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# NATIONAL TAX POLICY—GENERAL, PERSONAL, AND CORPORATE TAXATION

*Moderator: QUINCY S. ABBOT. Panelists: PETER W. PLUMLEY, GORDON H. JOHNSON**

1. What role should overall personal and corporate tax policy play in helping to define the taxation of insurance companies and their products?

2. Does the U.S. tax structure for life insurance companies and their products appropriately carry out national tax policy? Are revisions required?

3. Does the Canadian tax structure for life insurance companies and their products appropriately carry out national tax policy? Are revisions required?

MR. QUINCY S. ABBOT:

The life insurance industry study is the first in a series of analyses of the economic impact of Federal taxation on major industries. These studies were initiated by a Tax Policy Issue Area Plan dated May 30, 1978. The GAO Plan takes its statement of fiscal objectives of a tax system from Professor Richard Musgrave, Harvard University. These fiscal objectives are:

> Allocation "To raise revenue to finance Government activities and to raise that revenue in such a way that there is minimal interference in the private market allocation of resources."
>
> Income Distribution "To offset, to some extent, income inequalities generated by the market allocation of resources that are judged undesirable by society. For example, the progressive rate schedules take into account differences in ability-to-pay based upon income level."
>
> Stabilization "To act as a stabilization tool in order to minimize fluctuations in economic activity. For example, the Tax Reduction Act of 1975 lowered the tax rates in order to combat a deep recession."

These three principles of allocation, income distribution, and stabilization do not include the principle followed by tax lobbyists that Senator Long likes to quote. "Don't tax you, don't tax me, tax that 'feller' behind the tree." Today in the United States this saying can be adapted to fit the taxation issues facing insurance companies. "Don't tax stocks, don't tax mutuals, don't tax that policyholder behind the tree."

A list of specific questions GAO planned to address was discussed with a panel of industry personnel in the summer of 1979. These questions arose

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naturally from the statement of fiscal objectives of a tax system. They are briefly summarized below:

1. How has the 1959 Act affected the way that life insurance companies conduct their business? Specifically, how has it affected the way companies set investment policies and decide what products to offer?

2. How has the 1959 Tax Act affected industry structure? This question encompasses concerns such as:

   - The entry of new firms into the insurance business

   - The treatment of small business in contrast to large business

   - The concentration of business in a few companies

   - The diversification into new product lines

   - Corporate mergers

3. To what extent should the taxation or non-taxation of policyholders on "inside build-up" affect company taxes? Or should the company tax be modified to make it an explicit substitute for the tax that individuals are not required to pay?

4. Should the rationale for a lower-than-normal tax on underwriting income be re-evaluated since relatively little tax has been collected under Phase III?

5. Is the increased tax burden due to inflation reasonable? That is, should the Menge Formula be corrected technically?

6. Does the U.S. system for taxing insurers and their policyholders differ from that followed by foreign countries? If so, should the U.S. adopt those foreign practices?

7. What should be the overall level of taxation upon the life insurance industry? What should be the standard of comparison? The GAO study specifically addresses these questions as follows:

   "a. Life insurance companies are financial intermediaries, like commercial banks, savings and loan associations, fire and casualty insurance companies, etc. Should the tax burdens upon the U.S. life insurance industry be compared with those placed on other large corporate intermediaries? Is there any sense in which we can speak of a 'fair' distribution of taxes among financial intermediaries? Or should equity be put aside and should we be concerned to discover whether differentials in tax burdens among intermediaries are creating efficiency losses by distorting savings and investment flows?

   b. Should the standard of comparison be broadened to include the taxation of income from all forms of capital in the U.S. economy? Within this larger context, should we consider whether

> the taxation of life insurance companies is 'fair' or 'efficient?'"

A student of national tax policy will naturally and properly consider all of these questions in order to evaluate a nation's tax treatment of insurance companies and their policyholders.

MR. PETER W. PLUMLEY:

This discussion considers whether the 1959 Act is properly carrying out national tax policy, and whether certain revisions should be made in it.

The taxation of life insurance companies in the United States has presented difficult questions for many years because of the unusual and complex nature of the life insurance product. In addition, many have argued that life insurance serves important public purposes:

1. It provides security for persons so that they will not become public charges in the event of the premature death of a breadwinner.

2. It promotes savings and capital formation.

3. It funds retirement benefits.

These public purposes have been and continue to be a major argument against heavy taxation of life insurance and pension products.

The unusual and complex nature of life insurance and annuity products has presented the taxing authorities with several major issues to consider. One of these has been how to treat the so-called "inside build-up" of investment earnings.

