RECORD OF SOCIETY OF ACTUARIES
1978 VOL. 4 NO. 3

Vol. 4, No. 3 June, 1978

RECORD

INDIVIDUAL LIFE PRODUCTS IN THE EMPLOYEE MARKET

*Moderator: ROBERT P. BRADY. Panelists: RONALD E. RYAN, THOMAS C. SUTTON, JOHN H. STIGAARD**

1. What is the current status of the Section 79 market.
2. The "Retired Life Reserve" concept.
3. Trends in Deferred Compensation products.
4. Recent activity in the "Key Person" and "Split Dollar" markets.

MR. THOMAS C. SUTTON: "Section 79" is a phrase which is almost becoming descriptive slang within the insurance industry, in much the same way as other famous numerical phrases have come into general parlance from other sources. For example, Take 5, Section 8 and, of course, Catch 22. The aura around Section 79 includes opportunity, opportunism, confusion, complexity and change. Right now, the emphasis is on change ...... change resulting from the new regulations currently under consideration. The changes proposed are designed to reduce confusion. They may or may not accomplish that, but they certainly do increase complexity. The changes are also designed to reduce opportunism, and in so doing they perhaps have also reduced opportunity.

In any event, and at the risk of boring some of you with information which is only too familiar, I would like to sketch out some of the main features of the proposed regulations. As I'm sure most of us know, Section 79 is that part of the IRS Code that deals with the tax treatment of an employee who receives "economic benefit" arising from life insurance purchased on his behalf by his employer.

One basic set of concepts in the proposed regulations is how to determine the value of this "economic benefit". A second set is what I would refer to as non-discrimination items, and most of the balance of the regulations consists of clarifying a few details.

Concerning the value of the economic benefit, the basic idea is that the employee should be taxed on the value of the permanent portion of the insurance and on the value of the term portion of the insurance in excess of $50,000. This basic concept has been followed for many years. In the absence of any permanent insurance at all, the implementation has been clear, since the regulations have specified the value per thousand of term coverage which is to be used. The difficulties have arisen when permanent insurance has been present. Under past regulations, no exact method was specified for determining the amount or value of the permanent portion, and there was a wide variety of practice. However, under the proposed regulations these items are specific. First, the necessary calculations are to be made based on the 1958 CSO Mortality Table and 4% interest. This calculation basis obviously has impact on the degree of tax advantage and the ACLI counter proposal on this item will be to suggest use of 5% instead of 4%.

* Mr. Stigaard, not a member of the Society, is a Chartered Life Underwriter, and the Director of Marketing Services for First Colony Life Insurance Company.

Given a calculation basis, the next step is to determine the net level premium reserves for the benefits provided and net single premium using that calculation basis. Then the deemed death benefit is calculated as the amount of insurance which could be purchased at net rates by the larger of the specially calculated reserve or the actual policy cash value. Thus the deemed death benefit is really a specially calculated reduced paid-up insurance benefit.

The cost of the permanent insurance in a given year is then the increase in the deemed death benefit for that year times the appropriate net single premium.

The amount of the permanent insurance would be the actual reduced paid-up amount under the policy or, under one suggested change to the proposal, the larger of the actual reduced paid-up amount and the deemed death benefit amount.

Finally, under the proposed regulations, as in the past, any portion of the dividend under a participating contract which is received by the employee is considered to be taxable income.

Now with these calculations firmly in mind we may well ask--what are the implications for product design and marketing? To help address these questions I am going to use some ideas and numerical results developed by John Harding, of the National Life of Vermont. First, let us define tax leverage as the total premium paid, less dividend, reduced by the employee's imputed taxable income. (This will be the same as the term premium less the Table I cost.) Clearly if the tax leverage is zero, there is no advantage to the employee in obtaining the benefits through a "group product" arranged by his employer as compared with obtaining them himself. If the tax leverage is positive, there is an advantage to the "group" arrangement and if the tax leverage is negative, there is a disadvantage.

The figures I'm going to quote are for issue age 45 and are the averages of results for 7 participating policies and 5 non-participating policies. I should also state that the figures which combine results over a number of policy years ignore the time value of money and are thus not "interest adjusted".

First, the tax leverage over 20 years is as follows:

	PAR	NON-PAR	Excess NON-PAR Over PAR
10-76 Allocation	$34	$132	$ 98
1-78 Proposal (4%)	-63	60	123
1-78 Proposal (5%)	-27	89	116

From this remarkable display come several questions.

