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UNIVERSAL LIFE AND INDETERMINATE PREMIUM PRODUCTS AND POLICYHOLDER DIVIDENDS

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ABSTRACT

This paper was written to demonstrate that universal life and indeterminate premium products are similar to participating plans. For federal income tax purposes, "dividends and similar distributions" are asserted to include any benefit or premium reduction that is not fixed in dollars and cents at issue. Arguments that excess interest and indeterminate premium reductions are *not* dividends (or "similar distributions") are rebutted, and arguments that they *are* dividends are advanced. The paper challenges alternative tax treatments of excess interest credits and premium reductions (such as direct reserve increases, portions of assumed interest, interest-paid amounts, or return premiums) and argues that "add-on" features (such as outside bond indexes and advance guarantees) do not preclude dividend treatment for tax purposes. It also investigates reserve and policyholder tax questions.

Tax increases on companies selling universal life and indeterminate premium products are not suggested. It is hoped that this paper will encourage companies to unite in the goal of a full tax deduction for policyholder dividends of stock companies and a reasonable deduction for mutuals.

I. TAXATION OF UNIVERSAL LIFE AND INDETERMINATE PREMIUM PRODUCTS—THE POLICYHOLDER DIVIDEND ISSUE

Since 1959, life insurance companies have been taxed under a complicated formula involving four major categories. Life insurance companies that sell participating products are usually in the "phase 1" category; their tax base is an artificial quantity called "taxable investment income." Smaller stock companies are usually in the "phase 2 negative" category

and are taxed on profits, except that they are unable to utilize certain special deductions, including policyholder dividends. Larger stock companies that emphasize credit, term, or group insurance are typically in the "phase 2 positive" category and are taxed 50 percent on the artificial base of "taxable investment income" and 50 percent on profits. Companies that emphasize group accident and health business are taxed as casualty companies, with profits as a tax base, full exclusion for tax-exempt interest, and full deduction for policyholder dividends.

In recent years this complicated tax law has become the dominant factor in the pricing of permanent products. Phase 1 companies pay more tax if they use conservative actuarial assumptions. Inflation has raised both interest income and expense, but the former is fully taxed while the latter is not deductible. Most participating companies now are paying effective tax rates of 60–80 percent of "profits." Phase 2 positive companies may find themselves subject to a whipsaw effect. In good years they pay a tax on profits, but in bad years they slip into the phase 1 category and are unable to deduct the losses. Casualty companies have limited capacity to establish life reserves.

Phase 2 negative companies face large tax penalties for selling participating products because policyholder dividends are not deductible. This is unfortunate because smaller stock companies could use the marketing edge provided by participating products, and need to shift some of the risk to policyholders.

For many life insurance companies today, income tax is the most important factor in marketing and designing products. Interest, mortality, lapse, and expense assumptions are secondary. Tax considerations determine which companies can sell which products, and the tax law has become a Sherman Anti-Trust Law in reverse.

To increase their market share and avoid the tax disadvantages of the phase 1 tax, many stock companies have turned to universal life, indeterminate premium, and indeterminate benefit products. These products are called "nonparticipating" but they involve nonguaranteed elements—either benefits or premium reductions. The indeterminate premium product has a guaranteed maximum premium and a "current" premium that is lower. The indeterminate benefit product has a guaranteed death benefit or cash value and a "current" death benefit or cash value that is higher. The universal life product credits nonguaranteed "excess interest" on the cash value.[1]

[1] "Univeral life" includes any general-account life insurance product that is called "nonparticipating" and credits "excess interest." This includes "irreplaceable life," which has fixed contractual premiums.

These products help stock companies avoid deficiency reserves and give them the marketing advantage of participating products. Several questions may be asked, however:

1. Is the excess interest a policyholder dividend?
2. Is the difference between the current and maximum premium a policyholder dividend?
3. Is the nonguaranteed additional benefit a policyholder dividend?

If the answers are yes, then a phase 2 negative company issuing the policies is subject to the same taxes as a company issuing regular participating products. These taxes could even bankrupt such a company. The discussion will focus mainly on universal life contracts, but the issues are similar for the other two products.

A. *Arguments to Justify Nondividend Treatment*

Because the dividend treatment has such detrimental tax consequences for phase 2 negative companies (including subsidiaries of mutual companies), many have developed arguments to justify nondividend treatment. These are rebutted below.

1. DIVIDENDS ARE RETROSPECTIVE, WHILE PREMIUM REDUCTIONS ON INDETERMINATE PREMIUM PRODUCTS AND EXCESS INTEREST ON UNIVERSAL LIFE PRODUCTS ARE PROSPECTIVE

Actually, dividends are *both* prospective *and* retrospective in nature. For administrative reasons, dividends usually are determined one to two years in advance and, on December 31, are guaranteed until the next policy anniversary. Virtually no mutual company would pay large dividends from accumulated surplus in the face of prospective sharp declines in earnings. In fact, when interest rates declined in the 1930s and 1940s, many companies cut future dividends and strengthened reserves even though surplus was adequate, measured by past experience. Some companies even use prospective gross premium reserves to calculate dividends. For example, in "Modern Applications of Gross Premium Valuation to Participating Insurance" (*TASA*, XLIX [1948], 8), Bert Winter said: "There is a need for a standard [i.e., a prospective gross premium valuation] equally applicable to old and new issues to guide us in determining what earnings to return (whether in statement reserves, special reserves or unassigned surplus) to meet policy obligations that will arise in the future, and what earnings may properly be distributed in dividends."

C. L. Trowbridge, in "Theory of Surplus in a Mutual Insurance Organization" (*TSA*, XIX [1967], 265), also reported that his company, Bankers of Iowa, used prospective gross premium reserves to determine dividends. E. F. Estes determined dividends by a prospective asset share method (*RAIA*, XXI [1932], 20). Using prospective assumptions with a profit and contingency allowance, he calculated a level dividend and converted it to an increasing scale by using geometric progressions.

The 1981 *Recommendations of the Committee on Dividend Principles and Practices*, published jointly by a committee of the American Academy of Actuaries and the Society of Actuaries, specifically says that "experience of a factor class means such experience and *trends in experience* to the extent they are determinable, available and statistically credible" (emphasis added). Robert Jackson, in his landmark paper "Some Observations on Ordinary Dividends" (*TSA*, XI [1959], 771, 776) also refers to "trends."

a) Universal Life Is Really Retrospective

The distributions on some universal life, indeterminate premium, and indeterminate benefit policies are really more retrospective than prospective. There is little future risk to a "current interest" rate of 8 percent for one or two years if all the reserves already are invested in United States Treasury bonds at 11 percent. In this case, the 8 percent current rate is based on *past* investments, even though the money will be paid in the near future.

Some of the formulas used for indeterminate premium and universal life products are almost wholly retrospective. The premium reductions and excess interest credits are based on the investment-year method, or even an "investment-week method." Under these methods, the current interest rate reflects the long-term rates when the money was received. Two persons who purchased policies at different times will not receive the same premium reduction (or excess interest credit), even though their cash values and reserves are identical.

Finally, the cash-value formula used for universal life products is referred to as the "retrospective formula" or the "asset share accumulation" by Maurice LeVita (*PCAPP*, XV [1965], 58) and in recent letters to the NAIC by the chief actuary of the California State Insurance Department, John O. Montgomery.[2]

[2] For additional information on many of the works cited in this paper see the Bibliography.

b) Earnings and Surplus Are Partly Prospective

Some say that dividends are retrospective because they are distributed from surplus. Actually, life insurance reserves (which are 90 percent of total liabilities) are best computed by *prospective* formulas. Hence, surplus, which is assets less liabilities, is partly prospective. Also, earnings, which are affected by the "increase in reserves," are partly prospective. The Society of Actuaries study note on "Nonforfeiture Values," indicates that "reserves should be . . . in the aggregate at least as large as the excess value, as viewed *prospectively*, of the benefits for which the company is liable or may expect to pay, over the premiums it may expect to receive. Nonforfeiture values, on the other hand, . . . represent equitable values to which individual policyholders are entitled upon withdrawal, in the light of both *past* and estimated *future* conditions" (emphasis added).

Section 801(b) of the Internal Revenue Code also uses a *prospective* definition of reserves. (See the reference to "future unaccrued claims.")

c) Prospective Pricing Cannot Be Enforced

State regulations on both universal life and indeterminate premium products require prospective pricing assumptions. However, past losses can be made up from increases in the future profit margin or by more conservative assumptions. More conservative prospective assumptions may even be justified by past experience. Further, round numbers can be used to hide conservative assumptions. For example, 10 percent interest and 70 percent mortality might be used in place of best-estimate assumptions of 10.05 percent and 69 percent, respectively. Finally, if a company became impaired, it is doubtful that the states (mindful of their own guarantee funds) would allow liberal prospective assumptions.

It may be concluded that the difference between "prospective" and "retrospective" is largely a matter of semantics.

2. STATE INSURANCE DEPARTMENTS CATEGORIZE THE PRODUCTS AS NONPARTICIPATING

State regulations on indeterminate premium products are not very favorable for stock companies. The distinction in the regulations is not between nonparticipating and participating but between "guaranteed cost" and "nonguaranteed cost." New York, for example, allows mutual companies to sell indeterminate premium products, even though they cannot sell nonparticipating products. Some states have said that for purposes of calculating deficiency reserves, the maximum premium is to be used (*RSA*, VI, No. 2 [1980] 331). This means that the maximum premium has

real economic impact and is not just fiction. It could be argued that this same premium also could be used to measure dividends.

3. EXCESS INTEREST IS ACCRUED RATABLY, WHILE DIVIDENDS ARE NOT

Most companies pay pro rata dividends on death but not on lapse. In any case, most lapses occur at the end of the year, and these receive the full dividend.

4. DIVIDENDS HAVE A CASH OPTION WHILE EXCESS INTEREST AND PREMIUM REDUCTION DO NOT

Industrial policies, which are the exception, are *not* required to have a cash option, and most industrial dividends are credited as a payment of so many weeks' premium, or as a paid-up addition. In the United Kingdom, the principal form of distribution is the reversionary bonus or "paid-up addition" plan. Cash dividends are relatively rare.

The premium reductions and the excess interest credits on indeterminate premium and universal life products are not paid in cash, but they have an easily measured value and are virtually equivalent to cash.

Those citing the supposed importance of the cash option often refer to Regulation 1.811 of the Internal Revenue Code, which refers to dividends as "amounts returned to policyholders." They admit that nothing is returned to policyholders on a noncash dividend option, but claim that the cash option dividend is "constructively returned." Actually, in Regulation 1.811, dividends "include," rather than "are limited to," any "amounts returned to policyholders." Although a policyholder has a "cash option" on his surrender value, no one has ever claimed that this implied constructive receipt. Similarly, there is no constructive receipt of a dividend credited to the policyholder under a noncash option.

If noncash dividends are not "returned," then only dividends paid in cash would be considered dividends, and mutual companies (and the many stocks selling participating policies) would have overpaid their taxes from 1958 to 1981 by several billion dollars. Obviously, the "amounts returned" in Regulation 1.811 refers to "economic benefits provided policyholders."

5. UNIVERSAL LIFE AND INDETERMINATE PREMIUM PRODUCTS ARE ISSUED BY STOCK COMPANIES, WHICH SHOULD BE PERMITTED TO DEDUCT CUSTOMER DISCOUNTS

The type of company issuing the product is irrelevant. Further, some phase 2 negative mutual companies and subsidiaries of phase 1 mutuals are selling "excess interest" products, while many stock companies are

selling traditional participating policies. Some phase 1 mutual companies are even selling indeterminate premium products.

6. THE AMOUNT OF INTEREST THAT CAN BE COMMITTED PROSPECTIVELY IS NOT LIMITED TO THE SURPLUS OF THE COMPANY

The total excess interest paid under a universal life contract from inception to maturity may be greater than that policy's share of total surplus. Likewise, the total face amount at risk is many times the company surplus. The reserve for the death benefits and the reserve for the excess interest, however, are much less.

The total excess interest payable in the following year may be greater than the year-end surplus. It is argued that this "proves" that excess interest is not a dividend, because if it were, the dividend liability would make the company insolvent on a statutory basis. Since the states have not claimed that the company is insolvent, the excess interest is not a dividend.

There are a number of answers. First, some mutual companies set up only one-half of the annual dividend, on the assumption that only one-half is "earned" on December 31 (Robert Posnak, *GAAP, Stock Life Insurance Companies,* p. 175). The universal life companies put the "earned" part of excess interest into their benefit reserves, so there is no need to reflect it in the dividend reserve. Second, the excess interest may be guaranteed only "until changed" or only 90 days in advance, so there is no need for *any* reserve. Third, if excess interest is guaranteed one or more calendar years in advance, the entire present value is included in the benefit reserve. Fourth, the states may yet declare some companies insolvent for excess interest liabilities. The excess interest may also be discounted for death, interest, and persistency, but so are the dividend reserves held by some mutual companies.

7. DIVIDENDS ARE AN ALLOCATION OF SURPLUS, WHILE EXCESS INTEREST CREDITS AND INDETERMINATE PREMIUM REDUCTIONS ARE NOT

Dividends do reduce surplus. When dividends are paid in cash, the company assets are reduced. When dividends are applied as premium reductions, the premium income is reduced; and when dividends are applied as paid-up additions, the reserve increases. In all cases, surplus is reduced.

Similar results are obtained for universal life and indeterminate premium products. Surplus is smaller than it would have been if the premiums had not been reduced or if the excess interest had not been credited.

8. REVENUE RULING 69-444 IMPLIES THAT EXCESS INTEREST IS NOT A DIVIDEND

This revenue ruling dealt with additional accidental death benefits granted on old policies. The ruling merely said that the additional reserve was not a "change in basis"; it was silent on the dividend issue. It is likely that the company receiving the ruling was in tax phase 1 or 2 positive, so that the dividend issue was moot.

9. THERE IS NO PREMIUM REDUNDANCY INVOLVED IN EXCESS INTEREST

Actually, there is an interest rate redundancy. The guaranteed cost of a universal life product is as redundant as the guaranteed cost of a traditional participating contract. Furthermore, some universal life contracts return nonguaranteed mortality and expense savings. These contracts use precisely the same three-factor source-of-earnings formula that has been used by mutual companies for over a century.

10. DIVIDENDS ON PARTICIPATING POLICIES DEPEND ON THE "EXPERIENCE OF THE COMPANY," WHILE EXCESS INTEREST CREDITS AND INDETERMINATE PREMIUM REDUCTIONS DO NOT

Regulation 1.811, defining dividends, uses the shorthand phrase "experience of the company." Some have interpreted this to mean that dividends are based on the "experience of other clients or the overall profit and loss of the company itself," while excess interest or rate credits are based on intercompany experience or the experience of a class or a single policy. Actually, as is demonstrated below, dividends usually are based on the experience of a class or a single policy, and sometimes even on intercompany experience. A participating policy "participates" in earnings reasonably attributable to its own contribution, not in the earnings generated by "other clients" or in the overall earnings of the company. The average experience of the entire company may be used to calculate a particular experience factor, but that does not mean that the company takes profits from one class of policyholder and distributes them to another class by design. The average experience is used merely to provide statistically credible results. The whole point of a participating policy is to provide insurance at cost.

a) Supreme Court Cases

The "insurance at cost" view is supported by two early Supreme Court cases on dividends, including *Mutual Benefit* v. *Herold*, decided under the 1909 law, and *Penn Mutual* v. *Lederer*, decided under the 1913 law. In these cases, the companies won the right to deduct dividends in computing taxable income precisely because the purpose of dividends was to provide insurance at cost.

b) Rhine Case

Rhine v. *New York Life* also supports the "insurance at cost" position. The company used classes only for practical reasons. The decision indicated that "the apportionment must be based upon calculation of the *actual cost* of furnishing the insurance which the company provided for that *particular* policyholder. . . . The defendant in applying the 'contribution' method does not attempt to determine exactly the proportion which *each policyholder* has contributed to the divisible surplus. That would not be practicable for reasons set forth in the agreed statement of facts" (emphasis added).

c) State Laws and Regulations

Mutual companies are prohibited by New York law from using the profits from one class of policyholders to subsidize another class. In fact, states have prohibited stock companies issuing so-called "charter policies" that promised policyholders a share of the total profits from other clients. In New York, mutual companies cannot issue nonparticipating whole life policies.

d) Company Practice

Mutual companies rarely use the experience of the entire company to determine any dividend factor. Virtually every company separates the experience by line of business. Some of the smallest companies use intercompany data within the ordinary line. Furthermore, almost all companies divide their experience (with respect to interest, mortality, lapse, and expense) by *class*. For example, the mortality experience may be separated by valuation basis, by term versus permanent, by smoker versus nonsmoker, and by underwriting type (standard versus substandard). Interest may be divided by valuation base and by policy loan rate; some companies (notably the Equitable) follow the practice of some universal life companies and use the "investment-year method."

e) Actuarial Literature

The contribution dividend formula was described by its coinventors, Sheppard Homans and David P. Fackler, in *JIA*, Vol. XI (1863), and also in their 1868 letters to the Massachusetts insurance commissioner. In his letter, Fackler specifically refers to "class" and *not* to the overall profit and loss of the company itself. For excess interest, Sheppard Homans refers to the experience of "each person" and not to the experience of other clients: "Thus, we see that each person derives the full benefit . . . from the excess of interest on that *portion of the assets of the company*

belonging to himself exclusively, namely *the value of his policy, the same having been reserved from his own previous payments*" (emphasis in original).

The individual theory of dividend distribution also was employed by James Dodson, the inventor of the whole life policy and a founder of the Equitable Society (United Kingdom). (His work is described by Robert Henderson in his presidential address to the American Society of Actuaries, *TASA*, XXIV [1923], 292.) Dodson proposed to allocate surplus by taking into account actual premiums received at compound interest and deducting the face amount. In effect, Dodson's formula was a 100 percent credibility formula applied to each individual. Later modifications used the reserve instead of the full face amount. Sheppard Homans's original formula is a direct descendant of this modification.

Harlow Staley, in his discussion of Robert T. Jackson's paper (*TSA*, XI [1959], 801), has commented, "As regards premiums, any distinction in possible loss made at the time of issue of a contract would seem to be justified without defeating the insurance principle even if, as it sometimes does, it puts the policyholder in a *class by himself*" (emphasis added).

f) Conclusion

The phrase "company experience" in the income tax regulation is shorthand for the experience of the policyholder, a class of policyholders, the company, a group of companies, the nation, or any experience that is used to measure the earnings reasonably attributable to a policyholder. The assertion that dividends reflect "overall profit and loss" and "experience of other clients" is false.

11. THE COMPANY NEVER RECEIVES THE MAXIMUM INDETERMINATE PREMIUM

Only the difference between the gross premium and the dividend may be collected on traditional participating policies. In fact, some states may prohibit a company from lapsing a policy if the dividend is sufficient to cover the premium.

12. INDETERMINATE PREMIUM REDUCTIONS OCCUR AT THE BEGINNING OF THE POLICY YEAR WHILE DIVIDENDS ARE PAID AT THE END OF THE YEAR

The payment of dividends at the end of the year was one of the reforms suggested by the Armstrong Commission. Mutuals used to make the dividend contingent upon payment of the next year's premium (section 216 of the New York Insurance Law still allows companies to make the first-year dividend contingent upon payment of the second year's premium).

Also, some stock companies pay dividends at the beginning of the year on group term and single premium immediate annuity policies.

B. *Arguments to Justify Dividend Treatment*

Historical and logical reasons suggesting that indeterminate premium and universal life products are participating and involve dividends for tax purposes are discussed below.

1. RISK

Indeterminate premium policies and universal life, like regular participating policies, shift the risk of premium or interest changes to the policyholder. This is true even if the premium or interest is tied to an outside bond index.

2. MARKETING ADVANTAGE

Indeterminate premium products and universal life, like regular participating products, have a marketing advantage over "guaranteed cost" products. That is, through sales illustrations the policyholder is led to expect benefits or premium reductions that are not guaranteed in dollars and cents at issue.

3. NONGUARANTEED ECONOMIC BENEFIT

Excess interest credits and indeterminate premium reductions (like dividends) are economic benefits to policyholders that are not guaranteed in dollars and cents at issue.

Annual benefits or premium reductions that are fixed in dollars and cents at issue are called "coupons" (also called "guaranteed dividends" or "guaranteed premium reductions" or "guaranteed annual pure endowments"). The distinction between dividends and coupons was given in the 1934 case of *Commissioner* v. *Great American Life Ins. Co.* The court said that "these coupons, like the surrender values, fix an obligation upon the company the moment the policy is issued. Dividends grow out of a policy, but are not a part of its obligations."

The distinction between coupons and dividends is recognized in the annual statement where coupons are shown as a separate column in Exhibit 7. IRS regulations also recognize the distinction; the definition of "return premium" (another name for coupon) is simply the negative of the definition of dividend. Furthermore, the standard valuation and nonforfeiture laws recognize the distinction between dividends and coupons. Future coupons affect guaranteed cash values, which future illustrated dividends do not.

It is impossible to consider excess interest not guaranteed at issue to be a coupon, since the amount to be credited is not known at issue.

4. BROAD REGULATIONS DEFINING DIVIDENDS

The tax regulations defining dividends are very broad. Regulation 1.811 of the Internal Revenue Code states that "dividends to policyholders mean dividends and *similar distributions* to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is *not fixed in the contract* but depends on the experience of the company or the discretion of management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which, during the taxable year, contains the right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to *either* a participating *or* a nonparticipating contract shall be treated as a dividend to policyholders, if such amount depends on the experience of the company" (emphasis added).