Another issue has been how to determine the portion of investment income of the life insurance company to be exempt from current taxation because it is needed for the maintenance of life insurance and annuity reserves. The 10-for-1 rule in the 1959 Act provided an equitable basis for determining tax exempt investment income. However, the 10-for-1 rule no longer works in the current economic environment.

The question of how to handle tax exempt interest has also been a major problem somewhat peculiar to the life insurance industry. The proration feature of the 1959 Act provided a reasonable basis for treating the interest on tax exempt securities. However, it has made the purchase of tax exempts undesirable investments for life insurance companies.

A final problem peculiar to the life insurance industry has been the special need for contingency funds because of the unique long term nature of life insurance and annuity products. The 1959 Act attempted to solve this problem by permitting the deferral of tax on part of a life insurance company's profits and the deduction for special contingency reserves.

With regard to all of these issues, it is important to provide reasonable equity among the different types of life insurance companies, and among

life insurance companies and other financial institutions. Although such equity may have existed fairly well in 1959, it is less true today.

Are major changes needed in the 1959 Act? One way to test for this is to see what types of tax planning devices life insurance companies are using. While all industries must do tax planning to some extent, if this planning is creating excessive distortions in normal business practice, it may indicate that changes are in order.

Currently, one of the most wide spread tax planning devices is the use of a modified coinsurance arrangement with the election available under Section 820 of the Code. For Phase 1 companies, this has transformed investment income into underwriting income, and thereby avoided tax. This tax planning device had a major impact on 1980 tax revenues from the industry.

Another tax planning device which many companies are considering (or are already doing) is called 'policy updating'. One major company, Northwestern Mutual, did this by offering new policies to its existing policyholders in order to take advantage of the higher valuation interest rates available on such policies. The tax savings generated through such policy rewriting can be passed on to the policyholders.

Finally, companies must do tax planning because companies are taxed differently, depending on their tax situation. Therefore, many companies have utilized subsidiaries or otherwise managed their corporate structure in such a way as to develop certain tax advantages.

Although these examples indicate the distortions which have occurred, probably the best argument for some measure of tax reform and tax relief is that the 1959 Act is generating excessive revenue. From 1960 through 1979, U.S. Federal Income Taxes paid by the life insurance industry increased by 582%. This is approximately the same as the growth rate for investment income, and is far in excess of other measures of growth such as assets, reserves, and premium income. Although the use of modified coinsurance dampened this growth in 1980, it is clear that, in the absence of the use of modified coinsurance, continued high interest rates will push tax revenues up at a far higher rate than other growth measures in the next few years.

What changes really need to be made in order to put the taxation of life insurance companies back on a more rational basis? The answer to this question depends upon the standards used to judge a tax law. These standards include the following:

1. When Congress is trying to direct individual or corporate actions, the tax policy should accomplish its purpose.

   For example, tax deferral for investment earnings of qualified pension plan reserves results in corporate actions in the design of pension plans which are in the public interest.

2. When Congress is not trying to direct individual or corporate actions, the tax should be as "neutral" as possible.

That is, it should result in as few actions as possible by taxpayers or the public which distort what would otherwise be methods of doing business in the absence of tax considerations.

3. The tax should not give an unfair competitive advantage, or create an unfair penalty, to competing business interests.

   For example, it should be fair to the various financial intermediaries competing for savings dollars.

Based on these standards, we can answer the following questions regarding taxation of life insurance companies:

1. What is the appropriate base for determining taxable income?

2. What is the appropriate method of handling policyholder dividends?

3. What portion of investment income should be excluded from taxable investment income?

4. How should tax exempt interest be treated?

5. What contingency funds in addition to statutory reserves should companies be permitted to accumulate on a pretaxed basis?

There is no "right" way of taxing anyone. Obviously, any business is going to prefer to be taxed lightly relative to its competition, and the life insurance industry is no exception. However, a few concepts might be applied to life insurance company taxation.

First, the taxable income for most companies is based on taxable investment income, gain from operations, or a combination of the two. The fact that there are quite different bases for taxable income has led to a great deal of tax planning, and has given some companies important competitive advantages over others. Although this has provided a substantial amount of employment for persons, it definitely violates the principle of neutrality. While specific suggestions for change in this area will have to come later, the current system of taxation tends to create too many distortions in the ways companies conduct their business. Therefore, this system needs a thorough re-examination.

A more specific problem area involves the deductibility of policyholder dividends. The 1959 Act represented a compromise between the position of the mutual companies, which wanted full deductibility, and the stock companies, which wanted a limit placed on the deductibility of dividends to prevent mutual companies from paying virtually no tax. Because of the rapid increase in the adjusted reserves rate, the proportion of the policyholder dividends that actually has been available to reduce taxable income has been dropping rapidly, from about 90% in 1960 to 65% in 1978. This ratio presumably will decrease further in the next few years, and is a major indication of the excessive taxation which has developed.