1. *Why is the leverage so much greater for non-par contracts?*

   The essential answer is because the net cost of the non-par contracts is greater. For the policies above, the traditional net cost was $-67 for the par contracts and $+77 for the non-par. Thus the difference in net cost is $144 in favor of the par contracts. If the sale of those policies is thrown into a "tax deductible" situation, it would be expected that the after tax cost gap (for a 50% tax bracket employee) would be considerably less. In fact the gap is narrowed by 50% of the $98 tax leverage. While this narrowing might not be viewed favorably by par company actuaries such as myself, it is hard to fault such narrowing on logical grounds.

2. The tax leverage for par companies under the 10-76 allocations seems rather small, so was the marketing impact only minor?

   No, the marketing impact was enormous, partly because of the predisposition of business men to be favorably inclined toward any tax savings techniques. Also because the incidence of the tax leverage greatly eased the initial purchase (but I'll come back to that).

3. Will any par companies market products under the proposed regulations?

   At least one already is, although the marketing is designed to take advantage of positive tax leverage in the initial policy years and then drop the plan of group insurance, with the policy carried thereafter under some other arrangement.

4. Even under the proposed regulations, the net after tax cost of a non-par contract would be $47 while the par contract has a net cost on a direct sale basis of $-67. Why would anyone buy Section 79 non-par insurance?

   Aside from the usual reasons as to why someone purchases non-par instead of par, it appears true that many people wish to save taxes at any cost. That is, tax advantage often prevails over cost superiority.

Now, let's look at the incidence of tax leverage. In the first policy year, we have:

	PAR	NON-PAR
10-76 Allocation	$22	$20
1-78 Proposal (4%)	7	3
1-78 Proposal (5%)	9	5

Obviously, the leverage under the 10-76 allocation was large in the first year, and did not differ too much between par and non-par. Under the Proposed regulation, the first year leverage is still significant although not nearly as large, and it appears to favor par somewhat more than the prior allocation.

Moving to policy years 2 through 5, the average annual tax leverage is:

	PAR	NON-PAR
10-76 Allocation	$3	$6
1-78 Proposal (4%)	5	3
1-78 Proposal (5%)	6	6

So here we have changes which are relatively small and appear to favor par somewhat as compared with non-par.

Finally, in years six through twenty the average annual tax leverage is:

	PAR	NON-PAR
10-76 Allocation	$0	$6
1-78 Proposal (4%)	-6	3
1-78 Proposal (5%)	-4	4

Here we see why the overall average tax leverage for par contracts was negative and that of non-par was positive.

Now what questions can be asked? How about these:

1. Can a par policy be set up under a Section 79 arrangement during the early policy years when there is positive tax leverage, and then removed from the plan?

   Yes, or at least I do not know any reason why this can't be done, and one large mutual is marketing Section 79 on this basis.

2. Is it possible to design a par contract with positive long term tax leverage?

   Perhaps, but the dividend practice on such a policy would have to be "non-standard" at best, or at worst inconsistent with the usual principles and practices for dividend distribution. Such practices might include

   a zero or nominal dividend on a very low premium policy, or

   unusually long deferral of significant dividends, that is, to age 65.

3. Will actions along the lines above result in further future change in Section 79?

   It seems quite conceivable.

4. Is it possible to frame an approach to determine economic value in a way that precludes manipulation but also provides tax incentive for purchase of permanent insurance?

   The answer is not clear, but for an allocated policy no one has yet found such an approach.

MR. RONALD E. RYAN: The concept of retired lives reserve, or RLR as we have come to call it, is really quite simple. It is merely the setting aside during an employee's working years of sufficient dollars to provide for the continuation of some or all of his group life insurance after retirement.

RLR is not a new concept; it has been available for quite a few years but not generally on a basis suitable for small groups of employees where the sale is made by an individual life insurance agent. Just about the same time as the announcement of proposed changes in the Section 79 regulations was creating considerable uncertainty in that market, the appearance on the scene of several articles on the RLR concept created an awareness of the tremendous programming possibilities of RLR. In retrospect, it seems that for us this was the beginning of a cross between an extremely interesting actuarial project and a tremendously complex administrative system.

The attractiveness of the RLR concept is that, if properly set up, a corporation can take a current tax deduction not only for the pre-retirement group life insurance costs, but also for the deposits made toward the funding for post-retirement group life insurance. Furthermore, earnings on the deposit fund accumulate without producing taxable income.