The second sentence of the regulation gives the three familiar tests. The most important test is "not fixed in the contract." Based on congressional testimony, this test can mean only "not fixed in dollars and cents at issue." The other two tests are subsidiary. They prevent companies from avoiding the dividend limitation by "guaranteeing" to credit whatever the board decides, or "guaranteeing" to base dividends on the variable experience of policyholders. (In the old tontine period, some companies actually "guaranteed" future dividends, subject to board action. Of course, many of the tontine companies did not pay off despite the "guarantee." The dividends of the first mutual, the old Amicable, were "guaranteed" subject to the variable experience of policyholders.

The third sentence of Regulation 1.811, which covers participating contracts, is very broad; it refers to "any payment not fixed in the contract." There is no mention of "retrospective" or "prospective."

The fourth sentence covers nonparticipating contracts and apparently was designed to include group experience refund contracts, which are also mentioned in New York Law section 216 on dividend distribution. In 1959, the only other nonparticipating contracts were "guaranteed cost." The regulation is meant to apply with equal force to both participating and nonparticipating contracts.

With this broad regulation, it may be hard to avoid dividend treatment for any nonguaranteed premium reduction or benefit.

5. NONPARTICIPATING MEANT "GUARANTEED COST" TO CONGRESS

In the 1959 House and Senate hearings, nonparticipating meant "guaranteed cost." A score of such references equating the two terms may be cited; several are given below. Certainly, indeterminate premium and universal life contracts are no more guaranteed cost than are regular dividend policies.

Deane C. Davis, president of National Life of Vermont, said: "It is true, however, that stock companies issuing *guaranteed cost* insurance under which there are no dividends paid to policyholders, would have no opportunity to adjust net gains from operations by increasing dividend distributions" (House hearings, p. 189; emphasis added).

H. Lewis Rietz of Great Southern Life Insurance Company testified: "So the loss in surplus in the stock companies that were on a *fixed and guaranteed* premium basis . . . was much more substantial relatively than it was in mutual companies who had the higher premiums and the right to change their dividend patterns on all business" (Senate hearings, p. 214; emphasis added).

Manton Eddy of Connecticut General indicated that "stock companies must *guarantee rates* for the life of the contract. . . . During the 1930's we suffered because of a decline in interest rates which continued also through the next decade. We also had several capital losses in those years and we had losses on account of disability provisions which had been issued at *guaranteed rates*, which proved to be inadequate. We had *guaranteed rates* for life insurance which could not be increased" (Senate hearings, pp. 478 and 481; emphasis added).

Claris Adams of the American Life Convention explained that "the [stock] company then *guarantees this rate* for the life of the contract. It assumes the risk of the transaction and pledges its capital to the performance of the contract" (House hearings, p. 52; emphasis added).

The description of Bill 13707 stated that "the insuring public therefore has a choice—a *guaranteed cost* which is particularly attractive over the immediate short range at issue, or a more attractive long range cost without any *guaranty* other than the full participating premium" (House hearings, p. 140; emphasis added).

Today, companies issuing indeterminate premium products and crediting excess interest on universal life certainly are able to protect themselves from future worsening of experience, such as a decline in interest rates. Their current premiums and cost of insurance definitely are not guaranteed for the life of the contract. The new products are no more guaranteed cost than are regular participating plans.

6. NONDIVIDEND TREATMENT WILL ERODE REVENUES

If universal life (and indeterminate premium) contracts receive a full deduction for nonguaranteed excess interest credits and premium reduc-

tions, while similar participating products receive a less favorable tax treatment, we can expect traditional participating products to be replaced, rewritten, or updated by the tax-favored products. These updates would cut tax revenues drastically. Assuming that dividends are 70 percent deductible under the 1959 law, and assuming that there are $10 billion of policyholder dividends, the loss could approach $1.4 billion. Under a "doomsday" scenario, companies that did not or could not update or rewrite their products into tax-favored vehicles could be facing insolvency. (The replacement threat is even greater for traditional guaranteed cost business than it is for participating business.) Such alarming developments are sure to produce changes in the tax law or adverse court decisions. Furthermore, such unfair treatment is not in line with congressional intent to provide proper "balance."

7. THE ACTUARIAL LITERATURE SUPPORTS DIVIDEND TREATMENT FOR INDETERMINATE PREMIUM PRODUCTS

The actuarial literature is important because the tax laws have been designed by actuaries. For example, E. E. Rhodes, chief actuary for the Mutual Benefit, was a consultant on the 1913 act, and developed the 1921 formula. Walter O. Menge, F.S.A., chief executive officer of the Lincoln National, was chairman of a task force that developed the phase 1 and phase 3 formulas of the 1959 act.

Indeterminate premium and benefit products are not new. According to a paper by G. F. Hardy (*JIA*, Vol. XXXI), they were invented by the Scottish Amicable in 1854. There were two variations: either the sum assured could be reduced or the premium could be increased.

The participating nature of "discounted-bonus" policies (alias indeterminate premiums) was spelled out clearly in two papers written by Henry Moir. In the first paper, Moir was concerned about the equity of the "two classes of participating policyholders" and consistency among "three classes of policies" (meaning regular participating, discounted-bonus, and nonparticipating guaranteed cost) (*JIA*, XXXVI, 19, 21). In the second paper (*TFA*, II, 255), he discussed "policies affected with profits" (that is, participating policies). One of the three types of participating policies was the discounted-bonus variety; the other types were the reversionary addition system (a United Kingdom method) and the "contribution plan" (a United States method).

Lochhead, in *Valuation and Surplus* (p. 45), also refers to discounted-bonus policies as one of the "two classes of participating business."

8. THE ACTUARIAL LITERATURE SUPPORTS DIVIDEND TREATMENT FOR INDETERMINATE BENEFIT PRODUCTS

The indeterminate benefit version of the discounted-bonus product was reinvented by Norwegian actuaries in 1918. The Norwegian bonus system provided for nonguaranteed paid-up additions to the face amount and was described by the actuary Ivar Hesselberg in the *Transactions of the Ninth International Congress of Actuaries*, IV (1930), 321. He said: "According to this system, the amount insured is from the issue increased with an addition calculated on a secondary basis chosen so as to correspond to the real facts as much as possible. The addition is fixed in such a way that it may be expected that the company will be able to maintain it during the whole insurance period, but the company only guarantees it for one year at a time."

At the same International Congress, there was a lengthy discussion about the relative merits of participating and nonparticipating contracts. Various actuaries came up with new product designs. One actuary proposed the indeterminate premium approach with management discretion reduced by having the premium change rules "sanctioned by the King." The premiums were determined in advance for each *ten-year* period, and the maximum premium was fixed at issue.

Another actuary proposed a method that would translate high interest rates into premiums for additional insurance. The moderator of the discussion, the Swedish actuary K. G. Hagstroem, said that both forms were really *participating* contracts.

9. THE ACTUARIAL LITERATURE SUPPORTS DIVIDEND TREATMENT FOR UNIVERSAL LIFE

The actuarial formulas for universal life are virtually the same as those that mutual companies use in calculating dividends. The dividend formulas were derived over a century ago by Sheppard Homans and David Fackler. For example, the total interest credited on universal life is calculated by multiplying the policy fund (or cash value) by the current interest rate. The same approach was suggested by Homans. In universal life, the cost of insurance is found by multiplying the current mortality rate by the net amount at risk. The same aproach was suggested by Homans. In universal life, the policy fund is calculated by a retrospective formula. The same approach was suggested by Homans in his 1868 letter to the Massachusetts insurance commissioner, reprinted in *RAIA*, XI (1922), 120–21.

There are two types of universal life contracts. In type A, excess interest is added in equal amounts to both cash values and death benefits. In type B, excess interest is added only to cash values and not to death benefits.

The total-cash-value formula for either type can be derived by using Homans's contribution dividend formula. In fact, for type A, the total cash value equals Homans's "dividend fund" plus the reserve for dividend accumulations.

Some universal life contracts return mortality and expense savings as well as excess interest. These are the same three factors used by Homans and Fackler in the contribution dividend formula (see Appendix B). Since universal life and participating whole life are based on the same formulas, should they not be taxed in the same manner?

Many universal life contracts use flexible premiums and de-emphasize plan. These policies are similar to the participating adjustable life products sold by Bankers of Iowa and Minnesota Mutual (see W. Chapin, *TSA*, XXVIII [1976], 237, and C. L. Trowbridge, *CLU Journal*, 1977). In place of the retrospective cash-value formula used to calculate minimum cash values, adjustable life uses an algebraically equivalent prospective formula. (The prospective reserve is equivalent to the retrospective if both reserves are based on the same assumptions and if the starting and ending values are the same [see Appendix C].) Thus the retrospective formula is really an improvement in readability rather than in substance.

Furthermore, the automatic dividend option on the Bankers of Iowa policy is the only option for excess interest on universal life type B. C. L. Trowbridge of Bankers Life called this the "policy improvement option." It is similar to the old "accelerative endowment option."

10. PHANTOM PREMIUMS ARE TRADITIONAL IN INSURANCE ACCOUNTING

The real cause of the tax problem on indeterminate premium and universal life contracts is not the dividend but the matching premium (which is necessary to make the accounting debits and credits balance). Some stock company actuaries have called these "phantom premiums." On indeterminate premium products, the "phantom" is the difference between the maximum and the current premium, and on universal life it equals excess interest. These phantom premiums are real enough, however, when they are shown to the states to compute the cash values, the basic reserves, and the deficiency reserves on indeterminate premium contracts. Further, Henry Moir and other actuaries specifically have suggested "phantom" premium accounting.

According to R. D. Murphy (*TASA*, XV [1914], 330, 332), the phantom premium and dividend show "the payment of the dividend by the company and its return to the company for the purchase of insurance." Also, they enable the company to keep track "of what the company apportioned as dividends and what its gross renewals amount to." The phantom premium has been used by companies selling participating products for well over

a century (see C. O. Shepherd, *RAIA*, XXVI [1937], 121, 140).

There is precedent in general accounting for booking the gross price and a "cash discount" separately. Cash discounts are provided to encourage purchases. Likewise, dividends, excess interest credits, and indeterminate premium reductions also are used to encourage future payments. It might be argued that excess interest and indeterminate premium reductions are "trade discounts" (which, in general accounting, are netted against the gross price), but if these are trade discounts, then so are dividends. Even if traditional dividends, excess interest, and indeterminate premium reductions are trade discounts under general accounting theory, they cannot be netted against phantom premiums under 1959 income tax law. Under the 1909 "excise tax" law, companies were able to net noncash dividends against phantom premiums, but this does not seem possible under the 1959 act.

The phantom premiums have caused mutual companies to pay very high taxes since 1958. If the stock companies win their current phantom premium argument, no company will be subject to the artificial phase 1 tax.

C. *Alternatives to Dividend Treatment for Excess Interest*

This section discusses the commonly mentioned alternatives to dividend treatment for excess interest. (There are similar alternatives for indeterminate premium reductions.) It is shown that these alternatives are not supported by the current tax law.

1. TREAT EXCESS INTEREST AS A DIRECT RESERVE INCREASE

Under this theory, the excess interest causes an increase in the cash value and reserve, but there is no dividend or offsetting phantom premium.

Some who hold this view cite the "eastern mutual" industrial update, in which small policies were converted to paid-up status, or the "midwestern mutual" update, in which the face amount was increased with a concomitant increase in the reserve interest rate. It is true that there were increases in benefits after the updates. It is not clear, however, that these updates do not involve dividends. Since the companies were in either tax phase 1 or tax phase 2 positive in the years of the updates, any dividend would be moot.

Furthermore, both updates were quite different from the crediting of excess interest. The eastern mutual program was nonrepeatable; its main purposes were to save a considerable amount of collection expense and to increase the benefits on small policies. The main purpose of excess interest, on the other hand, is to pass along interest savings to policyholders. The eastern mutual program did not produce increased cash

values, whereas excess interest does increase the cash value. The eastern mutual program involved an exchange; the crediting of excess interest does not involve an exchange. The midwestern mutual program was a nonrepeatable *voluntary* exchange, and there was no increase in cash value at the time of the exchange.

a) Theoretical Problems with a Direct Reserve Increase

A direct reserve increase destroys the equality of the prospective and retrospective reserves, which is a requirement that the IRS has postulated in several private letter rulings. The equivalence of the prospective and retrospective reserves is equivalent to the requirement that life insurance reserves be calculated by the net premium method. Since Elizur Wright's time, it has been traditional for life insurance companies to use net premium methods. Both the standard valuation and the standard nonforfeiture laws are based on net premium methods.[3]

Problems remain even if prospective and retrospective gross premium methods are permitted. Reserve increases (on both net and gross premium methods) come only from premiums or assumed interest. (Small increases due to the effect of survivorship are ignored.) If assumed interest is ruled out as discussed below, then the reserve increases must come from *premium*. The premium represents the value of the excess interest, and, to balance the accounting debits and credits, a disbursement, such as a policyholder dividend, is needed.

The Supreme Court, in *Helvering* v. *Inter-Mountain Life* (294 U.S. [1935], p. 688, or see Ernst & Ernst, *Federal Income Tax*, p. 32), confirmed that reserve increases result from premium payments or assumed interest. "In life insurance the reserve means the amount, accumulated by the company out of premium payments, which is attributable to and represents the value of the life insurance elements of the policy contracts."

2. TREAT EXCESS INTEREST AS INTEREST PAID, AND THE RESERVE ITSELF AS ELIGIBLE FOR THE FULL PHASE 1 RESERVE DEDUCTION

This technique was tried for some pension contracts and was specifically overruled by the courts. It does not seem possible under current tax law to "double dip"; that is, to get both a reserve deduction and an interest-paid deduction for the same risk under phase 1.

A more reasonable proposal would be to ignore reserves, and to allow an interest-paid deduction for the *total* interest credited—the guaranteed rate used to calculate minimum cash values plus the excess rate. Since

[3] The "net" premium is a premium calculated from the assumed interest, mortality, lapse, and expense assumptions used to calculate reserves. Modified reserve methods such as Commissioners, Illinois, New Jersey, Ohio, and full preliminary term are net premium methods.

universal life involves life contingencies, this treatment would seem to be ruled out under the current tax law. The proposal also discriminates against companies that pay dividends based on mortality and expense savings. The latter would be ignored or subject to the section 809(f) dividend limitation, while excess interest would be fully deductible. Congressional intent in 1959 was to provide a full deduction for mortality and expense dividends, and a limited deduction for excess interest.

3. TREAT EXCESS INTEREST AS PART OF ASSUMED INTEREST

Under this theory, the excess interest on the cash value would be added to assumed interest to compute the phase 1 Menge rule adjustment for the reserve or the required interest under phase 2. This theory eliminates the (unfair) phase 1 tax, but it increases the (unfair) disallowance of tax-exempt interest under both phase 1 and phase 2. For variable annuities, the tax law specifically sanctions this theory. Also, for fixed annuities, there is a revenue ruling (76-12-611400 B) that seems to sanction this method, although it assumes that the company would use the "current guaranteed" rate in its annual statement.

For general account life insurance products, this theory presents many problems. Under current tax law, increasing the assumed interest rate would mean a change of basis, and the change in reserve would have to be spread into income over ten years. Furthermore, even accepting that excess interest is part of assumed interest does not necessarily eliminate the dividend problem. The excess interest still produces benefit increases. The dividend and offsetting phantom premium would be equal to the increase in the cash value or reserve.

There are many other complications. Historically, in reserve calculations, the assumed rates of interest were defined at issue, while the excess interest rate changed dynamically. Furthermore, section 801(b) of the Internal Revenue Code seems to allow only the prospective or net premium method of calculating reserves, but the dynamic interest method makes sense only under the *retrospective* approach. (Actually, the Internal Revenue Service has allowed only the net premium method in some recent private-letter rulings.)

Universal life and most deferred annuity products use a retrospective cash value formula. Increases in the assumed rate *increase* the cash value. This is contrasted with prospective gross premium reserves or with net premium reserves, which *decrease* with increases in the assumed rate. (Clearly, the Menge ten-for-one rule contemplated the latter.)

Excess interest is usually a percentage of the cash value (before surrender charge), while (under the tax code) the assumed interest is a per-

centage of the reserve. For the assumed interest to make sense, the reserves and cash values should be equal. Under current statutory laws, however, the two are not equal. Furthermore, the statutory maximums for reserve interest rates are fairly low. (In 1980, typical maximums were 4.5 percent for life insurance and 7.5 percent for deferred group annuities.) The sum of the excess and minimum guaranteed interest rates on universal life contracts (and deferred annuities), however, may exceed 11 percent, or go as high as 15 percent.

The assumed-interest theory also could produce an unintentional windfall benefit to universal life companies. The phase 1 taxable investment income would be reduced nearly to zero, and those companies would become taxed on only 50 percent of their profits as phase 2 positive companies.

4. TREAT EXCESS INTEREST AS A BENEFIT TO POLICYHOLDERS THAT IS CREDITED TO THE COMPANY AS A PREMIUM

Virtually no universal life (or indeterminate premium) company actually has employed this theory, because it would have to book the excess interest (or the full maximum premium) into the premium account. This theory is a fallback position. It is based on a group refund case for which the full maximum premium *was* booked as premium and a refund was paid or credited to policyholders as a "benefit." Group refunds are fully deductible (by phase 2 negative companies), in contrast to the nondeductibility of individual policy dividends.

Actually, dividends themselves often are called premium refunds or benefits. Sheppard Homans (*JIA*, XI [1863], 122) referred to his contribution-formula dividends as "overpayments." The American Academy of Actuaries and the Society of Actuaries have defined a dividend as "a refund or return of the premiums paid" (*Recommendations of the Committee on Dividend Principles and Practices*, 1981, p. 35). Most states consider dividends as rebates for premium tax purposes (McGill, *Life Insurance*, pp. 928–29). Also, the IRS considers dividends as premium rebates or a reduction in basis for individual taxation purposes. C. D. Rich (*JIA*, LXII [1930], 266) defined a dividend as "a *benefit* produced by the margin of the premium over and above what was required to provide the basic contract" (emphasis added). GAAP accounting also treats dividends as nonguaranteed benefits (Posnak, *GAAP, Stock Life Insurance Companies*, chap. 10).

Of course, for tax purposes, dividends are *not* considered as "return premiums" or as "benefits." The difference is that dividends are not guaranteed in dollars and cents in the original contract at issue. They are

guaranteed prior to their payment (up to one calendar year in advance) but not at issue. The contribution formula is required by state laws and state insurance departments, but the *amount* is not guaranteed. Likewise, excess interest credits and nonguaranteed premium reductions are not guaranteed.

The benefit theory is difficult to reconcile with current valuation and nonforfeiture laws, which require guaranteed benefits to be *prefunded* in reserves and cash values. But excess interest that may be declared by the company at some unspecified future date, in some unspecified amount, cannot be prefunded.

5. CONCLUSION

The direct-reserve-increase, assumed-interest, interest-paid, and benefit theories are invalid. The theory that best fits current tax law is that the excess interest is an annual dividend that immediately is paid back to the company as premium.

However, there are other theories regarding excess interest that may have a more adverse tax impact than dividend treatment. The following discussion of these theories does not constitute an endorsement of them.

a) Excess Interest as a Terminal Dividend

Universal life companies want to avoid booking the excess interest into the premium account. This could be achieved by reducing their reserves to the value computed using only the interest, expense, and mortality factors guaranteed at issue. The excess interest would be ignored until the policy lapsed, matured, or became a death claim. Then the additional benefits would be treated as a terminal dividend, subject to the dividend limitation of section 809(f) of the Internal Revenue Code. The terminal dividend treatment seems harsh, especially since the additional cash values are increased permanently.

b) Excess Interest Is Currently Taxable to the Policyholder and Fully Deductible by the Company

For almost three hundred years, periodic dividends have been considered a refund of premium. If the excess interest is not a dividend, it may not be a refund of premium, but may be currently taxable income to the policyholder.

D. *Distinguishing Universal Life and Participating Products*

Universal life and participating policies are basically alike. Both credit policyholders with excess interest and with mortality and expense savings

that are not fixed in dollars and cents at issue. Indeterminate premium products are basically the same as participating products that use a flat dividend scale with the dividend applied to reduce premiums.

There are certain cosmetic differences between universal life and the participating products sold by stock and mutual companies.

1. All universal life (and indeterminate premium) contracts are called nonparticipating. Apart from any tax benefit, the main significance of this is that companies selling these products are not subject to the statutory profit limitations imposed by certain states on participating products. As a result, the company can make more profits and return less to the policyholders.
2. All universal life contracts use direct recognition of policy loans so that the excess interest credit reflects the amount borrowed. Most participating contracts reflect policy loans on the basis of the contractual loan rate class.
3. Most universal life contracts employ a retrospective cash value formula, while most participating products use an equivalent prospective formula.
4. Many universal life contracts have flexible premiums, including a "zero premium" option, which allows the policyholder to stop premium payments and to reinstate simply by paying any "planned contractional premium." For most participating contracts, premiums are fixed and reinstatements require evidence of insurability.
5. Universal life reserves usually are invested in short-term assets, while most participating reserves are invested in long-term assets—which historically have higher yields, but are more risky, than short-term assets.
6. Universal life and indeterminate premium products have only a single dividend option (see Appendix A). With type A universal life contracts, excess interest is added in equal amounts to both cash values and death benefits. With type B, the excess interest is added only to cash values, so that, on the death of the insured, the beneficiary forfeits all the excess interest supposedly credited to the policy. Most participating policies offer several dividend options.
7. Most universal life policies credit no excess interest on the first $1,000 of cash value and little or no excess interest on amounts borrowed. Therefore, many policyholders never will receive the high interest rates cited in the advertisements. Participating policies credit excess interest on the first $1,000 and on amounts borrowed.
8. Most universal life contracts credit interest on a monthly basis, and change rates quarterly. Most participating contracts credit excess interest on an annual basis and change dividend scales no more frequently than annually.