The solution to this problem lies in treating policyholder dividends in conceptually the same manner as comparable items for competing savings

institutions. Thus, to the extent policyholder dividends represent a return of excess current year premiums, they should be deductible in full by the company and not taxed to the policyholder. On the other hand, to the extent that they represent excess interest earned on policyholder funds, savings and investments would be best encouraged if they were deductible by the company and taxed to the policyholder only if taken in cash. If the dividends were left with the company to purchase additional insurance or to increase cash values of a deferred annuity, they should be considered to be not currently available to the policyholder and the tax should be deferred. Finally, to the extent that policyholder dividends represent interest on the capital and surplus funds held by the company, they should be taxed in full to the company and taxed to the policyholder in the same manner as stockholder dividends are taxed to the stockholder.

An important by-product of such an approach is that it would serve to encourage savings, and would help increase the supply of capital funds for investment. The life insurance industry can play an even bigger role in this regard if the tax laws are properly structured.

Any attempt to apply these concepts with a high degree of accuracy is administratively very difficult. However, when designing a practical law, theoretical considerations should be considered.

Probably the most familiar problem of the 1959 Act is the way in which the 10-for-1 rule is operating today. This particular feature of the Act has developed into a serious problem. It is creating large amounts of fortuitous revenue for the government and is becoming increasingly burdensome to the industry. There is no question but that the mechanics of the 10-for-1 rule should be corrected. The geometric formula proposed by the ACLI is probably as good a method as any, assuming that the concept of the 10-for-1 rule is retained. However, this entire theory of what portion of investment income is really profit from investments should be re-examined. The very high investment yields currently available on new investments do not represent increased profits to the company because they must be used to defray increased issue and administrative expenses. One possible approach would be to allow a deduction based on the interest assumed in the asset shares underlying the premium calculations. This would be difficult to apply in practice, but it is similar to the concept which is already being applied to determine GAAP earnings. In any event, before any new statute is developed, this should be carefully studied.

The tax exempt interest has been a problem for years, and the 1959 Act has had the undesirable effect of keeping most companies out of the tax exempt market. The ACLI position, which allows companies to invest up to their capital and surplus in tax exempt securities without the requirement that the investment income on the securities be prorated is a reasonable one. Tax-exempt securities should also include the tax-exempt portion of dividends on common or preferred stocks.

One of the most potentially serious problems of the 1959 Act is the increasing amounts accumulated in the Policyholder Surplus Account (PSA), and the way in which insurance companies must account for PSA additions. There is no question but that life insurance companies should be allowed to set aside on a pretax basis some contingency funds in addition to their

regular policy reserves. However, they have been doing this since 1959 without recognizing in their earnings reports that some day these contingency funds will be subject to tax. This has created quite a time bomb which could bankrupt some companies under certain conditions. It is important that this problem be corrected, and it is probably equally important that the deductions for contingency reserves be re-examined and perhaps liberalized.

In conclusion, the 1959 Act has some serious deficiencies:

1. It will raise more revenue than the industry can tolerate over the long term.

2. It is driving many companies into tax planning devices that distort the normal business operations.

It is important that the government and the industry work together to develop legislation which will raise adequate revenue, but at the same time will keep the life insurance industry prospering and contributing to the U.S. economy.

MR. GORDON H. JOHNSON:

For many years up to 1969 the principal tax on life insurance in Canada was the 2% provincial premium tax. In addition, federal and provincial income taxes applied at normal corporate rates to amounts transferred to a stock life insurance company's shareholders' account. Mutual life insurers paid only premium taxes prior to 1969.

The Report of the Royal Commission on Taxation issued early in 1967 proposed four new areas of taxes for life insurance:

1. Company "business income"

2. Policy dividends

3. "Investment income" earned by policy reserves and other policyholder funds

4. So-called "mortality gains" in insurance proceeds

Fortunately, after the release of that Royal Commission, they decided that they would begin with the life insurance industry first, but in doing so, they were very astute. They got together with the Superintendent of Insurance's Staff, experts in the Department of Finance, and industry experts who carried on a dialogue as to whether or not the 4-fold tax basis was appropriate. They concluded that it was not and, therefore, in 1967 what was introduced was a 3-fold tax basis:

1. A business income tax on company business income at normal corporate rates.

   This tax also applies to the transfer to shareholders of untaxed pre-1969 earnings or foreign profits that were repatriated to Canada.

2. An investment income tax of 15% on investment income building up each year for policyholders which tax was paid by the company on their behalf.