The employee, on the other hand, is taxed only at the favorable Uniform Premium Table I costs for pre-retirement group life coverage in excess of $50,000. After the employee has retired there is no tax incurred for his post-retirement group life insurance. Thus the RLR concept is a great vehicle for providing an employee benefit when there is a continuing need for coverage after retirement, especially for owner-employees. The RLR concept itself is not sold; rather the long term insurance need is determined and sold, with RLR being the solution to the need.

The retired life reserve concept forms part of a group insurance plan and therefore is governed by Section 79 of the Internal Revenue Code also. However, there is no problem in allocating premiums between term and permanent benefits; there is only term insurance coverage and a deposit fund for future term premiums, the assets of which cannot be reached by the employee--he is entitled to term life insurance coverage only, not to any assets in the deposit fund. The deposit fund can never revert to the sponsoring employer either, except in the circumstances where no active or retired employees remain in the plan.

Although various approaches can be used, North American chose to use a group yearly renewable term insurance master policy with certificates for each employee. The deposit fund is handled by a rider to the master policy and the assets are comingled with other corporate assets--not held in a separate account or in a trust.

In many ways the RLR concept operates in a fashion similar to a defined benefit pension plan and many questions which arise can be answered by that analogy. For example, in determining the asset shares for the deposit fund, the decrements of mortality and termination are involved only insofar as the recovery of acquisition expense is concerned; no benefits are payable from the deposit fund to the employee or his beneficiary, or to the employer. The employee's beneficiary receives the death benefit from the group YRT coverage, while the assets accumulated in the deposit fund are used to reduce future deposits for other employees, normally through an amortization procedure.

The amount of assets required to be accumulated by the funding date can be determined by discounting all YRT premiums required for then future coverage, using expected interest and mortality factors. Depending on the underwriting and initial assumptions involved, some companies use purely ultimate factors while others take account of any remaining select period also. Normally this accumulation is guaranteed by the insurance company to be sufficient to provide for all future YRT coverage. This guarantee may stem from the issue date of the certificate for the employee involved, from the original master contract date, or may not be guaranteed until the funding date is reached. Some companies, however, allow the employer to bear the risk of sufficiency under rules which will preclude anti-selection. In this case any assets remaining in the fund at the death of the employee for whom they are earmarked, revert to reduce future employer contributions. Since the funding date is required to be at least as late as the retirement age, there is no termination decrement to be considered.

Flexibility in choosing a funding date is a valuable tool for designing an RLR plan to the circumstances of the sponsoring employer. There should be no discrimination in the funding patterns for various employees but we believe an example of an acceptable pattern to be funding to the normal retirement age or for ten years, if longer. Additional flexibility is provided by some insurers in that they allow a broad choice of funding ages--in our case the employer may choose any funding age from 55 to 85.

Flexibility can also be gained by funding for only a portion of the coverage and paying the premiums as they fall due on the non-funded portion. Still another way to vary the design is the choice of the amount of post-retirement coverage made available. Normally it will not exceed the total pre-retirement group life coverage, but it could well be less, depending upon the needs developed and upon the employer's financial constraints.

The regular deposits to the fund are determined by reducing them by the required expense factors and accumulating them at an assumed interest rate to the required funding value. The range of this assumption runs from the minimum accumulation interest rate guaranteed in the contract, if any, to the rate currently declared by the insurer for such accumulations.

If the regular deposits are determined using the relatively low guaranteed interest rate, there will be a gain each year that the declared rate is higher. This excess is normally used to offset the next premium due. Under this approach the required deposits for a certificate will decrease each year as the excess interest builds on the accumulation.

On the other hand, if the higher current rate is chosen, the annual or more frequent deposits will remain level so long as that declared rate is unchanged. Any change in the rate, however, will require a recalculation of then future level deposits or may give rise to a series of actuarial gains or losses which will then be credited to the next premiums due, or amortized as defined benefit pension plan gains and losses are handled.

The so-called level deposit approach, when combined with the YRT premiums for current coverage, results in an overall charge which increases as the employee ages. However, the decreasing fund deposit approach tends to produce a more level total cost when combined with the YRT rates. This leads to some interesting conversations unless it is made clear just what is being called "level".