In recent years, participating contracts have been modified to incorporate some of the better features of universal life contracts. For example, some companies selling participating products now use direct recognition of policy loans on new policy series and are planning to modify old policies

to the direct-recognition system. Also, some participating companies are offering contracts for which the assets are invested short term. Illustrations of participating policies can be prepared to show the retrospective development of cash values. Further, flexible premiums have been available on participating "adjustable life" products before universal life was sold widely.

Many of the cosmetic features discussed above are not found on all universal life plans. In any case, they should have no bearing on the taxation of the product.

1. SUPPLEMENTAL FEATURES

To avoid the (unfair) section 809(f) dividend limitation, stock companies have employed certain "add-on" devices to distinguish their products from traditional participating contracts. These include the following:

1. Use of a guaranteed dividend formula.
2. Guarantee of the premium reduction or excess interest two or more calendar years in advance.
3. Use of a section 1035 exchange or a "project update" in place of crediting dividends.
4. Elimination of the maximum premium for indeterminate premium products.
5. Of course, if these supplemental techniques work for single dividend option policies, they also work for fully participating business.

2. PERSPECTIVE

The stock companies' innovative attacks on the dividend limitation (and their greater pass-through of individual experience) are laudable. If the section 809(f) dividend limitation is defeated, all companies will benefit. Meanwhile, mutual companies will form new subsidiaries to sell universal life.

The following sections discuss the add-ons used to distinguish the new products from traditional participating products.

E. *Using an Outside Bond Index or Guaranteeing the Dividend Formula*

Some universal life contracts use an outside bond index to determine excess interest. In some cases, the index itself may be changed by management discretion, so that excess interest still meets this test of a dividend. In other cases, a conservative index is guaranteed at issue until final maturity. It can be argued, however, that the "experience" test applies, since the company can readily "immunize" its liabilities by in-

vesting in the assets included in the index. Some states require immunization.

Some indexes may produce a different interest rate each *quarter.* This is less of a guarantee than that provided by most mutuals, whose dividends are fixed up to a *year* in advance. The investment risk of the indexed products is much less than that assumed by many mutuals. To avoid an incredibly high (and unfair) tax load, many mutuals invest in long-term deep discount bonds or long-term tax-exempt bonds. (On these types of bonds it is necessary to go long term to get good yields.) The indexed products, however, typically are invested in short-term Treasury securities. Why should a company get *better* tax treatment if it offers *less?*

Of course, even if the premiums or excess interest credits of this product are tied to an outside bond index, the product still meets the risk-shifting, marketing, economic benefit, and nonguaranteed cost criteria of participating products.

Furthermore, the excess interest credits (or premium reductions) are not guaranteed as specific dollar-and-cent amounts; only the formula is guaranteed. The House of Representatives was specific that companies should not be able to turn excess interest contributions into return premiums or an absolute deduction merely by announcing their intention to return an indefinite amount of excess interest. Mr. Mills said (*Congressional Record—House,* February 18, 1959, p. 2574): "We are trying to permit an absolute deduction for refunds to policyholders if there is a contract with the policyholder to refund some definite amount, but if amounts are refunded that are not fixed in the contract, these will not be included as return premiums. These contingent amounts will not be treated as an absolute deduction but they will be treated as dividends to policyholders."

Mr. Rhodes then asked: "Suppose in the alternative, there is a contract which provides for a return to the policyholder in the form of a dividend consisting of a part of the investment income of the company, the amount of which is not set forth in the contract in dollars and cents or a percentage but depends on the experience of the company?"

Mills answered, "But we would not, in the example that the gentleman has used, permit a company to avoid the payment of a tax on its investment yield simply because the company had said that in a contract with the policyholder it wanted to or intended to refund to the policyholder some of that investment yield."

It could be argued that in indeterminate premium contracts the company is not returning any investment income; it merely computes a new pre-

mium based on a higher discount rate. This method, however, was exactly that used by actuaries to compute the premium reduction on discounted bonus policies, and is also used by some companies to compute level dividends.

1. STATE ENFORCEMENT

Although they usually do not print their dividend formulas in their contracts, virtually all United States mutuals use the "contribution method," invented by Sheppard Homans and David Fackler. In fact, Massachusetts law requires the contribution method. The New Jersey law and section 216 of the New York law require "equity." Further, the legal notes to section 216 of the New York law specifically refer to the contribution principle. The notes say: "The so-called dividend payable upon mutual life insurance bears no relation to a dividend upon stock corporation since a 'life insurance dividend' . . . is determined by the contract and former section 83 of Insurance Law of 1909, as amended. . . . The divisible surplus, payable to holders of both ordinary mutual life insurance policies . . . should be *apportioned according to each holder's contribution* thereto" (emphasis added).

The state insurance departments, particularly in New York, Massachusetts, and New Jersey, rigorously enforce equitable distribution of dividends, and dividend formulas are reviewed in the insurance examinations. No one has suggested, however, that state monitoring of dividend formulas transforms dividends into guaranteed benefits.

The very first "dividends" paid by a mutual company were based on fixed formulas. The company, the old Amicable, took the total yearly premium from policyholders and, after paying an annual dividend, divided the remainder as a terminal dividend among those who died during the year. In his early paper on discounted bonus policies, G. F. Hardy suggested that companies give the distribution formula to the policyholders, but he did not suggest that a printed formula would make the product "guaranteed cost."

F. *Guaranteeing the Excess Interest or Premium in Advance*

Some dividend options, such as paid-up additions, provide economic benefits guaranteed for all future policy years until maturity, which may be nearly a century in the future. Furthermore, the cash values of all policyholder dividends on ordinary insurance generally are guaranteed in October or November for the next calendar year. Since November and December are popular months for sales, as much as 20 percent of the in-

force may have cash-value guarantees extending one full policy year. To avoid dividend treatment, some universal life and indeterminate premium companies have tried to "guarantee" the premium reduction or excess interest two or more calendar years in advance. Others have tried thirty-day advance guarantees, and still others guarantee excess interest "until change," which may be only one day in advance.

1. ACCOUNTING THEORIES

The advance guarantees generate several alternative potential accounting practices. Only "excess interest" is discussed here, although the theories also apply to premium reductions. Both (i) the excess interest itself and (ii) the present value of the future guaranteed excess interest must be considered.

a) Dividend-When-Guaranteed Theory

Under this theory, the present value of the guaranteed interest (item ii) is added to dividends, premiums, and benefit reserves *when the guarantee is made*. The company makes no accounting entry when the excess interest credit (item i) is added to the policy cash value because it assumes that the policyholder received the economic benefit when the guarantee was made. This theory is analogous to the accounting method used by mutual companies on paid-up additions. (For phase 2 negative companies, the theory simply heaps the dividend disallowance. For phase 2 positive companies, the theory heaps the deductions.)

The dividend-when-guaranteed theory can be justified by the "economic benefit" theory of taxation. Under the economic benefit theory, taxable income is increased even when there is no cash payment and even though there is no constructive receipt.

The economic benefit that should be added to premiums and dividends is the value of the additional extended term insurance provided by the guaranteed excess interest. For example, the guarantee may lengthen the extended term insurance period provided by the existing cash value from five years to six years. Maurice LeVita showed that under the current nonforfeiture law, all life insurance premiums can be viewed as purchasing deferred extended term insurance. Even the individual policyholder ruling on universal life referred to extended term insurance. The ruling repeated LeVita's observation that "each net premium, . . . together with the reserve at the end of the previous period, will purchase insurance coverage for a period of years and days."

For the economic benefit theory to apply, three tests must be satisfied.

The benefit should have "current, real, and measurable value" (Stanley and Killcullen, *Federal Income Tax Law*, pp. 3–10). The "measurable value" is the company's reserve deduction. The extended term benefits certainly are real.

A reasonable argument could be made that excess interest guaranteed for the next valuation period is a "current" benefit, since the extended term period will increase even if the policyholder pays no more premiums. A case also can be made that excess interest guaranteed for policy years in the distant future is a current economic benefit. In effect, future excess interest is an option to purchase additional extended term insurance, where the option is executed automatically if the policy is in force. That option is the current benefit.

Some universal life advocates object to the dividend-when-guaranteed theory. They claim the added extended term insurance is not a current benefit. It is a secondary benefit that is activated only when a planned contractual premium is not paid. These advocates point out that this future guaranteed excess interest is subject to complete forfeiture on both lapse and death. Since the guarantee does not produce a cash payment or an immediate increase in cash value, there is nothing the policyholder can credit to the company as premium.

Others respond that cash surrender values and cash options are irrelevant, since these concepts developed long after that of the paid-up addition, and cash surrender values generally are ignored in reserve calculations.

b) Dividend-Reserve Thoery

Under this method, the present value of the guaranteed excess interest (item ii) is added to the *dividend* reserve when the guarantee is made. (Of course, under regulation 1.811, only the portion that is credited in the next calendar year—or fiscal year for some companies—would be included as a tax reserve.) When the excess interest is credited to policy cash values, the dividend reserve is reduced and the excess interest is added to *benefit* reserves, dividends, and premiums.

The dividend-reserve theory was developed in response to criticism from universal life advocates, who object to adding the reserve increase (item ii) to the premium account. Under the dividend-reserve theory, this is not necessary. Of course, the current year benefit-reserve deduction for future excess interest is lost.

Advocates of the dividend-reserve theory note that the "guarantee" of future excess interest is subject to full forfeiture on lapse or death. (In

contrast, paid-up additions never are forfeited on death, and, under current nonforfeiture laws, are not forfeited on lapse.) Further, a guarantee requires two parties, the party making the guarantee and the party receiving and accepting the guarantee. If the "guarantee" has no current economic benefit to policyholders, then the present value of future guaranteed excess interest should not be added to premiums, dividends, or the benefit reserve.

The dividend-reserve theory is consistent with mutual company practice. Dividends usually are guaranteed one calendar year in advance, and the provision for the following year's dividend is added to the dividend reserve at year-end. When the dividend is credited to policyholders, the dividend reserve is reduced and a dividend is booked. If the policyholder credits the dividend back to the company to purchase additional death benefits, both premiums and benefit reserves are increased.

This theory also is sanctioned by Revenue Ruling 67-180 (see Appendix D). That ruling applied to the casualty branch of a multiline insurance company that wanted to take a current tax deduction for the increase in its liability for future retrospective rate credits. Some of the policies were on a three-year retrospective plan involving refunds that would be paid up to three years in the future according to a guaranteed formula. The ruling disqualified the liability for the retrospective refunds as a return premium, or as part of the benefit reserve (referred to as the "unearned premium" reserve in the ruling). Furthermore, the company could not add the liability to its dividend reserve because the refunds were not a predetermined amount, but varied according to the future claim experience of the policyholder. According to the ruling, the year-end dividend reserve is for an amount "which is either fixed or determined according to a formula which is fixed." A "fixed formula" means that the amount can be subject to a contingency, if such "contingency is beyond the control of the taxpayer affecting whether the determined amount will be paid. An example of such contingency is a participating policy, which is contingent on renewal, or the policyholder being alive on the anniversary date."

Excess interest, however, does not depend on the policyholder's claim experience, and it satisfies the requirements of Revenue Ruling 67-180. The revenue ruling precisely fits situations where the premiums or excess interest credits are guaranteed two (or more) calendar years in advance. When the guarantee is made, its present value is added to the dividend reserve. On each anniversary, the dividend reserve is reduced and an annual dividend is booked. The dividend-reserve theory is consistent with both statutory and tax accounting principles!

c) Transfer Theory

Under the transfer theory, the present value of future guaranteed excess interest (item ii) is ignored and the excess interest itself (item i) becomes a fully deductible benefit when credited to policyholder cash values. But if the company does not place any value on the guarantee, why should the IRS?

d) Benefit-Reserve Theory

Under the benefit-reserve theory, the present value of future years' excess interest (item ii) is added to the benefit reserve as a direct reserve increase. No dividends or premiums ever are booked, either when the guarantee is made or when the excess interest is added to policyholder cash values. This technique heaps the tax benefits for phase 2 negative companies and is even more beneficial to the company than taking the current year's excess interest (item i) as a direct reserve increase. For phase 1 and phase 2 positive companies, the dividend-when-guaranteed and benefit-reserve theories have identical tax results.

The mechanics of adding the present value of future guaranteed excess interest (item ii) to the benefit reserve are quite interesting. The total interest rates (excess plus minimum) are used to calculate "projected cash values." These projected cash values at each duration are discounted to the valuation date using the fixed valuation rate. The greatest present value defines the current reserve.

The theory seems objectionable on several grounds. First, it is inconsistent. By taking an increase in its benefit reserves, the company asserts that the present value of future guaranteed excess interest is an economic benefit to policyholders. But this benefit is not recognized in its premiums and dividends. Second, the theory is based on the direct reserve increase. Direct reserve increases already have been shown to be illogical. Third, using the greatest present value as the reserve seems rather piggish. Finally, it is illogical that the company should get *more* (nondividend treatment) if the policyholder gets *less* (no immediate benefits).

Some universal life advocates have suggested that company taxation and individual taxation do not correspond. They feel that companies should be entitled to a reserve deduction for future excess interest even though the policyholder has received no benefit, and the company has booked nothing in the premium account. They refer to reserve deductions on regular guaranteed cost policies, where the company holds a reserve even though it has paid no claims. For such policies, however, the company

has booked premiums and the reserve is much less than the death benefit. Future excess interest, on the other hand, is forfeited on death, and is not added to the premium account.

2. CONCLUSION

Two dividend theories have been developed to deal with the guarantee of future excess interest. If the guarantee produces a "current" economic benefit to policyholders, then the dividend-when-guaranteed theory applies and the present value of all future excess interest is a dividend. If the guarantee does not produce a "current" economic benefit to policyholders, the dividend-reserve theory is useful. The transfer and benefit-reserve theories are invalid.

It is difficult to choose between the two dividend theories. Company reserving practices are consistent with the dividend-when-guaranteed theory. On the other hand, it is clear, as argued by universal life advocates, that future excess interest is a very weak benefit.

Some stock companies have complained about the harsh tax treatment for phase 2 negative companies that results from the dividend theories. They feel that advance guarantees and increased extended term insurance benefits are significant economic commitments. Mutual companies, however, have advance guarantees in their paid-up additions. A paid-up addition provides death benefits that are guaranteed for *all future years to maturity*. If a two-to-three-year advance guarantee avoids dividend treatment, then mutual companies have overpaid their taxes by billions of dollars since 1958.

Some feel that it is the job of the IRS to enforce existing law, not to make moral judgments. The appropriateness or inappropriateness of phase 1 of the 1959 law is not to be determined by the IRS. It is up to Congress, or possibly the courts, to change the law. Many of the companies that now are lamenting about universal life and deferred annuities are the same ones that helped draft the dividend limitation in 1959.

G. *Section 1035 Exchange or Project Update*

A section 1035 exchange allows a policyholder to make a tax-free exchange by trading one life insurance policy for another or by trading a life policy for an annuity. The tax-free exchange does not have to be with the same company. The policyholder can use his old policy as collateral to buy a new one from a different company. If cash is received, however, the exchange probably will not be tax-free. The tax-free exchange means that the policyholder keeps the same tax basis. In this respect, an exchange is exactly like a noncash dividend option.

A typical exchange occurs when a policyholder buys, say, a whole life policy and then decides that he has made a mistake and wants a twenty-payment life policy instead. In an effort to preserve his business, the company usually permits him an original-date conversion with the payment of a small fee related to the difference in reserves, cash values, or premiums.

1. PROJECT UPDATE

Instead of using section 1035 to make an individual exchange at the initiation of the policyholder, some companies have offered specially designed changes in order to provide additional benefits to large classes of their policyholders. Are these additional benefits policyholder dividends, and, if so, what is their value?

Some argue that no dividend is involved, since the exchange is really the surrender of an old policy at the purchase of a new one, and that the increase in reserves and benefits is irrelevant. Others hold that the company tax treatment for a "project update" should be the same as for advance guarantees (as discussed earlier). Thus, the updated policy is a continuation of the old one, and the present value of additional benefits (on the old reserve basis) should be included in premiums and in *annual* dividends. A third group holds that the increase in reserve represents a *terminal* dividend on the old policy, applied as a premium to help purchase the new policy. The latter two approaches have similar tax results.

The dividend treatments do have historical support. The old Equitable's dividends or bonuses were declared rather infrequently, like a project update. Its first dividend, in 1776–77, was a 10 percent reduction in all future premiums. The distribution in 1781–82 introduced the "reversionary bonus" or paid-up addition plan. In the middle of the nineteenth century, United States companies distributed dividends on the five-year plan. Sheppard Homans (*JIA*, XI [1863], 123) discusses the payment of excess interest on the policy fund, which was updated from the 4 percent Gill table to the 4 percent American Experience Table. The funds released by the update were included in the dividend.

Rules of fair play seem to require dividend treatment. When a football team fumbles the ball and recovers its own fumble, the down marker changes. The team does *not* get a new series of downs. On an update the company should not get new-issue treatment. The terminal-dividend approach has an analogy with car sales. Sometimes a dealer will give an extra high price on an old car to get the customer to buy a new one. The trade-in allowance on the old car is greater than its value on the open market. The car dealer offers the attractive trade-in only to make the sale.

Of course, if a project update does not produce a dividend, then it may become the standard method of granting nonguaranteed premium reductions and additional benefits. A low-taxed method (updates) will drive out a high-taxed method (dividends). Some specific project updates are explored below.

2. "EASTERN MUTUAL" INDUSTRIAL UPDATE

Several years ago, an eastern mutual updated many of its industrial policies by converting them to paid-up status. The primary reasons for the update were to improve persistency, to distribute accumulated surplus equitably, and to reduce expenses. On many policies, the cost of collection exceeded the small weekly premium.)

After the update, the reserves increased because paid-up factors were used. The cash values and death benefits were not changed, but the extended term benefits were immediately and permanently increased. Future dividends were reduced to reflect the reduced premium income.

A logical argument can be made that the update is an economic benefit to policyholders with a real, current, and measurable value. The company's own reserve increase provides the "measurable value." The reduced premiums have a "real" value to policyholders, but it is uncertain whether they represent a current value or a deferred value. Since the current year's premium is eliminated, and since the added benefits obviously are not contingent on payment of future premiums, many observers would agree that the update has a current value. Therefore, the dividend-when-guaranteed theory should be applied and the reserve increase should be included in dividends and premiums. The eastern mutual was in phase 1 or phase 2 positive in the year of exchange, however, so that the dividend would have had no tax effect. (Future phase 1 taxes were slightly reduced because of the larger reserves.)

3. "MIDWESTERN MUTUAL" UPDATE

A midwestern mutual recently offered its old policyholders a voluntary exchange. "Old" policies were traded in for "new" ones with a higher reserve valuation rate, an increased face amount, and increased extended term benefits, but with future dividends reduced. The cash values were the same at the time of the update. In a private-letter ruling that has no precedent-setting value, the IRS ruled that there was no change of basis, but it was silent on the dividend issue.

If the value of the dividend were defined as the increase in reserve before and after update, it would be small or even negative. A better

measure of the value of the transaction, however, would be the increase in reserve on the old basis.

The midwestern mutual update, which increased death benefits 15–20 percent, was strikingly similar to the original reversionary bonus addition of the old Equitable, which increased benefits up to 28½ percent. In any case, the midwestern mutual was in phase 1 or phase 2 positive in the year of the update, so the dividend question would have been moot. The purposes of the exchange were to discourage replacements and to reduce future phase 1 taxes.

The expected tax savings on the update program may not materialize, however, if the tax law changes so that companies are taxed on gains. Under phase 1, an increase in required interest *reduces* taxes, but under phase 2, required interest generates additional taxes by increasing the (unfair) disallowance of tax-exempt interest. (For my company, the phase 1 savings is 25 percent and the phase 2 cost is 15 percent of each dollar of required interest.)

4. CHANGE OF BASIS

Under the terminal-dividend approach there is no "change of basis" (in agreement with the midwestern mutual ruling). The update is a terminal dividend on the old policy, which is credited back to the company as premium to help buy the new policy. Old reserves are released and new reserves established. (The dividend equals the increase in face amount times the old reserve factor.)

Some companies, however, have tried a two-step approach on unilateral exchanges. Initially, death benefits and reserves are increased. Several months later the reserves are destrengthened. This approach clearly involves a change of basis.

5. COUPON UPDATES

Because of the severely adverse (and unfair) tax consequences of the section 809(f) dividend limitation, many small stock companies have updated participating policies by guaranteeing all future dividends. In effect, the dividends become guaranteed annual pure endowments called "coupons." There are some regulatory problems with such updates. The coupon net premiums may generate deficiency reserves, which can be as great at $100 per thousand. To avoid this, some companies have used a "serial" approach. Initially, they guarantee a $1 level coupon. The guarantee on the same policies is increased to $1.50 the next year and to, say, $2.00 the following year. The serial method eliminates the deficiency reserves and (supposedly) avoids the section 809(f) dividend limitation.