3. A policyholder income tax on the future "gain" in amounts withdrawn by policyholders at their own effective rates.

The business income tax attempts to determine and treat the so-called business profits of a life insurance company in the same way as the taxable profits of other corporations; special Regulations govern policy reserves for tax purposes.

The investment income tax was designed to tax, in the Minister's words: "the investment income benefiting policyholders by way of reduced premiums or increased policy dividends". The company paid the tax at a special flat rate of 15% (intended to represent a composite rate for all policyholders) instead of the policyholders doing so at their own rates as the Taxation Commission had proposed. This tax was withdrawn effective from 1978 because of other changes which had occurred in the general tax structure in Canada.

The policyholder income tax applied, again in the Minister's words, to "those elements of investment income actually received by the policyholder before he dies, either through cashing in his policy or selling it".

The life company tax system in Canada applies only to the Canadian operations of insurers. Other domestic Canadian corporations are taxed on their worldwide operations with a credit for foreign taxes. Special provision was made for life insurance in order to insulate Canadian policyholders from the effects of foreign taxes.

As the industry became more familiar with the 1969 legislation and certain modifications were made to incorporate general tax policy changes, such as the taxation of capital gains, it became apparent that there were significant anomalies in the system. The introduction of changes in the March 31, 1977 federal budget was not unexpected, but the extent of the changes was unforeseen by many in the industry. The changes in 1978 taxation of life insurers were in six key categories:

1. Policy reserves

2. Gross investment revenue and related gains and losses

3. Taxable Canadian dividend income

4. Policy loans

5. Segregated funds

6. Repeal of the 15% investment income tax

1. <u>Policy reserves</u>

The pre-1978 basis of calculating policy reserves was the net level

premium method for policies with a fixed annual or other periodic premium.

This basis assumes a level incidence of expenses. Since these expenses are deductible for tax purposes as incurred, their deduction, together with a deduction for a policy reserve determined on the net level premium method, results in a significant loss in the year the insurance contract is written. This mismatching of costs and revenues under the pre-1978 rules was of great concern to the government. In addition, the interest and mortality assumptions used in determining the tax reserves were more conservative than those used in pricing policies, which resulted in further tax deferrals.

For basic policy tax reserves, the net level method was replaced in 1978 by the "one year preliminary term" method. A suitable modification was proposed where the premium was payable over a short term. A policy with a cash surrender value was permitted a minimum reserve equal to that value. With that change in 1978, tax reserves were thus made less generous than formerly and were brought closer to book reserves in the aggregate.

2. Gross investment revenue and related gains and losses

Prior to 1978, multinational Canadian insurers were permitted the choice of two methods of determining gross investment revenue called the proportional method and the branch accounting method. These methods proved inadequate, and despite numerous changes in the intervening years between 1969 and 1978, they were replaced in 1978 by a more narrowly determined branch method. The concept of the "Canadian Investment Fund" which is filled with income-producing assets at least equal to that Fund was retained. The Fund represents the asset equivalent to Canadian policy reserves and liabilities; and the gross investment revenue, and the gains and losses from such property form part of the tax base. This amendment had the effect of requiring multinational insurers to designate as assets in the fund some Canadian property which formerly escaped income tax in any country. Non-resident insurers doing business in Canada were also required to include a deemed surplus in establishing their Canadian Investment Fund.

3. Taxable Canadian dividend income

The Canadian tax system generally allows dividend income from taxable Canadian corporations to flow through without tax. Dividends are included in income and then deducted in calculating taxable income. In the period from 1969 to 1971, life insurers were allowed only a formula deduction for their dividend income which was only a small portion of the actual dividends received. In 1972, the formula was adjusted to eliminate the disallowance of investment expenses related to dividend income. The March 1977 budget repealed the dividend formula and permitted a full deduction for taxable dividends received from Canadian corporations.

Since 1978, life insurers are on an equal footing with competing financial institutions by the full deduction of Canadian dividend

income in calculating taxable income. Some insurers found their deduction increasing 10-fold with this change. It has stimulated insurer investment in Canadian equities as companies who were lower in equity investment seek to obtain the advantage of a higher tax shelter. This seems in concert with present government policy regarding encouragement of Canadian ownership of business enterprises. The only limitation on equity investment relates to the multinational insurer who is limited to investments in equities to the same degree in Canada as abroad.

4. Policy loans

Commencing in 1978, policy loans were removed from the invested asset category and classified as prepayments of policyholder benefits. In the summary of computation for tax purposes, a loan is deductible as an expense when made by the insurer and repayments, together with interest, are treated as premium income. The regulations provide that the actuarial reserve otherwise determined with respect to a policy is reduced by any policy loan (including unpaid interest) outstanding at that date. Most insurers were not affected by this change. Multinationals, however, could have the gross investment revenue included in their Canadian Investment Fund affected by the world proportion of policy loans.