Agency compensation for RLR can vary considerably. In the smaller plans the YRT premiums provide compensation similar to that for individual annual renewable term policies, whereas for larger plans compensation will tend to move from that level towards typical large group insurance plan compensation. Compensation for the deposit portion will also tend to decrease with the plan size. Normally, it also decreases as the funding period decreases, similar to the patterns shown as the premium paying period reduces for limited pay life insurance policies.

The underwriting aspects of RLR are under the Section 79 restraints for cases involving fewer than ten lives. Other than this, there tends to be full regular individual underwriting for superimposed or "carve-out" groups involving only a few lives. For cases involving more lives, companies are using expanded non-medical limits, various approaches to simplified underwriting, and are at least considering some forms of guaranteed issue.

Risks which are classified as substandard give rise to some interesting pricing approaches. Different methods are used by companies in determining extra premiums for the current YRT coverage, although most seem to be using some multiple of the base rate. For the substandard risks, other than those assigned temporary extra premiums only, the accumulation at the funding date must be larger than that for a standard risk.

North American developed level substandard extra premiums, payable to the funding date, designed to cover the additional mortality on the post-funding coverage, and on an equal amount of pre-funding coverage. Any additional pre-funding coverage is charged a multiple of the base YRT rate.

There are some interesting administration problems to be resolved for RLR. As for any group insurance plan, there can be additions and increases in coverage; this can make the funding calculations quite complex if the changes occur off-anniversary.

The interest credited to the accumulations can be significant on larger certificates and large groups, forcing the insurance company to place some limit on the grace period for fund deposits to earn interest. The combination of a late payment for an amount other than billed can nearly defy explanation of the next billing statement in some instances.

Additional benefits offered on RLR contracts are typical of those on other life coverages--accidental death benefit, waiver of the YRT premiums, and sometimes waiver of the fund deposit. Since much of the RLR coverages will be issued to executives, there is a larger probability that it will be converted in the event of termination from the group. For this reason some companies develop a "portable" plan by allowing conversion to any ratebook product, including annual renewable term.

MR. JOHN H. STIGAARL : With every sale that's made in the employee benefit market place you not only illustrate insurance, but you must show the impact IRS will have on the sale. I know Actuaries have an interest in numbers. Some of the numbers that apply here are 61, 79, 83, 111, 162, 404, 501, 531. However we don't talk to you about those numbers. First, we talk to our tax lawyers because those numbers are sections of the Internal Revenue Code. Then we come to you and talk about the product and how it can be designed for the market.

Let's talk about one area - Deferred Compensation. In February, Treasury issued proposed regulations on Deferred Compensation. Basically, the proposed regulations prevent salary reductions through deferrals of compensation. If deferred salary is an addition to compensation, it would be O.K. However, when you are dealing with a small corporate stockholder-employee there is no arms length transaction and that transaction would be questionable with the proposed regulations.

What logic is there in taxing something that may never be received. The IRS source must have been this scene from Lewis Carroll's Alice's Adventures in Wonderland. "Take some more tea", the March Hare said to Alice, very earnestly. "I've had nothing yet", Alice replied in an offended tone": so I can't take more". "You mean you can't take less", said the Hatter: "It is very easy to take more than nothing".

Recently another possible problem has come up in Deferred Compensation plans when life insurance is used as a source of the deferred payments and the death and disability provisions. In March, the Goldsmith case was decided by the Court of Claims. The Court held that the death and disability benefits under this particular deferred compensation agreement provided a current economic benefit to Dr. Goldsmith and was taxable to the doctor. However, the future retirement benefit under the agreement was not taxed on a current basis.

In May, IRS held hearings on the Deferred Compensation regulations. Forty-five witnesses spoke, and there were some pretty strong comments. As a result of the hearings the Treasury is not actually considering the proposed deferred compensation regulations and has gone to Congress with proposed legislation. It also appears that the House Ways and Means Committee will not be adopting the tax reform proposals this year.

I want to talk a little bit about the markets for Section 79 and especially Retired Lives Reserve. We have been selling Retired Lives Reserve at First Colony for the past year. The employees covered by the RLR tend to be over age 50. It is not a sale being made to the younger corporate stockholder-employees. Section 79 continues as the effective sale there. With the Retired Lives Reserve you are selling permanent term insurance. You are selling a pure death benefit. You are not transferring cash from the corporation to the employee. Also, the corporation must have money and it must be able to tie it down on a long term basis.