There are different reserve techniques for the coupons. Some companies set up premium-paying reserves for the new coupon benefit, treating the update as an original-date conversion. This reserve is equal to the present value of future coupons less the present value of future coupon net premiums. If the coupons are level, the premium-paying terminal reserve is zero, and the mean reserve is one-half of the coupon. Some companies apparently set up a reserve for one-half of the next year's coupon even if the coupons are increasing. This premium-paying reserve is much smaller than the single premium reserve for the coupon benefit, which would be simply the present value of future coupons.

The economic effect of the coupon update is similar to the effect of guaranteeing future excess interest. The tax effect of a coupon update depends on the following:

1. The tax category of the company (phase 2 negative, phase 1, phase 2 positive, or casualty company).
2. The accounting theory (dividend-when-guaranteed, dividend-reserve, transfer, or benefit-reserve theory).
3. The method of computing the reserve and dividend, if any (paid-up reserve or premium-paying reserve).

Few companies that are phase 2 positive or are taxed as casualty companies have implemented coupon updates, because they effectively can deduct all dividends anyway. (For these companies, the benefit-reserve and dividend-when-guaranteed theories are equally favorable. Paid-up reserves are more favorable than premium-paying reserves.) For phase 1 companies, the coupon update will have no current value unless it causes a shift to phase 2 negative. Phase 1 companies would get a slight future benefit from the increased reserves.

For phase 2 negative companies, any kind of dividend treatment would be harmful, but the dividend-when-guaranteed theory, in which the dividend equals the paid-up reserves, would produce the worst outcome. Unfortunately, this seems to represent the most logical tax treatment.

Most companies employing the coupon update have contended that the transfer accounting theory applies, avoiding all dividends. A fall-back position would be to acknowledge that the update involves a dividend, but maintain that the dividend equals the premium-paying reserve.

Presumably the IRS eventually will rule on coupon updates. If the transfer theory is upheld, or if the dividend equals the premium-paying reserve, then even the largest phase 1 mutuals will be able to obtain almost a full dividend deduction by using coupon updates.

Project updates involve dividends. In the specific updates cited, the value of the dividend was the net single premium for the additional benefits, computed on the old reserve basis. In the coupon updates, either the dividend-reserve or the dividend-when-guaranteed theory applies.

H. *No Maximum Premium*

A variant of the indeterminate premium contract that some feel will pass muster is to eliminate the maximum premium and have a guaranteed renewable contract. In theory, since there is no maximum premium, there is no base upon which to compute the dividend.

Of course, this product may be hard to market because it provides no guarantees to the policyholder. Even a traditional participating policy has a maximum cost; the dividend cannot be reduced below zero. Also, there are state regulatory questions. The NAIC still is wrestling with the nonforfeiture, valuation, and deficiency reserve requirements of traditional indeterminate premium contracts. A product with no maximum premium will be even harder to handle.

Besides these questions, there are tax problems. Traditionally, "guaranteed renewable" is applied to health insurance benefits. In health insurance products, the *benefits* are not stated in fixed dollar terms, so the *premium* cannot be fixed. (The benefits may be all "reasonable and customary charges" or the "semiprivate room rate." In guaranteed renewable disability income contracts, claim costs depend upon claim termination rates after the onset of disability as well as on the rates of disability themselves.) By target loss ratios and other means, the states severely limit the insurance company's freedom to change rates. The code section defining "guaranteed renewable" does refer to "life and health" contingencies, but some experts believe that the reference to life insurance was limited to life coverage sold in conjunction with health insurance or to annually renewable life products.

It also is conceivable that if there were no maximum premiums and no statutory restrictions on premium increases, the terminal reserves might not qualify technically as life insurance reserves. With no guarantees on future premiums, the guaranteed renewable clause has little worth. If there were little or no risk of loss beyond the current policy year, the cash-value buildup could be treated as an investment, so that the insurance company would have to give policyholders Form 1099 statements. (This outcome would be even more harmful than losing the dividend issue.)

The IRS also could find a substitute for the maximum premium. To define the case values and reserves, the net premiums at all durations must be specified. The initial gross premium times the ratio of the current duration net premium to the first-year net premium would be a reasonable substitute for the maximum premium. If the net premium is level, any decrease from the initial gross premium certainly would be considered a dividend. (In guaranteed renewable health policies, premium modifications are almost always upward.)

II. ADDITIONAL ISSUES

Some additional issues are so intertwined with the dividend issue that they must be considered at the same time. These issues, including the reserve problem, the section 818(c) deduction, the definition of life insurance, and the dividend option on universal life, are discussed below.

A. *The Reserve Problem*

Many of the companies selling flexible premium and single premium deferred annuities are using a complicated "prospective" method that is variously called the "triangular method," the "dynamic segment method," or the "Commissioner's Annuity Reserve Valuation Method" (CARVM). The CARVM produces very large reserves, even larger than the retrospective accumulation of excess interest. Recently the CARVM technique has been suggested for universal life contracts (*Best's Review*, September 1981, p. 130). Let us examine CARVM.

1. COMMISSIONERS ANNUITY RESERVE VALUATION METHOD

The CARVM does not use net valuation premiums; rather, its "net premiums" are really the unloaded gross premiums used to calculate minimum cash values (New York Insurance Law, secs. 208(c) and 205). The reserve at duration 0 rarely equals zero, which is a characteristic of the net premium method.[4] Also, CARVM does not use a simple application of the reserve equation. It attempts to cover the worst possible case by computing prospective reserves, assuming the policy matures for its cash value. The reserve at any duration is the largest prospective reserve obtained by assuming maturity for the cash value in any future policy year.[5]

[4] See Appendix C.

[5] In more detail, assume that the policyholder buys a single premium deferred annuity. If he lapses at duration 1, he has purchased a one-year-endowment in column 1. If the policyholder lapses at duration (t), he has purchased a t-year endowment for the cash value. Place the prospective reserves in column t. Note that at any duration s, the CARVM reserve has the greatest value in the sth row.

If the rate used to accumulate cash values and the reserve discount rate are equal, then the CARVM reserve usually will equal the cash value (unless there are dips in the mortality table).

For flexible or single premium contracts, CARVM assumes that future net premiums will be zero, since there is no contractual requirement that premiums must be paid.

2. TAX QUESTIONS

There are many open tax questions concerning CARVM. First, do the various state laws requiring the triangular method automatically make it acceptable for IRS purposes, or must the tax reserve be calculated on traditional net premium methods? Second, can the company use a prospective gross premium method? Third, is the "assumed interest rate" for CARVM the rate used to accumulate the cash value guaranteed at issue, the rate used to accumulate the current "guaranteed" cash value, the rate used for annuity or extended term purchase rates, or the reserve discount rate? Fourth, is the CARVM reserve calculated using the minimum cash value guaranteed at issue including any dividend additions or the cash value defined by the nonguaranteed accumulation rates?

The questions are exceedingly complex, but some logical answers are indicated below.

a) Acceptability of the Triangular Method

Since the CARVM triangular approach is required by law, the method should be satisfactory to the IRS. Admittedly, the method does not use the traditional reserve formulas based on the principle that the reserve at the end of the year is the reserve at the beginning plus the premium and assumed interest less assumed benefits and expenses.

There are three basic kinds of reserves: prospective gross premium reserves (often called the "liability share"), net premium reserves, and retrospective accumulations (often called the "asset share"). All are defined using the "equation of equilibrium." The difference is in the "initial conditions." Two of the following three quantities must be defined: (1) the reserve before issue, (2) the reserve at maturity, and (3) the reserve premium. For *net* premium reserves, the reserve at maturity is the fixed maturity value and the reserve before issue is zero. Then the net premium may be calculated. For *prospective* reserves, the premium is the gross premium, or an unloaded gross, and the reserve at maturity is the maturity value, so that the reserve before issue may be calculated. In *asset shares*, the premium is the gross premium or an unloaded gross and the reserve

before issue is zero. The reserve at maturity is the guaranteed maturity value plus accumulated profit.[6]

The CARVM uses both prospective and retrospective formulas with the complicated triangular technique. The reserve standards have been defined by some of the actuaries most involved with selling universal life and deferred annuities, which should avoid any problems with the IRS. The additional reserve deductions so created merely offset some of the inequities in the existing law, such as the unfair limitation on the deduction of tax-exempt interest, policyholder dividends, and employee wages.

b) Prospective Gross Premium Reserves

The prospective gross premium reserve is as old as the net premium reserve, so there is ample precedent for it. Furthermore, if the contracts were profitable, the prospective gross premium reserve would be less than the net premium reserve, so that companies would not be overstating reserves for tax calculations. Actually, the health insurance law specifically allows gross premium reserves. The IRS has given many private-letter rulings indicating that only net valuation methods can be used.

c) What Is the Assumed Rate?

On most policies, the reserve rate is usually equal to the rates used to calculate guaranteed cash values and extended term benefits. To decide which rate to use in the general case, we must investigate the actuarial history of the law. The rate used to calculate the total cash value is not even known at issue, and would seem to be ruled out.

The 1921 law was based on the 1895–1938 Gain and Loss Exhibit, which used the reserve discount rate. There are other reasons for preferring the reserve discount rate. Universal life policies use a retrospective gross premium accumulation for the cash value. But section 801(b) of the Internal Revenue Code refers to prospective or net premium reserves. Walter O. Menge, who was chairman of the 1958 committee on the "investment income" approach to taxation, clearly refers to prospective or net premium reserves in his discussion of the "reevaluation method" (*Proceedings of the American Life Convention*, 1958). While the "Menge rule" contemplates reserves that decrease as the valuation rate increases, retrospective gross premium reserves move in the opposite direction. These considerations further rule out both types of cash-value rates. The rate

[6] See Appendix B.

used to calculate extended term or annuity benefits would seem to apply only to policies receiving these benefits.

It seems reasonable to conclude that the reserve rate should be the "assumed rate" for tax purposes.

d) Cash Value Guaranteed at Issue or Current Guarantee

Unless the excess interest is credited as a disbursement to policyholders that immediately is paid back to the company as premium, the company should not take reserve credit for the excess interest on the current "guaranteed" rate. In that case, the portion of the reserve due to the excess interest on cash values would be a general solvency reserve like the mandatory securities valuation reserve or deficiency reserves, or even the New York State reserves for minimum interest rate guarantees on interest-paid contracts.

B. *The Section 818(c) Deduction*

In the CARVM method for flexible premium annuities, future valuation premiums are ignored and the reserves are calculated as for a single premium policy. Treating flexible premium universal life policies as single premium policies has distributing regulatory and tax implications. On single premium life products, there probably is no section 818(c) adjustment. Also, the New York State commission limits are very small for single premium contracts, so the product would not meet section 213 limits.

Ignoring future premiums on flexible annuities does not seem unreasonable, since the payment of future premiums will have a relatively minor impact on future benefit costs. For life insurance, however, the ability to skip future premiums on a flexible premium contract makes the product riskier than one that requires both evidence of insurability and the payment of past premiums in order to reinstate. Therefore, ignoring future "planned contractual premiums" seems unjustified. Future premiums are not ignored on the adjustable life product.

1. HOW MUCH TO DEDUCT?

One problem with some universal life contracts is that the company does not compute the guaranteed plan. If the plan is an endowment at age 95 under a 12 percent assumption, the guaranteed plan (based on 4 percent interest) may be only term to age 65, and eligible only for the $5 section 818(c)(2) allowance.

2. RECOGNIZED FULL PRELIMINARY TERM METHOD

Some universal life plans have a 95 percent commission on the "mortality charge" and a low commission on the "savings element." Therefore, the reserve, which often is defined as the cash value, may be very close to the net level reserve.

To be permitted to use the $21 per thousand deduction ($19 under the Tax Equity and Fiscal Responsibility Act of 1982), the company would have to convince the IRS that the cash value was a proper preliminary term method. The companies effectively are using the ancient "Wisconsin method," under which they could "value policies in accordance with the expense assumptions made in the calculation of the gross premiums" (*RAIA*, XXV [1936], 215). If an exact revaluation increased the reserve only $7 per thousand, however, it would seem rather greedy for the company to declare $21 per thousand.

C. *The "Nonparticipating" Deduction*

In 1959, "nonparticipating" meant "guaranteed cost," and the nonparticipating deducation was instituted to provide a contingency reserve for the greater risk on these policies. Thus, we have the following quote from Louis Adams of the American Life Convention (*House Hearings*, 1958, p. 62): "It has been suggested that a temporary tax deferment might be accorded a fund which would go part way in equalizing the obviously greater surplus required by nonparticipating, guaranteed low gross premium life insurance." Since universal life and indeterminate premium products are no more guaranteed cost than regular participating policies, it might seem difficult to justify the nonparticipating deduction (even if the companies won the dividend issue). Conditions are very volatile today, however, and even dividends and nonguaranteed elements do not provide enough of a hedge against fluctuating interest rates. (If companies invest long, they suffer market losses when rates rise. If they invest short, the interest margins are reduced when rates fall. Furthermore, the liabilities shorten and the assets lengthen if rates rise, and the converse happens if rates fall.) Therefore, it would be desirable to extend the nonparticipating deduction to all individual policies under any change in the tax law.

D. *Is It Life Insurance?*

George R. Dinney, who coined the term "universal life" in the mid-1960s, pointed out that every life insurance policy could be split into four "modules":

1. Death protection exceeding the initial cash value (term insurance).

2. Savings fund (cash and maturity values).
3. Guaranteed life insurance (or extended term) purchase rates.
4. Guaranteed settlement option (or annuity) purchase rates.

It is the first, third, and fourth modules that distinguish "life insurance" products from "term plus side fund" products. In universal life, the company guarantees to apply the cash value toward the purchase of extended term insurance, using specified purchase rates, such as the 1958 Commissioners Standard Ordinary Table or perhaps the 1958 Commissioners Extended Term Table. The reserve for the extended term (based on the purchase rate table) is equal to the "savings fund."

Most universal life policies sold today provide for guaranteed purchase rates and are guaranteed renewable at guaranteed premium rates. Therefore they seem to qualify as life insurance products. Furthermore, in many private-letter rulings, the IRS itself has recognized the importance of purchase-rate guarantees.

1. SOME GRAY AREAS

It is unclear how much "initial death protection" should be required for a fund to qualify as a "life reserve." Some may feel that no initial death protection is needed; extended-term purchase rates are sufficient. But that implies that dividend accumulations would qualify as life insurance reserves, since they provide for both permanent life insurance and permanent annuity purchase rates. On some participating policies, the dividend accumulation automatically is applied with the basic cash value to purchase extended term insurance when a policyholder stops paying premiums. Further, the dividend accumulation has a loan value. Dividend accumulations, however, have been denied reserve treatment for twenty to thirty years. Instead, the company gets an interest-paid deduction and the policyholder has current income.

Others feel that the death benefit should exceed the initial cash value by an actuarially computed amount. For example, for level death benefit policies the cash values could be required not to be larger than the net level reserve for the "guaranteed plan." The plan would be specified by the guaranteed coverage period, gross premiums, death benefits, and the maturity value. The assumptions for the net level reserve (interest, mortality, expense, lapse, and the net-to-gross ratios) should be "reasonable." The guaranteed plan is important because it also affects policyholder taxes (such as Internal Revenue Code, secs. 72, 101, and 1035). The guaranteed plan for many universal life contracts is unspecified.

Inappropriate risk amounts also can occur with increasing death benefit contracts. For example, it is possible to have "insurance policies" where the initial cash value is $1 million and the initial death benefit is $1 million plus $1. In succeeding years, both death benefits and cash values increase at a guaranteed 4 percent rate. Clearly this is an abuse.

E. *The Dividend Option on Universal Life*

One private-letter ruling issued to an individual taxpayer referred to the excess interest as a "paid-up addition," or as buying deferred extended term insurance. Actually, the excess interest does not increase the net amount at risk, as is typical of paid-up additions. Instead, in universal life type A, the excess interest leaves the net amount at risk unchanged, as is typical of dividend accumulations. In type B, the excess interest *reduces* the net amount at risk, or effectively converts part of the face amount into a savings account.

Under current tax law, interest added to a dividend accumulation or a savings account is taxed currently to policyholders. The dividend-option issue has received virtually no publicity, but it will be important once universal life reserves reach sizable levels.

III. CONCLUSION

The dividend issue is a definitional one. The nonguaranteed nature of universal life and indeterminate premium products is clear. The indeterminate premium and universal life contracts are consumer-oriented products. My company has sold similar products for over a century, calling them "participating."

Using congressional intent, regulations, letter rulings, and the historical development of dividends, it has been argued that "excess interest" payments and "indeterminate premium" reductions should be treated as dividends or similar distributions for tax purposes. This does not suggest any desire to "take away tax benefits" from these products. Simply stated, the goal is product equity, and the restoration of something close to the full tax deductibility of policyholder dividends provided under the 1913 law—which the Treasury proposed in 1959. For policyholders, dividend treatment of excess interest actually is more favorable than interest-earned treatment. For the companies, handling the excess interest as an annual dividend may be better than reducing the reserves and treating the excess interest as a terminal dividend when the policyholder dies or surrenders.

Of course, actuaries and tax lawyers may have various opinions on the dividend issue. Some may believe there is no dividend; others may be

less confident. I hope the IRS eliminates the uncertainty by issuing definite rulings as soon as possible.

If, in the final analysis, the indeterminate premium and universal life products are judged not to involve dividends, then many participating companies will want to offer them as well. All new participating policies could be issued on the basis of the indeterminate premium or universal life approach. In addition, a project update program to change old policies into universal life at least would have to be considered. In effect, a version of Gresham's law would operate: low-taxed policies would drive out high-taxed policies.

If the indeterminate premium and universal life products prove to have dividend problems, the phase 2 negative companies will have some motivation to change the tax law regarding dividend deductions. If full deductibility cannot be obtained for all companies, I would favor a change to the David A. Lindsay plan, which is inspired by statements made by the assistant secretary to the Treasury in the 1959 Senate hearings on life insurance taxation. This plan would admit only one tax category, and companies could deduct 90 percent of policyholder dividends even if this produced a loss. Lindsay felt that if the operation of the various tax phases ever limited companies to a 50 percent deduction for dividends, it would be "very harsh." He pointed out that participating companies could deduct 90 percent of their dividends in 1959. Amazingly, the 90 percent criterion also is used by New York and Illinois in determining the proportion of the predividend earnings that belongs to the policyholders. (Canada uses a graded profit limit, with 90 percent for small companies and $97^1/_2$ percent for the largest companies.)

The comments on indeterminate premium and universal life insurance products in this paper do not extend to excess interest on deferred annuities. That topic is left to another paper.

APPENDIX A

SINGLE DIVIDEND OPTION POLICIES

Dividend Option	General Account	Separate Account*
1. Cash		
2. Premium reduction	Indeterminate premium	
3. Cash-value additions†	Universal life type B	Universal variable
4. Accumulations‡	Universal life type A Deferred annuities	Universal variable
5. Additional insurance		
a) Paid-up additions	Indeterminate benefit	Equitable design
b) Premium-paying additions		New York Life design
c) One-year term	Indeterminate benefit	

* Additions under variable life can be both positive and negative and, therefore, are not really dividends.

† For cash-value additions, the dividend is added only to cash values and not to death benefits.

‡ For dividend accumulations, the cash values and death benefits increase by the same amount.

APPENDIX B

THE UNIVERSAL LIFE RESERVE EQUATION DERIVED FROM THE CONTRIBUTION DIVIDEND FORMULA

Let ${}_te'$, ${}_tq'$, and ${}_ti'$ be the current rates of expense, mortality, and interest. Let ${}_tR$ be the policy "fund," G the gross premium, and ${}_tDB$ the guaranteed death benefit. Then the Homans-Fackler contribution dividend-fund formula is

$$ {}_tdiv = ({}_{t-1}R + G - {}_te')(1 + i') - {}_tq'({}_tDB - {}_tR) - {}_tR , \qquad \text{(B1)} $$

where $t = 1, 2, \ldots, m$. (See *JIA*, XI [1863], 123, and *RAIA*, XI [1922], 119.) The formula for the dividend accumulation liability ${}_tW$, is

$$ \begin{aligned} {}_tW &= 0, && t = 0 \\ &= {}_{t-1}W(1 + i') + {}_tdiv, && t = 1, 2, \ldots, m . \end{aligned} \qquad \text{(B2)} $$

Define ${}_tV$ to be the total fund:

$$ {}_tV = {}_tW + {}_tR, \quad t = 0, 1, 2, \ldots, m . \qquad \text{(B3)} $$

Then

$$ {}_tV = ({}_{t-1}V + G - {}_te')(1 + i') - {}_tq'({}_tDB - {}_tR) . \tag{B4} $$

If ${}_tDB = face + {}_tR$, we derive the universal life type A formula:

$$ {}_tV = ({}_{t-1}V + G - {}_te')(1 + i') - {}_tq'(face) . \tag{B5} $$

The cash value of additions (under the policy improvement option) is forfeited on death. Thus the liability is given by

$$ \begin{aligned} {}_tW &= 0, && t = 0 \\ &= {}_{t-1}W(1 + i') + {}_tdiv + {}_tq'{}_tW, && t = 1, 2, \ldots, m . \end{aligned} \tag{B6} $$

Then the universal life type B formula may be derived as

$$ {}_tV = ({}_{t-1}V + G - {}_te')(1 + i') - {}_tq'({}_tDB - {}_tR - {}_tW) . \tag{B7} $$

Note that equation (B1) did not even assume that ${}_tR$ was a reserve. Actually, ${}_tR$ can be almost anything, even a straight line from zero to the maturity value. If ${}_tR$ satisfies the "equation of equilibrium"

$$ {}_tR = ({}_{t-1}R + P - {}_te)(1 + {}_ti) - {}_tq({}_tDB - {}_tR) , \tag{B8} $$

then the source-of-earnings formula can be derived from (B1):

$$ \begin{aligned} {}_tdiv = {} & ({}_{t-1}R + P - {}_te)(i' - i) + ({}_te - {}_te')(1 + i') \\ & + ({}_tq - {}_tq')({}_tDB - {}_tR) + (G - P)(1 + i') . \end{aligned} \tag{B9} $$

The source-of earnings formula is also called the three-factor formula. The fund formula, however, was the original formula; the three-factor formula was derived later.