5. Segregated funds

For 1978 and subsequent years, segregated funds are deemed to be trusts separate from the insurer. No fundamental change affected the insurer or policyholder.

6. Repeal of the 15% investment income tax

When the 15% tax on investment income was introduced in 1969, it was intended that the insurer would pass it on to the policyholder. Such an indirect tax at the corporate level gives the insurer the problem of distributing the tax load among policyholders through pricing or dividend policy. The insurer is unable to make an equitable allocation of this burden.

Between 1974 and 1978, the government introduced a much amended personal tax exemption of up to $1,000 of an individual's investment income, dividend income and capital gains to be received annually tax exempt.

Policyholders were not permitted the same treatment for the inside build-up in their policies. The tax system thus had a bias against saving through life insurance.

The repeal of the 15% investment tax was welcomed by the industry as producing some type of equity where it had been lacking during those intervening years.

Tax survey

A survey of the industry in Canada showed that 82 companies supplied tax

information for a three-year period. That voluntary survey, however, lacked data from five of the more significant-sized companies. The figures in millions of dollars are:

| | 1977 | 1978 | 1979 |
|---|---|---|---|
| Federal | | | |
| Part I business income tax | 13.7 | 32.7 | 31.1 |
| Part II investment income tax | 27.8 | N/A | N/A |
| | 41.5 | 32.7 | 31.1 |
| Provincial income tax | 4.8 | 11.5 | 11.1 |
| *Income tax on Canadian operations* | 46.3 | 44.2 | 42.2 |
| Non-resident withholding tax on investment income | 12.5 | 14.1 | 15.3 |
| Total Canadian income tax | 58.8 | 58.3 | 57.5 |

In the three most recent years there has not been an appreciable change in the level of the tax load to insurers carrying on business in Canada.

The income tax take of $40 million plus in 1978 and 1979 on Canadian operations should be compared with a Finance Canada reported industry total for 1976 of $9.6 million income taxes (other than on investment income). The 1978 amendments obviously fine-tuned the tax system introduction of 1969 and raised more tax as a result.

Premium taxes have remained a significant tax in Canada and are the largest tax paid by insurers in Canada. The industry totals in millions of dollars for three recent years are:

| 1977 | 1978 | 1979 |
|---|---|---|
| 69 | 70.5 | 77 |

Does the Canadian tax structure for life insurance companies and their products appropriately carry out national tax policy?

Since the repeal of the 15% investment tax at the end of 1977, life insurers doing business in Canada have been exposed to income tax on business income only. This moved the companies from a two-tax system similar to the present United States system to a single tax computation. It seems to be the Canadian consensus that the single basis with the more refined accompanying tax rules is superior to the initial tax system in 1969 and is viewed as more equitable among different types of life insurance companies.

Policyholder dividends in the Canadian computation are handled in two separate calculations. The first is the provision for dividends. The

second is the dividends actually allotted to policyholders during the year. These two amounts are limited in total to a calculation of "income from participating life insurance business" in Canada. Although the dividends allotted computation has been cumulative since 1969, some life insurers have found that in some earlier years of restricted par income they did not obtain a full deduction. In most instances it would seem that with the tax changes of 1978 they were successful in picking up the underclaim of policyholder allotments by a claim against a higher par income. The current policyholder dividend treatment in the Canadian context does not appear to be a problem.

The tax concerns in the United States currently relate to tax exempt securities and their interest as one issue. In Canada there is not a category of tax exempt interest. The concern before 1978 was similar, however, as it related to the receipt of dividends from taxable Canadian corporations. Partial deduction for such dividend income in both the investment tax and business income tax was permitted. The portion deemed to be used to build up actuarial reserves or pay investment expenses was not deductible. The 1978 amendment permitting all Canadian dividend income to be free of tax has been a decided improvement in the Canadian formula. It sits comfortably with Canada's emerging consciousness of self as a nation. It encourages life companies in Canada to own a greater portion of Canadian industry. Life insurers are diversifying a greater portion of their investments into Canadian equities as a result. However, the "equity limit" presently in the tax law does not seem reasonable and it is not appropriately determined because it creates a situation where the multinational insurer has equal opportunity for equity investment outside Canada, as well as inside Canada. Finance Canada have asked us to demonstrate a life company hurt by the present rule. With increased equity ownership, this should be possible before long.