As we see it, Retired Lives Reserve can be sold in four traditional insurance markets. These markets are: First, the employee benefit market, second, the pension market, third, the estate planning market and fourth, the business insurance market.

This is a natural for someone who has been selling small group insurance cases and sell it as a fringe benefit, especially with the ordinary type commissions. Not only does he sell the top stockholder-employees, but he will go down and provide coverage for the foremen, the office manager and a few other people. However, if he goes too far, such as selling the rank and file employees with these individual products you are going to have persistency problems very similar to what we have had on the pension business. This is an improved or enhanced group that is being sold as a fringe benefit.

The pension producer can adapt to this market very readily because they understand the sale. They understand a tax deductible product. They understand the lower reportable income of a Table I as opposed to PS 58 in a pension plan. They are not afraid to tie down money. With RLR you do not have to meet ERISA requirements as to vesting since the plan is vested only at retirement. Also many pension producers are shying away from placing individual insurance policies in a pension plan and would prefer to sell insurance outside the plan. If you have pension producers, a larger number of them will have a natural entre to the Retired Lives Reserve market.

In the estate planning market, the Tax Reform Act of 76 has totally changed that market. Many of the old key person policies that were sold in that market place are no longer being sold.

A stock redemption is not as attractive as before because the remaining stockholders do not get a stepped-up basis. The buy-sell is again popular. Liquidity has become more important with capital gains on estate assets and Retired Lives Reserve and Section 79 are both excellent solutions for estate liquidity needs.

The person who concentrates on selling business insurance, tends to be the last one to enter the RLR market place. He cannot use a Retired Lives Reserve or Section 79 to fund to buy-sell, and the corporation cannot own group term life insurance so two of his markets have been removed. With the retired lives reserve he has an additional emotional problem. He cannot minimum deposit the product. The above facts do not enhance his ability to mentally adapt to the RLR market place. However, if the situation is right he can sell this in lieu of a deferred compensation plan or split-dollar insurance.

Right now among the many approaches with individual products for the employee benefit market, the retired lives reserve provides the best tax leverage for the client. Essentially you are talking of concept here that is equivalent of a Life Paid-Up at 65 with the premium 100% deductible and the cost to the employee is the income tax he pays on Table I.

However, I would not categorize retired lives reserve as that being the one single best sale. There is no best sale in this individual market because there are four steps that a professional life agent goes through. He will look first at the facts concerning his client. Second, he will look at his client's tax situation along with his client's tax advisers. Third he will look at his client's objectives. Fourth, he then finds the best product among all of these available to serve that client's needs. Thank you.

MR. DICK SWIFT: Regarding Retired Life Reserves, I understand that a trust is established in order to put the money away so the employer can not have use of that money. Is one trust established and filed in one state, or is the product filed in all states in which it is sold?

MR. RON RYAN: We filed a group master policy and certificate in our own state. We also filed a multi-employer trust in one state because of the Section 79 limitation on group term insurance.

MR. DAVID MORDORSKI: Concerning the Retired Life Reserve concept, is mortality taken into account in determining the level contribution to the fund?

MR. RON RYAN: In determining the amount of the level deposit required, mortality and termination rates are involved only in an attempt to determine the recovered acquisition costs. In the event of death prior to the funding date, the accumulation remains in the trust fund.

MR. JOHN STIGAARD: Revenue Ruling 69-382 is important in understanding the Retired Life Reserve funding concept. This is the first revenue ruling the Internal Revenue Service put out on the Retired Life Reserve. The products must be adapted to meet the requirements of this ruling and it discusses how the money has to be tied down and credited to the fund to amortize the cost over the working life of the employee.

MR. DAVID MORDORSKI: Mr. Stigaard, are you using a deposit rider type of approach with the proceeds transferred over at time of retirement?

MR. JOHN STIGAARD: No, we use an annuity approach. In February, 1977, a private letter ruling was issued by the IRS to Gene Pollard, C. L. U., a Dallas based consultant, who came up with the idea of an individual policy approach to the Retired Life Reserves. This favorable private letter ruling approved a plan that used an individual ART contract for the group term and a reserve that was funded by a flexible premium retirement annuity issued to a non-exempt employer's trust. We are using a group term life master policy and a group annual premium deferred annuity issued to a multi-employer trust. The non-exempt employer's trust owns the annuity certificate to accumulate the money in the fund for the post retirement benefit.