APPENDIX C

THREE TYPES OF RESERVES

There are three types of reserves: (*a*) retrospective gross premium reserves, (*b*) net premium reserves, and (*c*) prospective gross premium reserves. All three are calculated using the basic reserves equation, which Homans called the "equation of equilibrium." In the following develop-

ment, t is the policy year; m is the coverage period; e, i, and q are the expense, interest, and mortality assumptions; P is the gross (or unloaded gross) or net premium; DB is the guaranteed death benefit; *matval* is the guaranteed endowment value; and V is the reserve. The equation of equilibrium is

$$ {}_tV = ({}_{t-1}V + P - {}_te)(1 + i) - {}_tq(DB - {}_tV) , \tag{C1} $$

where $t = 1, 2, 3, \ldots, m$.

Let $v = 1/(1 + i)$, $D_x = 1$, and $D_{x+t} = D_{x+t-1}v(1 - {}_tq)$. Given any two of the three quantities P, ${}_0V$, and ${}_mV$, all other reserves ${}_tV$ can be calculated by formula (C1). The "equation of equilibrium" can be used to derive equation (C2), which relates P, ${}_0V$, and ${}_mV$:

$$ \begin{aligned} D_{x+m}\,{}_mV + \sum_{t=1}^{m} vD_{x+t-1}\,{}_tq\,{}_tDB = \\ D_x\,{}_0V + \sum_{t=1}^{m} D_{x+t-1}(P - {}_te) . \end{aligned} \tag{C2} $$

The three types of reserves are distinguished by their initial conditions. In each case, two of the three quantities P, ${}_0V$, and ${}_mV$ are defined. For retrospective reserves,

$$ P = \text{Gross (or unloaded gross) premium} \quad \text{and} \quad {}_0V = 0 . $$

For prospective reserves,

$$ P = \text{Gross (or unloaded gross) premium} \quad \text{and} \quad {}_mV = matval . $$

For net premium reserves,

$$ {}_0V = 0 \quad \text{and} \quad {}_mV = matval . $$

In each case the missing parameter is calculated by formula (C2) or formula (C1). For retrospective reserves, ${}_mV$ equals the guaranteed maturity value plus the accumulated profit. For prospective reserves, ${}_0V$ equals the negative of the present value of future profits. For net premium reserves, P is the "net" premium, which is also called the "pure premium."

If the same assumptions for interest, mortality, and expense are used, then prospective reserves, retrospective reserves, and net premium reserves will all be equal if they all satisfy the same initial conditions, or, in other words, if either of the following equivalent conditions holds:

a) For both prospective and retrospective reserves, the premium is the net premium.

b) For both prospective and retrospective reserves, ${}_0V$ is zero and ${}_nV$ is the fixed maturity value.

While some authors use the reserve at "duration 0" to mean the reserve after the payment of the initial premium and expense, in this paper ${}_0V$ means the reserve before any premiums or expenses have been paid. The reserve equations can be modified to handle lapse rates, conversion rates, and settlement option rates.

APPENDIX D

REVENUE RULING 67-180

The revenue ruling prevented a life insurance company from taking a tax deduction for the liability for future retrospective rate credits. The liability could not be deducted as a "reserve for return premiums," or as a benefit reserve, or as a dividend reserve.

The liability cannot be deducted as a "reserve for return premiums," because a "reserve for return premiums" cannot be contingent on risk factors. (On cancelable policies, a casualty company holds a "reserve for return premiums," that is equal to the funds the company would return if it canceled the contracts. But the return premium is not contingent on past claims.)

Also, the refund itself depends on the experience of the policyholder and is therefore a policyholder dividend and not a return premium.

The liability cannot be included as part of the benefit reserve (referred to as the "unearned premium reserve" in the ruling), because the liability is not payable until after the insurance coverage has expired. (Furthermore, the regular benefit reserve already provides adequately for unaccrued claims.)

The liability seems to be a reserve for future policyholder dividends. But it does not meet the specific tax rules governing the calculation of the dividend reserves. To be included in the dividend reserve, a specific dollar-and-cent amount must be fixed. The money can be subject to the contingency that the policy will no longer be in force, but the payment cannot be reduced because of other factors, such as adverse claims.

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DISCUSSION OF PRECEDING PAPER

TED BECKER:

I want to compliment Mr. Kabele on his well-researched and thought-provoking paper. The universal life and indeterminate premium plans are still relatively new. They have been developed and marketed in a high-interest-rate environment. It will be interesting to see whether policyholders are satisfied with these plans over a long period of time, when a variety of economic conditions may prevail.

The following comments are my own views and do not necessarily represent a position of my employer, the Texas State Board of Insurance.

The paper indicates that state insurance departments generally have treated the entire stated maximum premium in an indeterminate premium plan as a very real quantity, even though in most cases a substantial part of this premium will not be paid. While this method of viewing the maximum premium seems to have prevailed, it should be pointed out that there are other ways of looking at indeterminate premium plans. Here are some significant differences between indeterminate premium plans and traditional plans.

1. The Standard Valuation Law and the Standard Nonforfeiture Law do not require, or even imply, that indeterminate premium plans and traditional participating plans should be treated in a parallel manner (with premium reductions below the maximum considered as equivalent to dividends). These laws define specific formulas for participating policies, but contemplate that a regulation will be applicable to indeterminate premium plans.
2. Language that severely impedes the company's right to charge the maximum premium at a future duration has been permitted in indeterminate premium contracts. On the other hand, contract language that would restrict the company's right not to pay a dividend, or to pay a very nominal dividend, is not allowed in participating policies.
3. In a traditional participating policy, a high gross premium could be advantageous to the policyholder by creating higher profits for distribution as dividends. However, a high stated maximum premium in an indeterminate premium policy appears to be entirely unfavorable to policyholders. (This assumes the company is ethical and has not artificially inflated the maximum premium for later policy years to reduce cash values and compete with lower current premiums on that basis.)
4. Indeterminate premium plans can be sold to policyholders in the anticipation that gross premiums are likely to remain level at the initial premium rate if current economic conditions persist. Yet, there is no limit on the company's right to select a maximum premium rate for its contracts. One such indeterminate premium plan con-

tract permits the company to charge more than twice the initial premium at certain later durations. An attempt by the company to charge such high premiums in later years might well create some of the same problems encountered with accident and health insurance. This could happen either with one large increase in out-of-pocket gross premium, or two or three smaller ones in successive years. Rate spirals that are not anticipated by policyholders could "cream off" the good risks and expose a company to financial hazards. Of course, the dividend scale under a participating policy can be reduced or the dividend discontinued entirely, but typically the participating policyholder does not expect to have a level out-of-pocket premium rate. The participating policyholder is more likely to view his dividend as incidental to the premium-benefit structure of his contract.

The paper also mentions the increasing impact of federal income tax treatment on policy design. Companies are guaranteeing more and more, and at some point the boundaries of prudence will be exceeded (if indeed, they have not been already). Also, there is often a long delay before federal income tax questions finally are resolved.

To some extent, favorable treatment of policyholders and protection of company solvency always have been necessary goals, to be balanced against each other. Years of regulation of insurance at the state level apparently had resolved this balance in a way that was reasonably satisfactory to both companies and policyholders.

Now this delicate balance has been disturbed by federal income tax considerations. It is deplorable that a company feels obligated to make guarantees for any reason except to offer a more competitive product. Something is wrong if the purpose of the guarantees is to reduce taxes and if the company feels it can pass the tax savings on to policyholders.

Unfortunately, it is much easier to state the problem than to do anything to cure it. Ideally, federal tax questions should be resolved promptly, and in a manner that is fair to competing products. Federal tax policies should not encourage companies to make imprudent contractual guarantees. Such incentives are detrimental to the goal of company solvency and ought to be discouraged.

ROBERT J. CALLAHAN:

Mr. Kabele makes an excellent case that the "premium reductions" under indeterminate policies and the "excess interest" under universal life policies should be treated as "dividends and similar distributions" for federal income tax puroses. Yet, it is possible that these "premium reductions" and "excess interest" payments are *not* dividends for state insurance regulatory purposes.

It appears that many insurers have not considered the benefit increases and premium reductions as dividends in computing federal income taxes for

1981 and earlier years. If the IRS were to define these items as dividends and require insurers to refile tax returns for the past years, the back taxes conceivably could bankrupt an insurer that had not established reserves or allocated surplus in anticipation of an adverse retroactive ruling. This possibility is of concern to other insurers who may be part of a fund guaranteeing to pay benefits and claims of bankrupt insurers and to state insurance regulators concerned with solvency and payments of benefits. Fortunately, under the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA), Congress specifically ruled out any adverse retroactive ruling but put the insurers on notice not to draw any inference with respect to the treatment of any item in taxable years beginning after December 31, 1981 (Sec. 263(b)).

As Mr. Kabele notes, "In recent years this complicated tax law has become the dominant factor in the pricing of permanent products." At times, insurance department regulators are put in the delicate situation of approving or disapproving forms and products with considerable apparent tax advantages without any ruling from the IRS. The split of permanent insurance into term and permanent portions for group term insurance and for the term premiums is a prime example. In many cases, there were long delays in receiving tax rulings requested by insurers. The insurance department regulators do not have the responsibility of either administering or interpreting the federal income tax law, but they do have responsibility for proper disclosure to policyholders, for prevention of misleading advertisements, for regulating insurer solvency, and in some cases for the review of policy provisions and contract forms.

Products designed for tax advantages may have features that are otherwise beneficial to policyholders and that tend to safeguard the solvency of insurers. Such products might have been developed even though there were no tax advantages. The indeterminate premium policy and the universal life policy are examples. Under the indeterminate premium, an insurer can assume continuation of high interest rates and pass on anticipated savings in the form of lower premiums, provided it has the right to increase premiums if future expectations deteriorate. Policyholders are protected against excessive increases by a fixed maximum premium.

The New York Insurance Department spent two years considering the indeterminate premium policy. The dominant question was whether or not the policy was participating under New York insurance law. If, for state insurance regulation, it had been concluded that the indeterminate premium policy were a participating policy, then it is doubtful that it would have been considered an equitable distribution method. The Society of Actuaries study notes (82-41-74, p. 5, and 89-61-79, p. 14-15) recognize the experience premium method of dividend distribution but point out that this method is

used primarily to level out the factors of mortality and expense savings and is not used if the investment fund is an important element. Where the investment fund is an important factor, a dividend is calculated in two portions: (1) a level portion representing the mortality and expense factors, and (2) a portion representing the excess interest factor times an increasing fund for permanent insurance (Study Note 89-61-79, p. 14).

If the indeterminate premium policy were determined to be participating, then it would have to provide the four dividend options required for permanent policies under Section 216 of the New York law and the amount of stockholder dividends would be limited under the same section.

Traditionally, nonparticipating business has been identified with fixed premiums. But there is no specific reference in the insurance law requiring a nonparticipating policy to have a fixed premium. In calculating minimum reserves and nonforfeiture values, Sections 205 and 208(a) refer to the "respective contract premiums" and the "respective premiums specified in the policy." An interpretation could be made to use either the initial premium scale with no changes in assumptions or the maximum premium scale.

The guaranteed renewable adjustable premium accident and health policy served as somewhat of a precedent. Some insurers issued both a guaranteed premium policy, commonly called noncancellable, and an adjustable premium policy, commonly called guaranteed renewable. The noncancellable premium generally was larger than the guaranteed renewable premium, although theoretically the reverse could be true as, for example, when an insurer felt that disability income claim rates would come down in future years. Guaranteed renewable policies generally had no maximum premium and were written by both stock insurers (labeled nonparticipating) and mutual insurers (labeled participating). While mutual insurers may have anticipated dividends on disability income policies, there were other guaranteed renewable adjustable premium accident and health policies such as hospital, medical, and surgical policies under which no dividends were contemplated and under which the only direction of premium changes was upward.

The insurers argue that the indeterminate premium policy is not participating since (1) the dividend is a distribution of surplus, whereas the premium redetermination does not distribute surplus, and (2) a dividend is based on past experience, whereas adjustments in premiums are based on future expectations as to interest, mortality, and expense. One insurer suggested that the New York Insurance Department require that adjustments not distribute past gains or recoup past losses and that any adjustment be made upon prospective assumptions. Both such requirements subsequently were incorporated in Circular Letter 18 (1980) dated December, 19, 1980. Mr.

Kabele points out the practical difficulty of enforcing the first requirement. In this regard, the circular letter relies on certification by the company actuary. Mr. Kabele aptly points out that future expectations are based upon past experience and that future investment income is based in part on past investments. The circular permits a participating indeterminate premium policy that could distribute any past gains in addition to "premium reductions" based on future expectations.

Although the circular letter made the distinction between actual past experience and future expectations, such distinction may be questionable in view of the fact that Sections 204, 221, and 223, pertaining to group life, group accident and health, and group annuities, respectively, explicitly recognize the readjustment of the rate at the end of the policy year based on the experience thereunder. Some consider these sections as permissive, whereas others view them as restricting the period of retroactivity.

Perhaps the real distinction lies in whether or not there is a distribution of surplus.

It is highly unlikely that an insurer in danger of insolvency could be barred from including provision to replenish surplus depleted through past losses in any readjustment of future premium.

The New York Insurance Department also considered the federal income tax question. The tax treatment would not have made much difference for some mature stock companies being taxed on taxable investment income. For other insurers in a different tax phase, the tax treatment would have made a great difference. In any event, the department was satisfied that the question was before the IRS and no matter what the final determination, the product appeared beneficial to the insurance public with a premium lower than otherwise available.

Some mutual insurers, recognizing the potential of a participating indeterminate premium policy with premium reductions based on future expectations that would not be considered dividends, threatened to amend existing policies as well as to write new business on that basis, effectively wiping out the tax base.

Deficiency premium reserves are a highly controversial topic. They may be desirable from a solvency standpoint, but the drain on surplus may either curtail the sale of business or force the premium up to avoid surplus drain. The right to charge a higher premium appears to justify reducing the premium deficiency reserve, making low premium products more available.

The indeterminate premium policy is limited in that adjustments can be made only to future premiums. This reduces its applicability to limited-payment and paid-up policies. However, some ingenious actuaries devised

a continuation-of-premiums concept in which premiums would be paid by automatic premium loan, producing a quasi-paid-up policy that continued to "participate" in future expectations.

No sooner had the circular letter been issued than the excess-interest universal life concept became prominent. The annual declaration of factors of interest, mortality, or expense more favorable than the guarantees closely resembled the traditional dividend contribution method. This required a new review of the universal life product, even if only one or two of the factors were subject to more favorable rates.

The major question was whether the annual crediting of additional interest made the policy participating. As an exception Section 216.7 permits both participating and nonparticipating policies or contracts to pay additional interest over that guaranteed on the deferred payments of the proceeds at such rate as the insurer may declare annually. In 1970, this section was used as the basis for approval of annually declared excess interest on nonparticipating deferred annuity contracts. Subsequently, in 1979, the insurance law was amended to add a new section 216(a) to recognize explicitly the crediting of additional amounts under deferred annuity contracts as another exception under Section 216.7.

Section 227 specifically authorized insurers to credit interest in accordance with the experience of the separate account whether the policies were participating or nonparticipating. Mutual companies have to label their separate account deferred annuity contracts "participating" even though the main source of the dividend is likely to be excess interest credits and, under a separate account, there are not likely to be any excess interest credits over and above those resulting from the investment experience.

One large mutual insurer asked the IRS for a ruling by presenting two similar policies side by side, one a traditional participating whole life policy and the other a universal life policy, with either dividends or additional amounts calculated in similar fashions. From a practical standpoint, it appeared that the IRS would have to consider the premium reductions under indeterminate premium policies and the additional amounts under universal life policies as in the nature of dividends or suffer the destruction of the tax base, unless Congress revised its formula for taxing insurance companies.

The New York Insurance Department's decision to require changes in the insurance law to make an exception for universal life bought some time during which tax rulings could be issued and/or the law changed for the policyholder tax as well as the company tax. Mature companies were in danger of losing business to newer companies using a product featuring not only the higher new-money rates but also a more favorable tax treatment on the distribution of such savings.

The Department worked with an industry advisory group for changes in the insurance law. Among the changes enacted in the spring of 1982 was another exception in Section 216.7 and a new Section 216(b) to recognize additional amounts declared prospectively under life insurance policies as not being dividends. The law permitted the department to withhold approval based on tax considerations. Subsequently, in 1982, Congress enacted TEFRA. The department continued to work on guidelines with an industry advisory group and issued Circular Letter 4 (1983) dated March 16, 1983. This circular recognizes that not all of the tax issues are settled yet. It prohibits claiming a favorable tax status unless a citable reference can be given. Nonetheless, the questions are currently before the proper authorities.

The circular recognizes that for state insurance law the additional amounts are not dividends, and that a participating universal life policy may provide for a dividend distribution of past gains as well as additional amounts declared prospectively.

As conditions change and new products appear, it is necessary either to interpret present insurance law or to amend the law to accommodate products that may be beneficial to both insurers and insureds. There will be reasonable differences of opinion. The interests of various parties must be balanced, including not only the insuring public but also the various insurance companies.

For years there have been complaints about excessive and discriminatory taxes on insurance companies. It was only natural that insurers would devise ways of lowering taxes. While the premium reductions of indeterminate policies and the additional amounts (mostly excess interest) of universal life policies had the potential to eliminate the tax base for both stock and mutual companies, the use of modified coinsurance did drastically reduce the taxes of several large mature insurers. The TEFRA stop-gap legislation eliminated the tax advantage of modified coinsurance but did not settle by law the questions concerning the indeterminate premium policy and the universal life policy.

In the current considerations of a permanent new tax law for insurance companies, the questions raised by Mr. Kabele should be considered by the industry, legislative committees, Congress, and the Internal Revenue Service. The law should be explicit enough to avoid undue pressure on the IRS for interpretation on important issues, and enable it to make timely decisions on items not explicitly covered by law. In drafting any new tax law, cooperation of mutual and stock insurers is needed to present a unified industry position, and to enable the tax burden to be shared equitably by the various types of insurers. Yet it is possible for some items to be defined differently for federal tax purposes and for state insurance regulation.

J. CALVIN WINTER III:

The purpose of the corporate federal income tax code is to tax "corporate" earnings, which generally would be defined as income that insures to the benefit of shareholders as a result of having invested risk capital in the enterprise.

The general tax code provides for full recognition of all sorts of variable product cost elements that benefit the customers, as contrasted with the owners, of an enterprise. These would include automobile and consumer appliance rebates, rent increases and decreases, indexed mortgage interest rates, and so forth. In the general corporate context, it is relatively easy to distinguish between variable product-cost elements and distributions of corporate earnings by determining whether a customer or a shareholder receives the benefit.

When Congress contemplated a new federal income tax law in the late 1950s, this distinction was not nearly as easy to make for mutual companies since the customers and owners were the same. To conclude that all moneys being returned to policyowners were reductions in cost, as contrasted with distributions of risk capital earnings, would have exempted a significant portion of the industry from taxation. Congress very properly felt that a portion of mutual company dividend distributions represented risk capital earnings. Or why else would such distributions be labeled "dividends"?

Mr. Kabele feels that the difference between this and the type of company issuing a policy with a nonfixed cost element is not all that important. Instead, I would assert that this distinction makes all the difference. Clearly, the intent of the corporate income tax code is to tax the owners of an enterprise rather than its customers. The limitations on deduction of policyholder dividends were meant for that one small subset of the corporate world, mutual insurance companies, where owner and customer are not mutually exclusive. For stock life insurance companies, the distinction between customer and owner is clear to all.

A major portion of the paper is devoted to refuting a set of arguments that stock companies allegedly advance as the reasons that excess interest, "phantom premiums," and various other elements of nonparticipating policy costs should not be considered to be dividends. I had previously come across only two or three of these arguments at the numerous stock company tax sessions that I had attended.

Three very basic stock company arguments, however, received a disproportionately small amount of discussion, in terms of importance. These are the three criteria by which the tax code identifies product-cost components as fully deductible returns of premium, rather than dividends. As a review,

a product-cost component is not a dividend if (1) it is contractual; (2) it is not subject to the discretion of company management, and (3) it is not dependent upon the overall profit and loss experience of the company.

A good source for the reader in determining precisely what these criteria mean would be the *Republic National Life* case (U.S. Court of Appeals, 5th Circuit, no. 77-2062, May 5, 1979). The verdict in this case was that refunds made to certain groups of nonparticipating group insurance policyholders in accordance with the terms of contractually defined formulas were properly defined as return premiums and were entitled to unrestricted deduction. In our society, the judiciary is charged with interpreting both the meaning of our laws and the underlying intent of the legislative bodies that enacted them. Therefore, with regard to the issues addressed, one would have to assume that the verdict represents a definitive view of the true intention of Congress in writing the 1959 act. The verdict clearly refutes Mr. Kabele's claim that "fixed in the contract" requires dollar-and-cent identification. While he may not personally accept the full deductibility of formula-generated amounts, it seems quite clear that the courts do.