Powers of financial institutions in Canada are an increasing concern. Each identifiable segment of the financial community seeks to protect its existing powers and tries to expand those powers. Recently, the Bank Act was revised in Canada with accompanying widespread power changes. Trust companies and finance companies are now seeking wider powers in the upcoming revisions of their legislation.

The life insurance industry is competing with banks and trust companies in the marketing of tax-sheltered registered retirement savings plans and some annuity products where there is no life contingency. There was the recent spectacle in Canada where one of the largest banks offered "free insurance" coverage at reportedly no charge in its registered retirement savings plans.

Government policy does not seem consistent in its application to all segments of the financial community. Equity does not now exist among competing financial institutions. Unfortunately, there is a crazy-quilt effect of different types of institutions encroaching on the specialty fields of others. Action to reduce unfair advantage is slow in coming and only results from very vocal industry presentations.

In 1966, the Carter Royal Commission on Taxation in Canada pointed out that premium taxes are not levied on any other form of savings. They

expressed the hope that when the provinces obtained a share of the business income tax in 1969 and subsequent years, they would forego these regressive premium taxes. In an inflationary environment, the provinces have been unwilling to forego this contribution to their tax base despite some legislation which specified it is levied "in lieu of income taxes". It may seem unreasonable to expect repeal of the premium tax in Canada. It seems so firmly established as a North American norm of life insurance operation. On the other hand, the struggling new company or smaller insurer is faced with de-minimus tax whether profitable or not. Perhaps the premium tax bears further scrutiny.

Canada's social policies, including the recommendations of the Carter Commission of 1966, have sought to recognize tax precepts of equity, neutrality, "a buck is a buck no matter how earned", and the need for the citizen to be encouraged to provide for himself, his family and his heirs. Tax policy, by personal deductions, has been drafted to encourage personal provision for retirement and other needs. Many of those personal tax limits in the light of inflation now need to be raised. A new pension debate in Canada, however, heralds a government now more determined to grab the pension dollars for its coffers, rather than allowing the private enterprise life insurance industry to provide for individual needs according to individual thrift and foresight. I personally deplore government intervention where free enterprise and expertise can meet the challenges. The Canadian pension debate will overshadow any tax concerns facing life companies at this time. While there are areas of the Income Tax Act, Canada, which should be overhauled, by and large, life insurers believe the amendments of 1978 made the Act more workable and equitable. We need a few years to demonstrate it does work and Revenue Canada is deriving appropriate tax revenue in accordance with the unique nature of the life insurance co-operative.

MR. HARVEY D. WILMETH:

Q. We are all aware of the inter-relationship between inflation rates and the impact of our tax laws. Do the proposals for the changes to the 1959 Act recognize the need for the law to be applicable at very high rates of inflation such as we are encountering today and also at much lower rates which we hope to achieve in the foreseeable future?

MR. ABBOT:

A. Harvey, I think you are addressing your question toward the ACLI deliberations. The members of the ACLI Steering Committee and their associates working on the ACLI tax reform proposals have been trying to anticipate the future. It is worth noting that the idea of 5% inflation rates today is absolutely as unthinkable as it was in 1959.

MR. JOSEPH C. NOBACK:

Q. Peter, could you expand on your remark that the whole question of determining the company share of investment yield for Phase I taxable investment income should be reviewed because the company share has increased substantially since 1959?

MR. PLUMLEY:

A. The present law attempts to define the policyholder's share of investment income in terms of the interest a company would need if it revalued its policies to a rate of interest approximating the company's average investment earnings rate.

This should be re-examined because the interest rate assumption used in premium calculations today is quite different from a company's average investment earnings rate. It is general pricing practice to offset future increases in investment income with future increases in expenses.

Another problem is that tax reserves based on the 10-for-1 rule are much smaller than exact reserves valued at the adjusted reserves rate because there is a technical flaw in this formula.

MR. ALLAN D. GREENBERG:

Q. Most people in the insurance industry feel that the insurance industry is being very highly taxed in relation to the initial intentions of the 1959 Tax Act. The burdens compared with similar institutions are quite onerous. On the other side of the coin, the public generally feels that the insurance industry is a favored industry with respect to taxation. What can the insurance industry do to make its position generally accepted that it is being overtaxed as opposed to being a tax favored industry?

MR. JOHNSON:

A. Let me give you an observation from Canada. The way we have brought about our tax adjustment has been a very healthy kind of thing. As I mentioned before, the Superintendent of Insurance and his staff and the Department of Finance tax policy draftsmen and representative committees of the industry have worked together on the various changes that have come along. Invariably, it would work out that the government would ask the insurance industry to critique the technical details in the draft legislation.

