sell that policy to my brother or sister or even if I give it to my brother or sister and then dad dies, we are hit with a transfer for value. In transfer for value, I am sure you know that if I pay for a life insurance contract and then transfer it, then the insured proceeds to die, provided I am not the insured (with a couple of other exceptions that I will not get into), the proceeds above what the new owner has paid for the contract will convert from what was income tax free to now a taxable item. In other words, we are converting a great thing into a pretty terrible thing. So, I can't sell the policy to my brother or sister nor can I even give it to them because the IRS says the consideration they are giving to me is taking over the obligation of buying dad's stock when he dies. So, here is what I think may work. That is what worries me. I want to get over this problem.

The corporation purchases a policy; we break the policy into component parts, cash value and amount at risk. We then spin out, by endorsement on the contract, the at risk portion to a trust. Now, when dad dies, cash is going to flow into that trust from the split dollar at risk portion of the policy. (An independent party will be the trustee.) The trustee will say that he thinks Joe and Joyce (my brother and sister), beneficiaries of the trust, should receive the insurance dollars. Now Joyce and Joe have the insurance dollar with which they buy dad's stock. In my opinion, this may avoid the transfer for value problem because we are not transferring the policy. We are merely shifting the beneficiary mix. If Joe and Joyce decide not to enter the business, other children could come in and receive cash to buy stock. It is an imperfect solution because the IRS may look through the trust and say that policy values are being transferred. If you can solve that problem, you will have performed a great service.

MR. NOTKIN: Maybe that is something that you actuaries could work out together with your lawyers. Given a situation of the desire to shift the policy from one owner to another, work it out so that the insurance company would buy back one policy (to wit, surrender it) and be able to issue a new policy, any midstream policy, with accumulated cash values. Conceivably that could be the answer if the new owner could be in approximately the same position as if the policy had been transferred but without the taint of the transfer for value.

MR. INGRAHAM: With respect to split dollar plans, can they more effectively answer the needs of young executives than pension plans?

MR. NOTKIN: Yes, I think they can because in this area we are just talking about compensation. There are two kinds of compensation. The first is "now" compensation and the other is "later" compensation. If you talk to a 30 or 35 year old, age 65 retirement, 30 or 35 years down the road is an abstraction, and if you tell him he is going to have a nice pension if he stays with the company, he doesn't really care. It won't attract him and it won't motivate him. For one thing, he is not even sure he is going to be there 10 years from now, let alone 30, 35 years from now. The need he does have right now, today, if he is a family man, is life insurance coverage and if through a well designed split dollar plan he can own life insurance protection at little or no after tax cost to him, then he has something that he needs now because he hasn't got enough dollars to go 'round for all the things he wants to do in life. So, there is always one need fighting with another need but he recognizes the need for life insurance. Life insurance can be much more meaningful to a young man with a family than the thought of a pension 30 or 35 years down the road. We can give this young executive an insurance benefit which is meaningful to him and fulfills this need of his. If he stays with the company long enough, using what we call our insured deferred compensation plan (which can be designed most attractively to have no long-term cost to the corporation) to fund a non-ERISA pension plan for him. Then, if he does stay with the company some period of time, it is just a matter of calling him in one day and telling him, "You are doing great; we are going to promote you and one of the things you are going to get is $18,000 per year at retirement in deferred compensation." The funding is already there so there is nothing that has to be bought. If he leaves, at least with New England Life, the policy is transferrable to someone else because if he does, presumably somebody else is coming to replace him. Now, if the corporation doesn't have to fund a pension plan for him, then they can take those pension costs and put it into other fringe benefits such as health plans, dental plans or the like. These plans are now compensation which is meaningful to him now.

MR. COUZENS: Let me just add that that same policy could perform three separate functions. Immediate death benefit to the young individual at a relatively modest cost of the PS-58 rate when it is low. Number two, estate tax free death benefit under a deferred compensation program prior to his retirement. Thirdly, conversion to a non-qualified payout when he is coming into an age where he may retire shortly.