STEPHEN D. BICKEL:

Mr. Kabele's paper has been very helpful in defining the issues involved in the income tax treatment of life insurance products.

There is a clear theoretical difference between participating and nonparticipating contracts, even if the contracts are universal life or indeterminate premium forms. The difference lies in the method used to compute revised premiums and interest rates after the policy is in force.

Under a participating indeterminate premium contract, the fund used to calculate a renewal premium should be a retrospective asset share, based on the actual experience prior to the date of the premium recomputation. This fund, plus the present value of renewal premiums, should equal the present value of future benefits and expenses based on current assumptions. In this manner, past gains will be distributed and past losses will be recouped from future premiums.

Under a nonparticipating form, the fund would be a natural reserve, with profits deducted, based on the experience assumed at the time of the previous rate computation. Under this method, the profits and losses resulting from variations between actual and assumed experience would be credited or charged to the stockholders.

The author's research into actuarial antiquity is interesting to read. It seems likely that the contracts described in Sections I.B.7–10 were truly participating plans. I suspect the "phantom premium" accounting suggested

by Henry Moir never was adopted officially. Certainly it would not be a permissible accounting method in the United Kingdom today, since it would inflate the policyholder's tax relief.

JOHN J. PALMER:

It is quite a challenge to respond to a discourse that covers as much ground in as much detail as does Mr. Kabele's provocative and timely paper on federal income tax treatment of dividend and (possibly) similar items. Nonetheless I feel compelled to respond, if only to provide a counterbalancing point of view on some of the issues raised.

However much I may envy Mr. Kabele his library (and the time to use it so thoroughly), I am troubled by the presentation. Aside from the distractingly polemical tone that pervades the paper, it seems to be compounded from three distinct assertions which are confusingly intertwined. These three assertions are:

1. Excess interest credits and indeterminate premium reductions *are* dividends or similar distributions under *current* law;
2. Excess interest credits and indeterminate premium reductions *should be* treated as dividends or similar distributions under *future* law; and
3. There are certain economic and actuarial similarities between dividends (in the traditional sense) and excess interest credits and indeterminate premium reductions.

It is not always clear which of these assertions is being advanced at any particular point. Further, it is doubtful that they and their supportive argumentation are appropriate material for the *Transactions*. It is my personal feeling that only the third assertion is appropriate. The first is appropriately a matter for the courts and the second a matter for Congress. However, since these nonactuarial matters have been raised, I presume that it is fair for discussants to comment on them.

Excess interest credits and indeterminate premium reductions were not even dreamed of by the framers of the 1959 act, however much actuarial archaeology is done to unearth the alleged forerunners of these items. The pertinent question for determining the appropriate treatment of these items is whether they meet the conditions laid out in the current law and regulations. It does not seem necessary to go as far afield as the paper does; consider Mr. Justice Holmes' comment on the limits of judicial inquiry into statutory construction: "We do not inquire into what the legislature meant; we ask only what the statute means" (Holmes, *Collected Legal Papers* [1920] p. 207). On the matter in question, the statute, together with its regulations, seems reasonably clear. Regulation 1.811 states

dividends to policyholders mean dividends and similar distributions to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which, during the taxable year, contains the right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders, if such amount depends on the experience of the company.

The second sentence gives sufficient conditions (but not *all* sufficient conditions, as evidenced by the use of the term "includes") for an amount to be treated as a dividend. The definition is generalized further by the following two sentences. Thus, to avoid dividend treatment, the items in question must be shown to avoid both the narrower test of the second sentence and the more general tests of the third and fourth sentences.

The basis for Mr. Kabele's argument (in Sec. I.B.4) that the phrase "not fixed in the contract" is the primary test, and that the phrase "depends on the experience of the company or the discretion of management" is a subsidiary test, is unclear. The grammatical construction implies parity; the purpose of giving both phrases, the one a negative formulation and the other a positive formulation, must be to sharpen and clarify the definition. To the extent that the two phrases define classes of items not exactly coextensive but overlapping, it is unclear whether the union or the conjunction of the classes is intended. In settling such a question it would seem reasonable to turn to the third and fourth sentences, which are by their own terms general statements of statutory intent.

The third sentence clearly has no application to the contracts under consideration since they are not "participating" under state law or under the terms of parenthetical definition provided by the regulation. The fourth sentence contains the key phrase "depends on the experience of the company." It seems clear that an amount guaranteed to be paid to the policyholder regardless of future experience (barring insolvency) cannot be said to depend on the "experience of the company." Mr. Kabele's treatment of this phrase (in Sec. I.A.10) is limited to analyzing its meaning with respect to the determination of traditional dividends. A showing that, to some extent, traditional dividends may not depend on the experience of the company does not constitute a demonstration that excess interest credits and indeterminate premium reductions do depend on the "experience of the company."

A similar logical failing undermines the arguments on the "retrospective versus prospective" issue (in Sec. I.A.1). This section argues that some

prospective element is involved in the determination of traditional dividends. However true this may be, it has no bearing on the prospective nature of the items in question.

This section also contains (in Sec. I.A.1.*a*) another fallacy worth noting. It is argued that because some of the formulas used for indeterminate premium and universal life products are retrospective in form, it follows that distributions made thereunder are "retrospective" (presumably meaning that they thus depend on the experience of the company). It seems clear that no amount of algebraic transformation of cash value or other formulas or subsequent general reasoning interpretation has any bearing on the real character of the items in question.

At most, the argument that traditional dividends do not depend on "experience of the company" or are partially prospective in nature suggests that some portion thereof is not treatable as dividends for tax purposes. Perhaps Mr. Kabele would argue (as in Sec. I.A.6) that such treatment would seriously erode the revenue base, and well it might. The remedy for erosion of revenues from an unanticipated source is the same as that used for modified coinsurance treaties based on IRC Section 820, and is the remedy on which Mr. Kabele and I seem to agree—change the law to provide clear and equitable treatment.

In Section I.E., and by implication in Section I.B.4, the paper uses a congressional colloquy to argue that excess interest credits and indeterminate premium reductions not fixed as to absolute dollar amount by contract must be treated as dividends. There are several problems with this argument:

1. It seems clear that neither Mr. Mills nor Mr. Rhodes had these particular items in mind during their exchange, contrary to the implication in the paper. Instead it seems much more likely that they had in mind the kind of vague promise apparently found in some participating contracts cited elsewhere in the paper (such as the Amicable "guaranteed" dividends mentioned in Section I.B.4).
2. The form of Mr. Rhodes's quotation (note the phrase "the amount of which is not set forth in the contract in dollars and cents *or a percentage*" [emphasis supplied]) clearly implies a parity between dollars-and-cents amounts and those determined by applying a percentage to some base, which is, after all, nothing but a rudimentary formula.
3. The courts seem to have refuted the interpretation drawn in the paper in two recent cases involving a formula determination of group experience rating refunds (*Republic National Life Insurance Company*, 77-1USTC 9133, and *American National*, 82-2USTC 9597).

Looking ahead to the development of a new law and the appropriate shape it should take (which may be an accomplished fact by the time this appears in print), the pertinent question is, what element of dividends and dividend-

like items should be captured by a dividend limitation? Recent testimony in Congress from various parties (including the Treasury) indicates clearly that a major conceptual purpose (and perhaps the only purpose) of any limitation is to capture that portion of distributions to mutual company policyholders that is a "return on owners' equity" (analogous to the return provided to the owners of a stock company) to prevent its deductibility in determining company taxable income and to tax it (directly or by proxy) at the time of distribution. While easy to state, this concept will be rather difficult to implement, as is evident from the extensive discussions on this point of the past year or so. Nonetheless, it does promise to avoid most of the product-design-related issues raised by current law, and seems consistent with Mr. Kabele's hope for the future. However, I have doubts that a limitation set as a percentage of the dividends themselves, as is done under TEFRA, is conceptually or practically sound. Why should the percentage of a dividend required to capture accurately the return on owner's equity for a high-premium high-dividend policy also be appropriate for a low-premium low-dividend policy? Will a limitation or a percentage of dividends not simply cause the definitional arguments to continue unabated? This approach would present serious problems for variable life insurance, particularly the variable form of universal life now on the drawing boards, which might well have no "assumed interest rate."

In conclusion, I would have found the paper easier to accept and to deal with had it been clearly divided according to its three underlying assertions, with each being discussed separately. That said, I agree completely with Mr. Kabele on two very basic points:

1. The dividend issue is a definitional one; and
2. I share his hope that the companies will unite in the goal of obtaining a full tax deduction for policyholder dividends of stock companies and a "reasonable" deduction for mutual companies. That seems to be the path being pursued as I write this.

I am glad to have the opportunity to support Mr. Kabele in his plea for clarity and rationality in the new wave of legislation that seems to be breaking over us.

MARK HUG:

Mr. Kabele's comparison of indeterminate element products to participating products is very provocative. Many of his arguments, which I believe to be invalid or unsound, are presented as indisputable truth. Therefore, my rebuttal will discuss Mr. Kabele's arguments in the order presented in his paper, rather than providing a well-organized statement of the other viewpoint. I anticipate other respondents will fill that gap.

I.A. *Arguments to Justify Nondividend Treatment*

At the beginning of this section, Mr. Kabele maintains that the arguments for nondividend treatment of indeterminate element products arose because of the detrimental tax consequences for phase 2 negative companies. He seems to have altered history in order to corroborate his position. Actually, the distinctions between participating products and indeterminate element products have been recognized for a long time. I am familiar with one company that introduced an indeterminate premium product twenty years ago. At that time, there was no question that such a product was nonparticipating. The arguments for nondividend treatment of indeterminate element products became significant only when certain companies tried to recategorize these products as "participating."

1. DIVIDENDS ARE RETROSPECTIVE, WHILE PREMIUM REDUCTIONS ON INDETERMINATE PREMIUM PRODUCTS AND EXESS INTEREST ON UNIVERSAL LIFE PRODUCTS ARE PROSPECTIVE

a) Universal Life Is Really Retrospective

Mr. Kabele contends that a policy revision with assumptions that contain little future risk is retrospective. While a retrospective revision does contain little risk, I do not agree with the converse of the argument. The absence of risk dose not dictate whether assumptions are redetermined retrospectively or prospectively.

Furthermore, a company may want to base its expectations on its past investments if it assumes that the past is a good indicator of the future. The significant point is that, once estimated, a credited interest rate (or other revision) will be paid regardless of what the company actually earns. The company will not distribute past profits or recoup past losses.

Finally, the author indicates that the investment-year method is retrospective because it utilizes recursive formulas. Apparently, he is confusing "retrospective" with "recursive." A retrospective formula is one that reflects the *actual* past in determining the present. A recursive formula is one that reflects the past (either actual or assumed) in determining the present. If a company has a prospective revision philosophy, then it can not change its past assumptions within a recursive formula to reflect the present. For example, if a company declares a new-money rate of 8 percent in conjunction with the investment-year method, then that rate should be used in its formulas regardless of what the company actually earns. Thus, a recursive formula is not inherently retrospective *or* prospective. The crucial point is how incorrect expectations are treated in revising assumptions to be used in the formulas.

c) Prospective Pricing Cannot Be Enforced

Prospective pricing and revision may not be strictly enforced, as Mr. Kabele argues, but such an argument is irrelevant to his stance that nonparticipating indeterminate element products are actually participating. The amount of regulation or enforcement underlying a particular revision philosophy cannot categorize this philosophy. If so, one could use the same type of argument to show the opposite of Mr. Kabele's stance. (For example, since participating business cannot be enforced, one may conclude that it is nonparticipating.)

2. STATE INSURANCE DEPARTMENTS CATEGORIZE THE PRODUCTS AS NONPARTICIPATING

The underlying goals of the state insurance departments are to protect the consumer and to assure company solvency. To meet these goals, the regulators have treated these nonparticipating products with caution. Also, it is logical for the insurance departments to allow guaranteed maximum premiums to be used for computing minimum reserves since the purpose of such reserves is to fund for future explicitly *guaranteed* benefits, while considering future *guaranteed* premiums.

Additionally, indeterminate element products have other constraints not characteristic of participating business:

1. The basic reserves and cash values commonly are required to be the maximum of those generated by the current premium slope and the guaranteed premium. Applying this constraint, one would conclude that most participating contracts are simply decreasing premium business with level guaranteed premiums *and insufficient cash values*.
2. Certain states require a company's assumptions, the method of revision, and the company's philosophy, before approving an indeterminate element product or approving the revision of such elements.
3. Most states demand that companies provide policyholders with a statement giving the current status for certain types of indeterminate products.

4. DIVIDENDS HAVE A CASH OPTION WHILE EXCESS INTEREST AND PREMIUM REDUCTION DO NOT

Mr. Kabele states that "the premium reductions and the excess interest credits on indeterminate premium and universal life products are not paid in cash, but they have an easily measured value and are virtually equivalent to cash." I disagree. Many universal life products incorporate surrender charges to be assessed upon termination of the policy. These charges decrease over time so that the full benefit to the policyholder is realized in cash only if the policy outlasts the surrender charge period. The value of this benefit is not easily measured, since the policyholder must subjectively weigh the greater future benefit against the lesser current benefit. Thus, indeterminate

element products do not necessarily yield immediate benefits as do participating products.

5. UNIVERSAL LIFE AND INDETERMINATE PREMIUM PRODUCTS ARE ISSUED BY STOCK COMPANIES WHICH SHOULD BE PERMITTED TO DEDUCT CUSTOMER DISCOUNTS

Mr. Kabele asserts that the type of company issuing the product is irrelevant. This is not true, since there is a difference in purpose between a mutual company and a stock company with respect to the policyholders. The purpose of the mutual company is to provide insurance at cost, allowing its owners (the policyholders) to share equitably in its divisible surplus. A stock company, however, is governed by its contractual obligations to its policyholders. Thus, business on which a stock company agrees that its policyholders are entitled to participate in the divisible surplus is called participating. Business on which the company agrees only to prospective revision is called nonparticipating, nonguaranteed business.

This company differential allows the policyholder a choice. For full participation, a policyholder may go to a mutual company or a stock company offering participating contracts. If the policyholder wants only a prospective revision guarantee, there are stock companies selling indeterminate element products.

9. THERE IS NO PREMIUM REDUNDANCY INVOLVED IN EXCESS INTEREST

Mr. Kabele states that there is an interest rate redundancy in universal life products. This is true only when the interest rate is not guaranteed at issue. My company's universal life plan, T-Plan, guarantees from issue to pay the policyholder the Treasury-Bill discount rate, thereby eliminating any interest redundancy.

10. DIVIDENDS ON PARTICIPATING POLICIES DEPEND ON THE "EXPERIENCE OF THE COMPANY," WHILE EXCESS INTEREST CREDITS AND INDETERMINATE PREMIUM REDUCTIONS DO NOT

Mr. Kabele remarks that "experience of the company" means that a participating policy "'participates' in earnings reasonably attributable to its own contribution." This misses the point that the distinguishing characteristic is not to be found in the interpretation of the previous phrase, but in the treatment by the company of the two types of products. There is a difference between participating in a company's surplus and having the policy's cost be commensurate with future expectations. The former entails a sharing of profit while the latter is governed only by changes in assumptions. With nonparticipating indeterminate element contracts, there is *no* participation.

12. ON INDETERMINATE PREMIUM REDUCTIONS OCCUR AT THE BEGINNING OF THE POLICY YEAR WHILE DIVIDENDS ARE PAID AT THE END OF THE YEAR

In this section, the author circumvents the intent of the argument by suggesting that dividends were at one time contingent on the next premium payment, thereby implying that they are paid at the beginning of the year. The original argument deals not with the timing of dividend payment or with the conditions of dividend payment, but with the period of time accounted for by the dividend. Dividends are retrospective adjustments that are necessary because of previous conservative assumptions of the future. They may also serve to correct erroneous prospective estimates upon which the dividend scale was based. Therefore, the logical time to pay dividends is after the period of time on which they are based.

Indeterminate element changes, on the other hand, are based solely on estimates of the future. Hence, it is natural that any changes in the indeterminate elements be made before the period affected by the pricing change.

I.B. *Arguments to Justify Dividend Treatment*

Throughout this section, Mr. Kabele describes the many similarities between participating policies and indeterminate element policies. The similarity between these two types of products originates from the fact that they are both nonguaranteed cost products. But, while both have nonguaranteed elements, they are still very much distinct.

1. RISK

Mr. Kabele ascribes similarities in risk to participating and indeterminate element policies by asserting that both shift the risk of premium or interest changes back to the policyholder. However, there is no shifting of risk with nonparticipating indeterminate element policies, since the company contractually undertakes less risk than with corresponding guaranteed cost products. This produces a lower risk premium for indeterminate element products.

The risk of incorrect projections is the major difference between these two products. If a company makes an erroneous assumption with respect to a participating policy, it may recoup the losses through the dividends. However, if the company makes an erroneous assumption with respect to a nonparticipating indeterminate element policy, it may not recoup the past losses associated with the error.

3. NONGUARANTEED ECONOMIC BENEFIT

Even though nonparticipating indeterminate elements are nonguaranteed economic benefits to the policyholder, this does not imply that such elements are to be treated as dividends. Dividends are nonguaranteed benefits that

reflect the experience of the group and its contribution to divisible surplus. The purpose is to provide insurance at cost in an equitable manner.

An indeterminate element is a nonguaranteed benefit that reflects the future expectations of the company for the purpose of stabilizing future profit for the company. There is no contribution to surplus nor insurance at cost. The company does not reflect the past experience of the group nor does it guarantee policyholder equity. Thus, while dividends and changes in indeterminate elements have similarities, they really are distinct.

5. NONPARTICIPATING MEANT "GUARANTEED COST" TO CONGRESS

Mr. Kabele, through several quotations, indicates that Congress assumed nonparticipating meant "guaranteed cost." However, careful consideration of the references leads to the conclusion that guaranteed cost products provide the policyholder with no right to *participate* in company surplus, thereby giving the company no opportunity to adjust gains from operations through dividend distribution. This is the same intent underlying indeterminate element products! A company cannot adjust future rates or benefits in order to adjust past gains from operations. This is very distinct from participating business.

7–9. THE ACTUARIAL LITERATURE SUPPORTS DIVIDEND TREATMENT FOR INDETERMINATE (ELEMENT) PRODUCTS

These sections cite actuarial literature that presumably substantiates Mr. Kabele's assertion that nonparticipating indeterminate element products originally were conceived as participating products. This argument begs the question. The literature quoted refers to participating business and does not describe nonparticipating indeterminate element products.

The name of the product does not determine its treatment. Any policy that shares in company surplus is participating regardless of the name given to it. Likewise, any policy that does not share in company surplus is nonparticipating. If such a policy incorporates nonguaranteed elements, it is simply a nonparticipating indeterminate element product.

Some actuarial literature supports the nondividend treatment of nonparticipating indeterminate premium products. In Paul Barnhart's article, "Adjustment of Premiums Under Guaranteed Renewable Policies" (*TSA* XII [1960], 472) he states:

> The function of the dividend is to allocate distributable earned surplus to the various morbidity classes recognized as significant for purposes of practical equity among participating policyholders. It deals with the total fund account retrospectively.
>
> The function of premium adjustment is to adjust the value of future premiums to a

change in the expected prospective value of policy costs and benefits. It deals with the total fund account prospectively.

In addition, the article "Universal Life Valuation and Nonforfeiture: A Generalized Model," by Shane Chalke and Mike Davlin, sheds new light on the treatment of universal life products (*TSA* XXXV [1984] p. 000).

I.D. *Distinguishing Universal Life and Participating Products*

Mr. Kabele contends that universal life and participating products are "basically alike" since both credit policyholders with mortality and expense savings as well as with excess interest that is not fixed in dollars and cents at issue. He does not attempt to distinguish how such credits are determined in the two types of products. How would he label variable life or foreign currency products? Would they be labeled participating, since they are basically similar to participating products?

All indeterminate element products are labeled nonparticipating because that is precisely what they are. The significance of the definition lies not only in the tax benefits and the lack of statutory earnings limitation, but also in the risk to the company and in the actual changes made to the indeterminate elements.

For an illustration of this difference, consider the volatile economic environment of the late seventies. During this period, companies experienced high inflation, high lapse rates, and high policy loan utilization. The latter two factors further inhibited companies from taking advantage of high-yielding investments.

Assume that, at the outset of this period, a stock company began selling two products that were identical in all respects except that one was a participating product and the other an indeterminate premium product. Further assume that the company did not correctly forecast the future. Upon revision of the dividends under the participating product, the company would incorporate all the past losses into its revised scale even if a more stable economy were projected. Thus, in this instance, dividends might be lowered. However, in revising the premiums under the indeterminate premium product, none of the past would be reflected. If a more stable economy were procted, the premiums would remain unchanged or lowered, with the company absorbing the past losses. For two products, whose only differences are cosmetic, in the eyes of Mr. Kabele, the net cost can move in opposite directions under the same scenario!

I.E. *Using an Outside Bond Index or Guaranteeing the Dividend Formula*

In this section, the author implies that all indexed products are partici-

pating because of certain characteristics of a few plans. There are companies with products for which the index cannot be changed or is not conservative. While it is true that a company may immunize its liabilities by investing in the assets of the index, there is no *requirement* to do so. Some states require immunization philosophies, but not one attempts to dictate what that philosophy should be. Therefore, the investment risk of an indexed product can be greater than that of a participating policy if the company chooses not to invest in the assets of the index. Furthermore, those products described above would not be participating because of their prospective nature and lack of management discretion.