This process has been a good process in Canada because we perhaps have avoided some of the things that could have been dumped on us if we had just come to the legislative process without having seen the draft legislation or without having had the chance to work on draft legislation. In some cases, a policy decision has been announced in a budget and then merely followed up with the government authorities and us working out the details together.

I suspect that you do not have quite that same interface. Perhaps, one way to keep taxes from going up is to find a mechanism whereby more of this interface can occur. We, by no means, win all the battles in this process, but we do minimize the impact of tax laws on us. The industry is happy with the 1978 tax law that is in place.

The problem of commmunication to the public at large concerning how

much tax you are paying and whether you are paying a fair share is a difficult one. Because policyholders pay insurance premiums with after tax money, there is a case for a very low incidence of tax on life insurance companies. However, we have to make that case and we also have to be very good in our public relations.

MR. HOWARD L. ROSEN:

In recent years, insurance companies have been coming up with more ingenious ways of passing through the investment dollar as a reaction to the criticism voiced against the insurance industry's investment returns to policyholders. In reaction to this, the IRS has been looking more closely at the relationship of the policyholder and the insurance company. In recent years, we had the FIAC, wrap-around annuity, and the E. F. Hutton rulings.

In the E. F. Hutton ruling, there is no mention of what happens to excess interest accumulations on the fund if they are withdrawn by the policyholder. Are they policy loans? Do they represent a reduction in basis or are they considered as a dividend.

MR. ABBOT:

The E. F. Hutton ruling says there are two possibilities:

1. The excess interest is an increase in the reserves. It presumably can be withdrawn tax free as a policy loan; or

2. The excess interest is a dividend. It presumably can be withdrawn tax free until the policyholder's basis in the contract is exhausted.

As a practical matter, there will be no tax under either of these approaches for at least a few years. By the time that a policyholder reaches the point where this issue becomes important, the IRS will have resolved the issue.

MR. RICHARD H. GUDEMAN:

Pete, I reviewed the 1980 financial statements of 15 to 20 major life insurers. I concluded that the 1980 tax revenues may have decreased in 1980 from prior years. You commented that the tax revenues from the life industry are continuing to be increasing and excessive. Is my conclusion incorrect?

MR. PLUMLEY:

I have not seen 1980 financial statement figures on this yet, but I understand that they are going down. This is because of the effect that Section 820 is having on tax revenues. However, tax revenues would be increasing without Section 820.

MR. CHARLES T. WHITLEY:

Mr. Plumley has written a professional paper. The paper has a

practical observation that I would like to emphasize using his words; "Development of tax legislation is a political process involving theories and compromises among various interests."

MR. JAMES HOPSON:

Mr. Abbot, could you tell us about the progress the ACLI has made in the proposals for changes to the 1959 Tax Act?

MR. ABBOT:

The ACLI is still alive and well. Last year, there were questions about whether this would still be true. The Steering Committee met on March 20. There seemed to be agreement on the package they had at that time, except for two areas:

1. Fair treatment of "Phase II negative" companies

2. Fair treatment for all types of companies for certain newer products such as excess interest annuities, universal life and the indeterminate premium products

Since that time the deputies, the groups under the deputies, and the teams under the groups under the deputies have been struggling to find a political solution to these remaining questions. I am optimistic that we can find a package around which the industry can rally. The alternative to reaching agreement among ourselves and taking a coherent, consistent, agreed upon package to the government is disaster. If, as an industry, we go into Congress as a divided body, the ACLI package would be defeated. Everybody's package would be defeated. There are significant risks that every segment of the industry, including our policyholders, would end up paying more tax than it is paying today.

MR. THOMAS G. KABELE:

What is the Treasury's thinking on the new types of non-participating products with indeterminate premium and indeterminate benefits?

MR. ABBOT:

The E. F. Hutton ruling is the latest indication of what the IRS is thinking about the universal life type of product. However, the ruling leaves many unanswered questions on the company tax side. To my knowledge, there are two rulings pending on the non-participating indeterminate premium product.

In one of them, the company has agreed to tie the adjustment in premium to standard external indexes, such as a bond index for the interest rate and a mortality index for the mortality rate. The latest indication is that the IRS will rule that the difference between the maximum premium and the premium charged to the policyholder would not be a dividend. The other pending ruling request deals with a product that does not have the mortality and

interest rate tied to external indices. That company has not heard from the IRS. I am not aware of any other rulings pending on non-participating indeterminate premium products.

MR. GILBERT W. HART:

In Pete Plumley's paper, he said that he limited himself to theoretical considerations. It has been my feeling from watching what has been happening at the ACLI for the past year that Pete's paper may be the only place where theoretical considerations are being considered. Gordon, I know in 1976 and 1977 various Canadian companies were not getting along, but in general, the Canadian companies and the government put together a package that is very sensible. Is the make-up of the industry different in Canada than in the U.S.? Why when developing legislation in Canada does there seem to be less of the building of a monster in the tax law than what we have in the U.S.?