Mr. Kabele asks "Why should a company get *better* tax treatment if it offers *less*?" He stereotypes all indexed plans into one category, which he believes offers less. His implication that indexed products offer less is completely unfounded and, with many products, false.

Later in this section, the author expresses the opinion, "Of course, even if the premiums or excess interest credits . . . are tied to an outside bond index, the product still meets the risk-shifting, marketing, economic benefit, and nonguaranteed cost criteria of participating products." Participating products have more significant characteristics not found in indexed products, such as management discretion, insurance at cost, the self-supporting nature of the block, class equity, and retrospective experience.

Finally, Mr. Kabele's quote of the *Congressional Record* is not applicable to the argument at hand. The discussion did not involve indexes but guarantees that dividends would be based on company experience. There is a considerable difference. In using an index, the company is contractually responsible to pay that index. In guaranteeing that company experience is used, there is still much discretion.

I.F. *Guaranteeing the Excess Interest or Premium in Advance*

Mr. Kabele confuses the difference between the guaranteeing of future benefits in advance and present benefits (already given) that are guaranteed for some period of time. Indeterminate element products fall into the former category, while dividend distributions fall into the latter.

III. CONCLUSION

I do not believe that "the dividend issue is a definitional one." It actually reduces to a question of ownership and contractual rights. The following questions illustrate the difference.

1. Are the policyholders guaranteed insurance at cost, thereby having an implicit right to divisible surplus?

2. Do the policyholders have a contractual right to divisible surplus as in the case of a participating policy issued by a stock company?
3. Does the policyholder have a contractual right to future indeterminate element adjustments with no right to share in surplus?

In his conclusion, the author suggests that "the goal is product equity, and the restoration of something close to the full tax deductibility of policyholder dividends." I find the former goal too ambiguous and the latter without theoretical foundation. It is very difficult to define a term as subjective as product equity, especially in light of the many different product types available. Furthermore, in order to define the appropriate tax deductibility of policyholder dividends, one must first consider tax parity between stock and mutual companies. When this tax parity becomes a reality, both will be able to compete in a healthy manner, optimizing the consumers' and the companies' best interests.

CLAUDE THAU:

In reading Mr. Kabele's paper, I find many statements about how stock companies handle indeterminate business. Practices obviously vary among stock companies, much as participating practices vary widely among mutuals. Since the indeterminate product held is newer and less analyzed, there may be a wider variation among indeterminate practices than mutual company participating practices. Mr. Kabele provides a great service in stimulating discussion in this area. However, his statements bear little resemblance to our philosophy and practice. Although we have given it much thought, there is little literature available in these areas. My disagreement extends beyond the stock company issues to include different theories regarding the nature of mutual company participating practices. In this response I will

1. Correct the inaccurate suggestions regarding the history of indeterminate products.
2. Reveal the basic error in the position that participating business is prospective as well as retrospective.
3. Explain some of the differences between mutual company participating products and stock company indeterminate products.
4. Delineate the basic ownership and profit-sharing aspects of stock companies and mutual companies.
5. Provide a brief view of nonparticipating indeterminate element guidelines.
6. Expose the weaknesses of the 90 percent earnings limitation that Mr. Kabele discusses.

1. *The History of Indeterminate Products*

Mr. Kabele implies that indeterminate products have recently been de-

signed to take advantage of current tax laws, thereby gaining a competitive advantage over participating policies. In actuality, the reverse is true. Occidental Life introduced its first nonparticipating indeterminate premium product over twenty years ago. At that time, it was a phase 1 company, but there were no tax advantages for such a product. No one ever questioned the fact that this successful product was a nonparticipating nonguaranteed premium product. It is only a recent development that the mutual companies have attempted to create a controversy.

Ironically, the mutual companies have been selling a significant amount of indeterminate products for a quarter of a century, such as the one-year term dividend option, under which rates are guaranteed at a valuation net premium level, but for which lower rates are charged. I am not aware of any mutual company that has ever included the so-called imputed dividend on these coverages in their tax returns.

2. *The Retrospective (Not Prospective) Nature of Policyholder Dividends*

Mr. Kabele states that dividends are both prospective and retrospective in nature, in an attempt to show that indeterminate element products are an extension of participating products. Unfortunately, his approach caused him to miss the essential difference. The supposed prospective element incorporated into dividends is an effort to provide insurance at cost more accurately. This prospective element is not guaranteed and does not affect the final net cost of the product. To the degree that a company issuing participating business discovers that its projected dividend scale has been inaccurate, it can change the dividend scale in the future to recoup past losses or distribute past gains. Thus, even though dividends incorporate prospective estimates, they are still governed by retrospective revisions.

3. *The Difference between Mutual Company Participating and Stock Company Indeterminate Products*

Nonparticipating indeterminate element products, on the other hand, are guaranteed until the next revision, a minimum of one year. To the degree that a company errs in its estimates of the future, it incurs the loss or reaps the gain. It cannot adjust its indeterminate elements in a future revision to account for such an error. Thus, indeterminate element adjustments are not dividend allocations but rather represent an entirely different process involving guarantees and hence risk on the part of the stockholders.

Paul Barnhart explains the difference very well in his 1960 paper entitled "Adjustment of Premiums under Guaranteed Renewable Policies" (*TSA*, Vol. XII [1960]). He states that the function of the dividend is to allocate

divisible earned surplus to various risk classes for purposes of maintaining proper equity among participating policyholders. The function of the premium adjustment is to adjust the value of future premiums in order to match a change in the value of expected future policy costs and benefits. Barnhart's paper explains the essential difference that dividends are retrospective by their very nature, while premium adjustments are prospective.

State insurance departments have taken many steps to ensure that stock companies do not try to recover past losses on indeterminate life and health products. (While that stance has been completely in step with theory, the departments have deviated from proper theory by requiring that the company share its past gains with the policyholder if the company has reason to increase future premiums.)

The following two examples highlight the differences between participating products and nonparticipating nonguaranteed products: In the first example, consider the experience of the last several years. Imagine two inforce products, a mutual company participating product and a stock company indeterminate premium product. This period was marked by rapidly rising interest rates, increased expenses, and high policy loan utilization and surrenders resulting in capital losses. If the dividends are revised at the present time, the mutual company would reflect all of the past in determining a new dividend scale. (Some of the experience might be "smoothed" away, but it then can be recovered subsequently.) In this particular illustration, dividends could conceivably be lowered or kept the same because of the unstable past. However, when revising the premium scale for the indeterminate premium product, the stock company will ignore the past and revise the premiums based solely on future expectations. Both products have the feature of adjusting the net cost. However, given the exact same circumstances and experience, it is possible for the net costs to move in opposite directions.

In the second example, assume that after these two products were put on the market, an epidemic causes mortality rates to increase dramatically for a few years. The losses due to the epidemic will be reflected in future dividends. On the other hand, since the epidemic was merely a past fluctuation in the company's mortality, the stock company would not reflect it in future mortality expectations. Hence, with its indeterminate product, the stock company would incur the loss and not reflect the past in its premium revision.

4. *Ownership and Profit-sharing in Stock and Mutual Companies*

It could be argued that the mutual company would cover the epidemic losses from contingency reserves or surplus. However even if such contin-

gency reserves were to be able to cover the loss, the mutual company could—and, according to the theory of providing coverage at cost, perhaps should—adjust policyholder dividends accordingly. That the mutual and stock companies conceivably could handle the situation identically through surplus simply underscores a very significant point in the current tax discussion within the industry; that is, that the mutual company policyholders have an ownership interest that matches the position of the stockholders in a stock company.

I conceptualize any non-fully-guaranteed product, participating or nonparticipating, stock or mutual, as having an implicit or explicit agreement between the company and policyholder that the company will revise nonguaranteed elements in a fashion consistent with the initial illustration. In my opinion, the actuary's professional responsibility is to revise such factors in accordance with the contract, implied or explicit, and to deviate from that basis only for reasons discussed in an actuarial report provided to management.

Applying this theory to indeterminate products of stock companies, I assert that policyholders of such policies are implicitly guaranteed that they will not be at risk according to the stock company's actual experience. They have no ownership risk nor any burden to share potential losses (or profit), but the stock company reserves the right to periodically revise its future guarantees.

5. *Nonparticipating Indeterminate Element Guidelines*

These sample guidelines parallel the American Academy of Actuaries guidelines for mutual company participating business. There are similar definitions of terms such as "policy factors," similar requirements for periodic review and for documentation, and similar recognition of practical concerns such as solvency, cost justification, smoothness, and so on. The primary features unique to this nonparticipating indeterminate element guideline are as follows:

1. All pricing is prospective. No past gains need be distributed. No past losses may be recovered.
2. Explicit contractual guarantees and implicit illustrative intentions are to be honored.
3. Prospective assumptions should be consistent across all in-force and new business blocks.

My experience with the mutual company participating guidelines is that the disagreements are most likely to be uncovered when one is trying to interpret the guidelines. While the general principles seem acceptable, differences become clearer when details are discussed.

A couple of examples may be helpful. In prospective pricing, an interest rate is expected, based on an expected distribution of assets. Upon a subsequent revision, it is presumed that the anticipated yields were obtained with an asset duration distribution as expected. Hence future interest rates are already defined; discretionary assumptions are set only for new cash flows, including the anticipated rollover.

Another interesting example could be the discount rate. It is an example of a potential formularized assumption. For example, discounting could be done at the CPI inflation rate plus 2 percent. This would result in dynamic, yet consistent, rates between revisions.

6. *Earnings Limitations*

Mr. Kabele cites earnings limitations for stock companies' participating products in some states, when suggesting 90 percent deductibility of policyholder dividends. Not only are such limitations completely arbitrary, but they are entirely irrelevant in determining a deductibility percentage for dividends. The key concern in determining any type of deductibility percentage is that tax parity between mutual and stock companies be upheld, recognizing taxes paid at all levels (company, owner, policyholder).

Although the balance of my discussion does not deal directly upon the issues presented in his paper, this discussion provides an opportunity to point out some of the weaknesses of such an earnings limitation:

1. It allows larger profits for companies who provide inferior guarantees (e.g., higher premiums and higher illustrated dividends) for the policyholders.
2. It does not relate to the risks involved.
3. It can cause illogical results due to timing differences as the 10 percent and $0.50 per thousand alternatives take turns dominating within a company. For example, reserve strengthening set up totally from policyholder surplus (while under a $0.50 guideline) can subsequently be released in part to the shareholders (under a 10 percent guideline).
4. Timing differences between GAAP and statutory accounting can also create problems. Because GAAP earnings might be limited by the $0.50 per thousand alternative, aggregate profits over a long period of time can be different on a GAAP basis than on Statutory basis.
5. It is arbitrary. Why should the limitation be 10 percent and not 5 percent or 15 percent?
6. An aggregate standard can restrict the profitability of marketing opportunities in such a way as to unfairly benefit mutual companies, while harming the consumer. For example, a stock company with a large in-force block on which it abides by a 10 percent limitation may be restricted, in effect, from initiating low-premium/low-dividend participating plans (especially term). A 10 percent limitation would be insufficient on such a plan. Although $0.50 per thousand might be reasonable on the new

plans, it could only be obtained by foregoing substantial profit on the in-force by moving to a $0.50 basis for all business.

Joseph Belth has also expressed concern over this type of earnings limitation in his book entitled, *Participating Life Insurance Sold by Stock Companies* (Richard D. Irwin, 1965, pp. 121–124). He states, among other problems, that "when the primary element in the definition (of earnings limitation) is the net gain from participating operations *before* dividends to participating policyholders, the results are extremely sensitive to reserve valuation techniques," He adds that "participating profits are (also) quite sensitive to the rate of growth of the participating branch."

To reiterate, the key in determining deduction percentages is tax parity, not earnings limitations.

7. *Summary*

Mutual company business is different from stock company business. Participating business is different from nonparticipating business. Inconsistent and misleading or incorrect arguments do not change the significant fact that participating business is retrospective and nonparticipating is prospective. Neither do such arguments change the fact that mutual companies have a single group of people (policyholders) who have the roles of both the policyowners and the shareholders of stock companies. More discussion of stock company indeterminate element business would be particularly worthwhile.

STEPHEN B. MOSES:

Mr. Kabele has given a rather wide-ranging discussion of dividends and nonguaranteed elements of life insurance policies. While I agree in general that these items should be treated in a similar manner for federal income tax purposes, I do not believe that dividends necessarily are identical to excess interest credits and indeterminate premium reductions. Also, I would like to discuss some of my philosophical views concerning the rationale of life insurance taxation.

One can construct a scenario in which classical participating blocks of business and indexed indeterminate premium policies will look very different. It is possible that an indexed policy, for which the premium varies according to some outside index defined in the contract and is guaranteed for the life of the policy, could have enormous losses year after year while the premium charged would have to be lowered. (One example: an index based on the greater of short-term and long-term bond yields.) Surely this is different from participating policies where dividends are set strictly at the discretion of management.

The tax law should reflect this difference in the definition of dividends, if guaranteed and nonguaranteed elements are to be treated differently. Indexed policies should fall somewhere between fully guaranteed and nonguaranteed: the formula and method are fully guaranteed in the contract, but the actual amounts are not known and thus not guaranteed at the time of issue. (The applicable definition of "indeterminate" is "not known in advance.")

It is important that the tax law be as clear and unambiguous as possible to avoid cheating and to let everyone know what is and is not allowed. For instance, the differences between retrospective and prospective probably are real for many companies, but these differences would be difficult to define adequately in the law.

As an example, the boards of some mutual companies may approve the amount of surplus to be paid out based on past earnings (85 percent of after-tax gains, for example) with only lip service given to the assumptions used in the dividend formula. The actuary's job is simply to pay the right dividends. However, pricing indeterminate premium policies involves a different approach, with or without an index. The actuary must develop a set of assumptions for the years ahead and calculate premiums on a purely prospective basis. While the past generally is used as a guide to the future, thus blurring the distinction between prospective and retrospective views, it is conceivable that future assumptions may not reflect past experience at all. An example of this might be lapse rates that are higher than originally assumed in the first policy year but reasonable in later years. State regulations generally would not allow the recouping of those early-year losses, as would be possible for participating policies. While this scenario may seem unlikely, recent years have produced events that our ancestors would have considered inconceivable.

If Congress is attempting to treat guaranteed and nonguaranteed items differently, the tax law should specifically define the differences in those terms. However, there seems to be little more rationale for treating dividends differently than an attempt to treat stock and mutual companies differently and obtain satisfactory amounts of revenue. Differences between stock and mutual companies, permanent and term plans, and so forth, are not really definable, and should be avoided in the tax law if at all possible. As we have seen the past few years, a clever actuary can find the loopholes and use them to his or her advantage.

Also, the tax law should be based on consideration of all possible future events. For example, the Menge formula appeared to be reasonable when the 1959 law was enacted, but the experience of inflation and high interest rates exposed its flaws. A judgment or comparison based on the past year

or two does not indicate whether or not such a relationship will hold in the future. Actuaries and legislators should analyze all contingencies, so that the final legislation does not become outdated in the near future.

My own proposal would be to base taxes on gain from operations, with all types of gains and losses treated the same whether they have been guaranteed or not, since the effects on surplus are the same. Responding to the concern that companies can reduce their tax liabilities by increasing dividends, I would point out that there is nothing to stop a (stock or mutual) company from reducing its fully guaranteed premiums unilaterally. These decreases would be fully deductible, although it would not be possible to increase those premiums in future years.

(AUTHOR'S REVIEW OF DISCUSSION)

THOMAS G. KABELE:

I wish to thank all discussants for their interesting comments, which add immeasurably to the value of the paper. I will respond to a few of their points.

Regulatory Concerns

Mr. Becker points up some of the nontax regulatory concerns with indeterminate premium plans. If an increasing scale of "maximum" premiums is used to calculate cash values, the cash values will be reduced, even if the company intends to charge level premiums. I agree with Mr. Becker that indeterminate premium plans also may have a psychological disadvantage as compared with dividends. Policyholders may view the latter as a windfall, while an increase in the current premium (especially on level-premium plans) may be viewed negatively. Mr. Becker also points out that the 1959 tax law tends to impair solvency by forcing companies into unsound long-term guarantees. I hope Congress heeds his concern.

Mr. Callahan, the chief valuation actuary for the New York State Insurance Department, focuses on the frustration of insurance departments in dealing with products that are under a dark cloud of possible adverse tax rulings. Such products may appear to be "consumer oriented" only because of optimistic tax assumptions. Yet state insurance departments have a resonsibility to consumers and to companies to insure solvency and to permit the more conservative companies to avoid paying twice, once in lost market share, and again in the guarantee fund payment to bail out companies that took a heavy tax risk.

The state regulatory authorities should be given authority to request a revenue ruling from the Internal Revenue Service. Companies should be

able to issue products that have uncertain tax consequences, but they should be required to post "tax reserves."

Mr. Callahan also gives nontax reasons for an insurance company to issue universal life or indeterminate premium policies. These include avoiding the requirements of section 216 of the New York insurance law of equitable dividend distribution, and of offering specific dividend options, as well as avoiding the 10 percent profit limitation imposed on participating policies.

Mr. Callahan also notes that section 820 of the Internal Revenue Code reduced the tax base for both stock and mutual companies. There were also other tax devices, such as "dividend reimbursement" (which was eliminated by TEFRA) and "coupon updates" (which were eliminated by Revenue Ruling 83-14-009). In fact, the entire tax law has fallen apart.

Participating versus Nonparticipating

Mr. Bickel presents an interesting (and reasonable) way of looking at participating and nonparticipating excess interest products. Actually, most dividend-paying products have used his nonparticipating approach, in which excess interest is credited on a natural reserve defined at issue (or a reasonable approximation, such as the cash value). Alternatively, universal life uses the participating approach, in which excess interest is credited on the historical asset share based on actual rates credited to the policyholder. Sheppard Homans did advocate the participating approach in his 1868 letter, but without computers it is difficult to keep track of the historical asset share.

Mr. Bickel points out that policyholders in the United Kingdom receive a tax benefit for life insurance premiums. The relief is paid directly to the companies. Most dividends are on the paid-up-addition or "reversionary bonus" plan, so their accounting treatment will not affect the premium tax relief. Presumably any cash dividends would be netted against premium (as with United States premium taxes) to avoid overstatement of the tax relief.

Origin of the Word "Dividend"

Mr. Winter points out that policyholder dividends are often confused with shareholder dividends. I urge the NAIC and policy form writers to drop "dividend" and use the synonym "bonus." The courts have long recognized, however, that "policy dividends" are not equity payments. (See the *Mutual Benefit* and *Penn Mutual* cases in the bibliography of the paper and the article by Andre Pouy in the discussion bibliography.) The word "dividend" has been used in the insurance industry to refer to nonguaranteed refunds or benefits for almost 300 years. The old Amicable, the first nonassessment mutual, founded in 1706, paid both annual dividends and ter-

minal dividends. The company charged £1.55 quarterly or £6.2 yearly, and, after paying an annual dividend of £1.2, divided the remaining £5 among those who died during the year. Thus "dividend" originally was used in its generic sense to mean "part of something divided."

Group Retrospective Refunds

Both Mr. Winter and Mr. Palmer mention the court cases on group retrospective refunds. We will refer to these as "Case A" (594 F.2d 530, 5th Cir. 1979) and "Case B" (690 F.2d 878, Ct. Claims). The courts did treat "fixed" as meaning "fixed formula," and "experience of the company" as meaning "overall profit and loss." The refund cases, however, still are being litigated in other circuits. Furthermore, the group term product and the credit life products are quite different from universal life and from indeterminate premium whole life contracts. The latter products, especially universal life, clearly involve a substantial interest component. The group term products generally are written for a short period and usually involve no savings component.

I feel that Case A and Case B may cause the universal life companies to lose the "dividend issue." The judges in both cases were very negative about passing interest to policyholders. Thus from Case A (4723–24):

> The Congressional debates indicate that a return premium cannot be paid from investment income. In fact, the debates reflect an understanding that "dividend" as used in the insurance industry is a term of art, which means almost any payment not derived solely from premium income. The refunds paid to policyholders pursuant to the contracts at issue satisfy the "solely from premiums" limitation because liability for the refund is not related to the company's investment experience.

Obviously, even indexed products cannot pass the "solely from premiums" test. In Case B (82-USTC, p. 85, 155) the court said:

> The important point is that in choosing the refund formula, [Company B] cannot manipulate the amount of the refund to distribute investment earnings.

Section C.4 of the paper indicates that the universal life companies have shied away from the "return premium" arguments precisely because they do not want to include the excess interest or maximum premium in "premium income."

Rebuttal Arguments to the Group Refund Cases

The logic used by the courts would limit the deductions for excess interest on universal life and rate credits on indeterminate premium whole life policies. The case for full deductibility of group refunds, however, is difficult

even though one could argue that group refunds meet all three tests for a dividend.

1. CONTRIBUTION DIVIDEND FORMULA

In both cases the companies essentially guaranteed the contribution dividend formula. Thus the refund equalled a percentage of premium less expense and profit charges less incurred claims. (See Case B, 82-USTC, p. 85, 148.) This formula is commonly used by mutual companies to distribute dividends Maclean and Marshall 1937, p. 112 and 117, and Bassford, "Discussion," 1922, p. 307).

2. FIXED DOES NOT MEAN FIXED FORMULA

Arguably, a "fixed formula" does not mean "fixed." It would be especially odd if fixing the contribution dividend formula turned a "dividend" into something other than a dividend. Note that Regulation 1.811-2, which defines dividend in paragraph (a), distinguishes "fixed" from "a formula which is fixed" in paragraph (c)(ii).

Even if "fixed" meant "fixed formula," the group refunds might fail the "fixed" requirement if the factors used in the formula could be changed after issue.

3. EXPERIENCE OF THE COMPANY

The courts interpreted "experience of the company" to mean the "overall profit and loss of the company." This interpretation is refuted in Section I.A.10 of the paper. Even the old Amicable did not use "overall profit and loss," since expenses and interest were ignored (See Sec. I.E.).

As used in the literature, "experience of the company" means "experience of the company for that particular policyholder classification" (see D.L. Bickelhapt, *General Insurance*, p. 107). The phrase "experience of the company" actually was used in Revenue Ruling 67-180, where it meant the experience of the individual group. The *Rhine* vs. *New York Life* case (248 App. Div. 136) used the phrase to refer to the experience of two classes of policies, those with the disability rider and those without.

Mayerson, in "Life Dividends," (see additional bibliography for discussion) refers to "the entire company's experience (p. 633), and it is clear that he did not mean "overall profit and loss." Instead, experience is determined separately for each pricing factor (interest, mortality, and expense), and for each factor the experience is subdivided by line of business, class, or even a single policy.

Group dividend formulas commonly use the experience of a single group.

This practice is pointed out in papers by Whitney, Keefer, Bjorn, Mayerson, and in the Maclean and Marshall text.

Group health insurance sometimes is sold by casualty companies. With the possible exception of assessment companies, casualty dividends are not based on overall profit and loss. Instead, dividend classes are determined by year of issue, or industry group, or by the individiual risk experience method (Leslie, 1921). C. A. Kulp pointed out in both the 1942 and 1968 editions of *Casualty Insurance* that "the application of retrospective rating by stocks . . . has gone so far toward participating insurance as to make traditional underwriting distinctions between stock and mutual nearly meaningless" (1968 ed., p. 950). Further (p. 913), "retrospective rating plans are termed occasionally 'participating plans.'" The official textbook for the charter property and casualty exam number 5 points out that "variable dividend plans bear a strong resemblance to retrospective rating plans" (Webb, Launie, Rokes, and Baglini, 1978, p. 193).

4. DISCRETION

If the companies could change the group refund formula at the beginning of each policy year, they would have the same type of discretion as is found in mutual policies.

5. COUPONS VERSUS DIVIDENDS

The courts and the Treasury had difficulty interpreting regulation 1.809-4(a)(1)(ii), which defines "return premium" and is the negation of the definition of "dividends" in regulation 1.811-2(a). The Treasury took the position that "return premiums" were limited to premiums refunded on cancellation or policy changes, or premiums on rescinded policies. The courts disagreed and broadened the definition to include retrospective refunds on group term insurance.

I believe that "return premium" could be broadened, but we should not go as far as the courts. The term could include "coupon" payments which typically are called "guaranteed premium reductions" in the literature.

In defense of the Treasury position, the definition of "return premium" originated in fire insurance and was applied to premiums refunded on cancelled policies (Moir 1919, and my discussion of the legislative history).

6. CONTRADICTS TAX COURT CASE

In a tax court case, *Bituminus Casualty* (57 TC 58 [1971], 85), the court said "the [1942] regulations affirm the fundamental similarity of all three rebate items"; the three rebate items were retrospective refunds, premium discounts for noncanceled policies, and policyholder dividends.

Arguments which can be made for not treating group refunds specified by a contractual formula as dividends are discussed below.

(a) Statutory Accounting

In the group contracts involved in Case A and Case B, the refund formula was specified in the contract and filed with the state insurance departments. New York has taken the position that such refunds are not dividends for statutory accounting purposes (Wightman 1952, p. 257, and Dept. New York State Insurance 1955, p. 429). If statutory accounting caries over to tax accounting, then the refunds are not dividends for tax purposes.

(b) Interest Returns

Congress in 1959 specified a global limitation for the deductibility of dividends. The test would theoretically allow full deductibility of the mortality and loading components of dividends, but only a fraction of the interest component. If the global test were applied on a policy-by-policy basis, the group refunds should qualify for full deductibility, even if they were classified as dividends.

(c) Stop-Loss and Administrative Service Contracts

Certain group contracts refund 100 percent of the excess of the policy premium over claims and profit charges, and further actual claims are 100 percent credible. These contracts are mathematically equivalent to "stop-loss" agreements with the addition of administrative services. The stop-loss premium is the "expense and profit charge." The insured is at risk for claims less than the policy premium, and the insurer only for claims which exceed the policy premium. Arguably, these contracts should be treated like stop-loss contracts for tax purposes. In that case, the refund would be netted against the policy premium and hence be fully deductible. The stop-loss treatment, however, may have unattractive consequences. The insurer would lose reserve deductions and any group special deductions, while the insured would be unable to deduct the policy premium.

Legislative History of the Three Dividend Tests

Mr. Palmer argues, using a quote from Justice Holmes, that we need look only at the statute itself to determine the law. While I agree that the courts should not try to rewrite laws, congressional intent and the legislative history are important factors in tax matters. In an early court case on the definition of the dividend, the Supreme Court commented that the "legislative history of an act may, where the meaning of the words used is doubtful, be resorted

to as an aid to construction." (See *Penn Mutual* v. *Lederer*, 252 U.S. 523 and 538.)

The three dividend tests go back to the House and Senate reports on the 1942 revenue bill on the taxation of casualty insurers. The House report said the following:

> "Similar distributions" include such payments as the so-called unabsorbed premium deposits returned to policyholders by factory mutual fire insurance companies. This is distinguished from the more usual "return premium" where the amount is not fixed in the insurance contract and does not depend upon the experience of the company or the discretion of the management.

"Similar distributions" are not limited to unabsorbed premium deposits, which merely serve as an example. Further, "similar distributions" are contrasted with the "more usual" return premiums, which are the refunds on cancelled policies. (Except claims, there are no other returns on a factory mutual policy.) The three tests of a "return premium" under the 1959 law regulation 1.809-4(a)(1)(ii) were listed in 1942 as characteristics of the "more usual" return premium, while the negative of the tests form the definition of a dividend in the 1959 regulation 1.811-2(a).

To understand congressional intent, we must examine the operation of factory mutuals. As a result of mergers, there are now four factory mutuals (Arkwright-Boston, Allendale, Protection Mutual, and Philadelphia Manufacturers). They insure large industrial corporations against fire, boiler, and machinery risks and stress fire and general safety through an engineering company that operates for the benefit of all the factory mutuals. The insurers charge a large up-front premium and "absorb" a certain percentage each month to cover the cost of insurance. The unabsorbed balance is returned at the end of the policy period. (For statutory accounting, the full premium is booked and "earned" on the standard pro rata basis. The refunds of unabsorbed premiums are booked as "return premiums.")

Because of coinsurance arrangements among the four factory mutuals, the absorption rates are usually the same for all four companies. Absorption rates for policies of the same class are usually constant, and the differences in risk are reflected in the original premium. The absorption rates do change, however, in response to a natural disaster such as a hurricane. The current monthly absorption rate is 1.55 percent for all three-year fire policies, so that 44.2 percent will be returned or applied against future premiums. The absorption rate is different for annual-payment policies and for boiler and machinery risks.

On the basis of the factory mutual "similar distributions" we conclude the following:

1. "Similar distributions" include items that are classified as return premiums for statutory accounting.
2. "Experience" is not limited to "overall profit and loss." Instead, experience may vary by policy parameters (such as the length of the coverage period) and by line of business, and even includes intercompany experience.
3. There is no requirement that "similar distributions" have an explicit interest component. (Interest merely arises from investment of cash flow, and the company can keep it as an extra profit margin, or make an implicit return by reducing profit and expense charges.)

Factory mutuals (like most property and casualty companies) return a portion of the prepaid premium on cancellation. An insured who cancels is charged the "short rate" premium. A company that cancels returns a "pro rata" refund. An insured also can request a "flat cancel" involving the refund of all premiums and the elimination of all risk for claims. The company has discretion whether or not to cancel, but if it cancels, the return premium is specified in dollars and cents, or equivalently by a fixed percentage of the policy premium. The company does not have discretion as to the dollar-and-cent amount of the refund, and the amount of the refund is independent of the experience of the policyholder, or a group of policyholders, or the entire company, or intercompany experience, or the experience of an outside bond index.

Based on the legislative history, universal life policies qualify for dividend treatment on two counts. First, the policies themselves are strikingly similar to the factory mutual policies. On the factory mutual policies the monthly cost of insurance is subtracted from the single premium. On universal life the monthly cost of insurance is subtracted from the accumulated premiums. Second, the mortality and excess interest returns on universal life are very dissimilar from the "more usual" refunds on policy cancellation.

Guaranteed Renewable Health Policies

Both Mr. Hug and Mr. Thau refer to E. Paul Barnhart's paper (1960), which indicated that the insurer "would seem" not to have the right to "recoup past losses." Several discussants, however, disagreed and pointed out practical problems. Thus (p. 501), "to the extent actual experience develops differently from anticipated, the budget must from time to time be revised. . . . The revised budget should also take into account any existing funds resulting from the excess of past income over past disbursements." Also (p. 502), "solvency might be threatened if rates could not be revised to provide the reserves required on a retrospective gross premium valuation." Finally (p. 506), "if a company had put off a rate adjustment for a period in the hope that adverse experience was merely a statistical fluctua-

tion, it would seem appropriate to include provision for losses of that period in the revised rates."

As Mr. Thau has pointed out, the states have not adhered to a prospective versus retrospective distinction on guaranteed renewable health policies. Also, the NAIC is now drafting model regulations that do include past experience when determining future rates.

Earnings Limitation

Both Mr. Thau and Mr. Palmer have raised concerns about the inequities in profit limits imposed by a number of states on stock companies selling participating insurance. The present New York and Wisconsin limit is the greater of $0.50 per thousand face amount or 10 percent of gains before dividends. Except for companies specializing in term insurance, most insurers use the 10 percent limit.

The inequities are not as bad as indicated by Mr. Thau. It is true that a high-dividend, high-premium company gets a greater limit, but for whole life plans, the "loading" component of the dividend is relatively small compared to excess interest and mortality savings. Most of Mr. Thau's problems could be solved by using Professor Belth's suggestions, such as expressing the limit as a percent of gross income or a percentage of dividends. Also, stock companies should be required to publish separate statements for their participating business. (Belth 1965, pp. 122–23, 138).

Arguably, the present New York limit is excessive. Assuming a company earns 12 percent on assets and has a 4 percent guaranteed rate, the excess interest profit is 8 percent. Thus the profit limit is 0.8 percent of cash values, plus additional profits from mortality and loading and surplus funds. The average no-load mutual fund charges only 0.25 percent of the account value, and the mutual fund manager must pay expenses. The average bank earns only 0.55 percent on assets.

The earnings limitation laws have an interesting history. William Morgan, Actuary of the old Equitable in London, decided in 1798–1800 to pay two-thirds of the earnings to policyholders and to reserve one-third for possible catastrophes. The Girard, founded in 1836 in Philadelphia as a "mixed" company selling "participating" policies decided to pay two-thirds to policyholders and reserve the other one-third for shareholders. British stock companies adopted a similar practice. The Manhattan Life, founded in New York in 1850 as a mixed company, raised the policyholders' share to seven-eighths, or, more precisely, limited the stockholder charge to one-seventh of policyholder dividends. Competition forced most stock companies in both the United States and the United Kingdom to increase the policyholders' share to around 90 percent by 1900. Today Canada limits the shareholders

of larger stock companies to 2.5 percent of policyholders dividends with the percentage grading up to 10 percent for smaller companies. Aetna used a 100 percent policyholders' share for policies issued prior to the mid 1960s. Certain Minnesota companies have both a stock branch and a mutual branch, and the mutual branch retains all the profits of the mutual business (Knight 1920, pp. 42, 93, 116; Supple 1970, pp. 122, 166; Lawson 1956, p. 233; Beers 1958, p. 273; Belth 1965, pp. 72, 80, 96, 99, 124, 172.)

Ownership

While the paper did not focus on ownership differential, I will respond to the comments made by Mr. Thau, Mr. Hug, Mr. Winter, and Mr. Palmer by discussing arguments for a tax differential favoring mutuals, for no differential, and for a differential favoring stock companies.

I. REASONS FOR A MUTUAL DIFFERENTIAL

Their capital structure and the regulatory environment are favorable to stock companies. First, shares of stock are a fairly cheap source of capital. The average shareholder dividend is only 4 percent of the market value of the stock. Second, stock companies can use their capital to finance expansion, or to merge, and therefore generate expense savings, and can merge with other companies merely by exchanging stock. Third, stocks can obtain significant tax benefits from a tax liquidation allowed by section 338 or 334(b)(2). Fourth, stock companies can sell profitable guaranteed cost business. Fifth, using an employee stock option plan (or ESOP), a stock company can obtain a greater investment tax credit. Sixth, stock insurers can form holding companies that give them enormous freedom to move capital from one subsidiary to another without tax consequences. Seventh, holding company investments are not subject to the proration rules for tax-exempt interest and intercorporate dividends. Stock companies can obtain full exclusion on tax-exempt interest and dividends by paying a "stock dividend" to the holding company. The holding company then makes the investment or else shifts the capital to a casualty subsidiary, which makes the investment.

Mutuals do not have outside capital. It is difficult for them to merge, and New York regulations prevent them from using more than 2 percent of their assets to buy stock life companies to take advantage of section 338. Because of regulatory constraints, mutuals have sold relatively little guaranteed cost business. Mutuals do not have capital to take advantage of the ESOP rules. Mutual companies cannot form upstream holding companies, and investments in tax-exempt securities are subject to stringent proration rules.

A tax on gains has built-in penalties for mutuals. A mutual's only sources of capital—premium and interest—are taxed at 46 percent under the gain-

from-operations phase, while stock company capital contributions are untaxed.

To make up for these advantages, a mutual company may need a differential. In fact, mutual property and casualty companies have a slight advantage, namely the five-year deferral of underwriting gains provided by the Protection against Abnormal Loss (PAL) account. Mutual savings banks also have a slightly more liberal bad-debt deduction than stock savings and loans. (See Ernst and Whinney, *Guide to Federal Income Taxes for Savings Institutions*, p. 87, and Tucker and Van Mieghem, *Federal Taxation of Insurance Companies*, p. 1501.)

2. NO DIFFERENTIAL

To prevent distortion in the marketplace, there should be no tax advantage to either mutuals or stocks. Congress has followed this principle in previous tax laws. In the 1894 tax law, mutuals were exempt because they were "non-profit." For competitive reasons stock companies selling "mutual-plan" products also were exempt from tax. The 1921, 1932, 1942, and 1955 laws did not distinguish stocks and mutuals. The 1959 law provided more liberal treatment for guaranteed cost products, typically sold by stock companies, but did not reward a company simply because its charter said it was "stock."

If stock companies had a tax advantage, through the 7.5 percent dividend addback, for example, then they could make their products more attractive than mutual companies could, simply by splitting the tax advantage with the customers. Alternatively, the tax advantage could be used for economic growth, rather than paid out to shareholders outside the controlled group.

Historically, the stock companies have been able to compete without tax benefits. For example, a study by Joseph Belth using actual dividend histories indicated that the level equivalent price charged by twenty-three stock companies was only 1 percent higher than that of thirty-one mutuals (1965, p. 41).

3. ARGUMENTS FOR A STOCK COMPANY DIFFERENTIAL

Some stock company actuaries have argued that policyholders are receiving an owners' return. For example, it is claimed the old policies finance new business. Also, the policyholders supposedly earn an investment-management fee (like the investment advisor of a mutual fund).

In rebuttal, my company's new policyholders finance virtually all their acquisition costs. The first-year commissions and underwriting and issue expenses are covered by first-year premiums. Also, the investment-management fee is included in the premium for both stocks and mutuals.

Perhaps the real argument for a differential is that stock companies have "hungry" shareholders, while mutuals do not. These shareholders provide one significant service: their capital contributions (and accumulated interest) provide an insolvency barrier that mutuals do not have.

The problem is that different stock companies have different levels of "hunger." Canadian stock companies are quite lean, demanding only 2.5 percent of policyholder dividends as their fee. Some subsidiaries of nonprofit organizations demand less than 1 percent of dividends as their fee. In fact, the surplus charges made by mutual companies may exceed 1 percent of dividends.

4. PROPOSAL

A neutral proposal that would allow mutuals some of the advantages and some of the detriments of stock companies is suggested below. It defines a minimum level of "hunger" for all companies, including mutuals, subsidiaries of nonprofit companies, and Canadian stock companies.

It is suggested that all companies be taxed on gains after dividends and subject to an "add-on" tax equal to 30 percent of the New York profit limit. (The 30 percent factor is used because roughly 30 percent of the earnings of the business units controlled by the stock company are paid to shareholders outside that controlled group. Of course, the add-on tax also could be defined as a percent of "equity," a percent of assets, or a percent of dividends.)

All companies could reduce the add-on tax by shareholder dividends paid to either policyholders or stockholders. In this case a "shareholder dividend" is simply any payment not deductible by the company, but taxed to the recipient (subject to usual exclusion rules). Mutual companies could reduce the add-on tax by dividends paid to holders of "guarantee capital."

To give some of the advantages of the holding company structure to mutuals and stock companies without holding companies, I suggest a "capital investment account." Assets in the account would not be subject to proration rules on tax-exempt interest and dividends. The account value would equal the equity of the company.

For administrative ease we can exempt small companies from the add-on tax and allow mutual companies to pay an average tax on shareholder dividends paid to policyholders.

Other Matters

Mr. Palmer questions the need for a paper on taxation. I believe such papers are appropriate, and the literature includes many papers on taxation (some of which are included in my bibliography). The tax law uses actuarial terms, and actuaries have been consultants and drafters of the various tax

laws, including E. E. Rhodes in 1913 and 1921, McAndless in 1942, and Walter O. Menge in 1959.

Mr. Palmer disagrees with my interpretation of Congressman Rhodes's reference in the 1959 *Congressional Record* to a "fixed percentage" (Sec. I.E.). I intrepreted it as a numeric percentage such as "7 percent" rather than an indefinite percentage such as the "treasury bill rate." A fixed numeric percentage of, say, the cash value, is equivalent to a fixed dollar-and-cent amount, and the fixed percentage may be easier to specify in a policy form.

Mr. Thau gives an interesting perspective from the point of view of a stock company actuary. I have spent part of my career at mutual companies and part at a stock company. From my point of view there is little economic difference in post-issue pricing adjustments made by either type of company.

Mr. Thau compares the one-year-term dividend option to an indeterminate premium contract. I view the term insurance as new coverage whose premium is fixed *at issue*, while indeterminate premium reductions on whole life policies are *post-issue* policy adjustments.

I agree with Mr. Moses that life companies should be taxed on gains after dividends with both guaranteed and nonguaranteed pricing adjustments treated alike. Also, stocks and mutuals should be taxed alike.

Mr. Hug and Mr. Moses discussed indexed products. Although indexing products is a clever marketing device, I do not believe it avoids dividend treatment. The three tests for dividend treatment (fixed in the contract, discretion, and experience of the company) were defined in 1942 in terms of the refunds on canceled policies. The refund on canceled policies are not subject to any index but fixed in dollars and cents or, equivalently, a fixed percentage of the original premium.

Mr. Moses has asked, in conversation, about the history of this paper. Originally, it was written in 1980 and concerned only indeterminate premium products. When the universal life rulings (81-16-073 and 81-21-074) were published, I added arguments concerning that product. A private-letter ruling, 82-36-069, and the public ruling, 82-133, reached the same conclusion as my paper. Ruling 82-133 also employed the logic about direct reserve increases being impossible, since reserves must come from premium or assumed interest. The arguments supporting nondividend treatment appeared in legal briefs and oral arguments made to the IRS.

I agree with Mr. Hug that indeterminate premium products are less risky than guaranteed cost products. I agree that dividends may reflect the "experience of the group." Mr. Hug correctly contradicts the assertion made in some group refund cases that dividends are based on "overall profit and

loss." I also agree that both indeterminate premium elements and dividends are "nonguaranteed."

Mr. Hug places a great deal of emphasis on philosophy. It may be true that stock and mutual company actuaries have different philosophies concerning nonguaranteed elements. But the actuary's philosophy has no influence on the IRS and, if it did, the philosophy with the lowest tax impact would prevail. I believe the distinction between prospective and retrospective to be largely a matter of semantics. In any case, past mortality losses are impossible to recover on individual life insurance, since those who caused the losses are dead. Mutual company bonuses or dividends long have been based on "prospective" experience. For example, in 1776–77 the old Equitable in London reduced all future premiums by 10 percent. In 1781–83 they introduced the bonus-addition plan, which increased future death benefits by up to 28.5 percent. (See H. Jackson, "The Wisdom of Mutual Life Insurance," *TASA*, XXXIII [1932], 121–22. Included in bibliography of paper.)

The History of Indeterminate Premiums

According to the *Record* (1980, pp. 320, 671), a large western stock company introduced an indeterminate premium product about twenty years ago. But they were not the first company. According to Henry Moir, a former President of the American Society of Actuaries and a president of U.S. Life, the product was invented over a century ago by the Scottish Amicable and also sold in the United States.

A Canadian stock company also introduced the product about ten years ago and won the right to issue it in Pennsylvania precisely because it was similar to a participating product.

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