MR. JOHNSON:

Before the tax changes of 1978, we wondered if the Canadian Life Insurance Association was going to fall apart completely. The attitude between resident and non-resident companies, stock and mutual companies, big and small companies was a major problem. The heat of some of that debate and the charges and counter charges were very serious. What happened ultimately was that it scared everybody. It made everybody get down to brass tacks and try to do something about the anomalies in the pre-1978 tax law.

Also, we owe much to Dr. Ed Nufeld who is now with the Royal Bank of Canada. Ed Nufeld was the economist in the Department of Finance who was responsible for tax policy when the 1978 changes were made.

Another difference is that the government in Canada is more concerned with equity within the insurance industry and also among insurance companies and other financial institutions than it is with the magnitude of tax revenues. The government feels that the 1978 changes achieved this equity.

MR. GREENBERG:

Many companies in Canada felt that the 1978 amendments which used the cash value floor as the absolute minimum reserve standard favor the mutual companies. As I understand it, there was some acrimony regarding this issue. Analogous to this are our issues in the U.S. regarding excess interest, annuities and indeterminate premium products. How did you come to a consensus on the cash value floor when so many companies had conflicting interests?

MR. JOHNSON:

This issue was resolved because of the involvement of the Superintendent and his staff. The Superintendent had a very strong position that a cash value is needed for everything and that the cash

value floor must be in place. Also, Revenue Canada depends on the Department of Insurance to certify all actuarial items in the tax return. Therefore, Revenue Canada does not challenge the use of the cash value floor for tax purposes.

MR. ROBERT T. SMITH:

The U.S. insurance industry has much to learn from the Canadian experience. In 1977, Canada went through very similar changes to what the U.S. is trying to accomplish now. The cash value floor was not as big an issue as that of what assumptions to use in valuing policies. Assumptions for participating and non-participating products differ greatly.

One of the reasons that Canadian companies got together is that there is not the difference between stock and mutual companies in Canada that exists in the U.S. Mutual companies in Canada sell par and non-par insurance and so do stock companies. The acrimony in Canada was not between mutual and stocks. It was between resident and non-resident companies. The resident companies felt that the non-resident companies had a significant advantage. The non-resident companies agreed to bite the bullet. However, all companies got hit with a reserve change which was quite arduous. The tax reserve basis was changed from net level premium to full preliminary term.

I want to warn the ACLI that even though you as an industry may be able to come together, the government might not see things as you hope they will, and they might impose significant changes on you. The 818(c) is one obvious thing that the government might remove.

The Canadians finally came up with a reasonable tax method. Mr. Plumley, whey can't the U.S. use Canada's tax system? To summarize it briefly, we are taxed as follows:

1. Profits are taxable with a deferral for acquisition expenses since preliminary term reserves are used.

2. Dividends are deductible.

MR. PLUMLEY:

The U.S. has a different competitive mix than Canada does. Also, it would be difficult for us to change from our current tax system to that used in Canada. Finally, we have a quite different political process in the U.S. The Canadian political process is a much more cooperative one between industry and government.

MR. RICHARD L. HALL:

At the opening session, Chuck Rohm showed a slide that said; "We have these public issues. We face them as individuals, employees and as professionals." How should we react to these problems as professionals? How should this organization react? What is our forum as professionals?

MR. PLUMLEY:

It is difficult for a professional who is also an employee to step back and publicly take an impartial position when such a position would hurt that person's company. Also, there is a limit on what we can do as professionals in this area because once we get beyond a certain point, we are dealing with a political process. It is at this point that we lose our professional approach.

MR. JOHNSON:

In Canada, groups of actuaries have private discussions in which they sort out some of their basic principles. They also have had a strong influence on the legislature in determining the theoretical and conceptual formula basis for the tax laws. For example, in the 1969 Act, Ted Harlem, an actuary from Great West, was one of the prime architects of the two simultaneous equations for the business income and the investment taxes. However, I do not think actuaries in Canada have been able to separate themselves and express their view, and I do not know how that might be achieved.

MR. ABBOT:

To sum up this discussion, I would like to quote a friend of mine who was involved in the deliberations on the 1959 Tax Act. He said that wherever the industry as a whole was united on a provision, the Congress accepted it. Wherever the industry was divided, somebody else made the choice.

That is why I welcome and encourage the large amount of debate that is going on within the industry today. This is the way we will be able to unite around something that we can, and will, sell because we have the ability to do so.