RECORD OF SOCIETY OF ACTUARIES
1982 VOL. 8 NO. 2

TAX PARITY FOR INDIVIDUAL LIFE INSURANCE PRODUCTS

Moderator: JOHN K. BOOTH. Panelists: GENE W. BUCHTER, DALE R. GUSTAFSON, JAMES C. HAMILTON

1. What is tax parity

    a. Between mutual companies and stock companies?

        1) Should tax allowances be made for stockholders' equity?

        2) How does the present non-participating allowance compare with the tax treatment of dividends on participating products?

    b. Between participating policies and adjustable price non-participating policies?

        1) What is the difference between a price adjustment and a dividend?

        2) Should the tax code recognize this difference?

2. What are the consequences of failure to achieve tax parity

    a. For new sales?
    b. For equity among companies?
    c. For replacements?
    d. For equity among different generations of insureds?

3. How can tax parity be achieved between

    a. Universal Life and traditional policies?
    b. Life insurance and annuity products?
    c. Life insurance companies and other institutions that compete for savings (including tax qualified savings)?

MR. JOHN K. BOOTH: Ever since a Federal Income Tax was introduced in 1913, there has been great difficulty in determining how it should be applied to life insurance companies. The determination of life insurance company taxable income, like the determination of life insurance company earnings or the "true" cost of life insurance, is beset with uncertainties and contingencies that are an inherent part of the business. The last major attempt to determine an appropriate federal income tax for life insurers resulted in the Life Insurance Company Tax Act of 1959. Today, in the face of soaring inflation and high interest rates, the 1959 Act is seen to have serious flaws which have caused the share of corporate income taxes paid by life insurance companies to grow from 2.4 percent in 1959 to 4.2 percent in 1978, even though the life insurance industry grew no faster than corporations as a whole.

This trend has forced life insurers to engage in tax-planning measures which alter company operations and product design in order to reduce to a more reasonable level the life insurance company tax burden, a burden that ultimately must be borne by the policyholders. Recognizing the instability of the situation, the life insurance industry began work over two years ago on a proposal to adjust the 1959 Act so that it would function under today's economic conditions in the way that Congress had originally intended. When industry representatives began to discuss the proposal with the Congress and U.S. Treasury in late 1981, they were told that both the proposal and the 1959 Act itself were too complex and that a completely new tax formula for life insurance companies should be developed as a joint effort of representatives of the industry, the Congress, and Treasury.

At about the same time, it became evident that Treasury planned to take steps in 1982 to eliminate some of the company tax-planning options in the reinsurance and product design areas without effecting any basic reform of the 1959 Act. If this were done, the life insurance company tax burden would become so intolerable as to threaten the viability of most of the business. Premiums, profits and tax revenues would tend to dry up as consumers redirected their dollars to competing financial institutions that were taxed more favorably.

Faced with this prospect, the life insurance industry, in early 1982, after extensive discussions and debate, agreed upon a stopgap measure which would fix the major deficiencies of the 1959 Act for the years 1982 and 1983 and would increase tax revenues to a reasonable level by eliminating some of the unintended effects of some sections in the current law. If enacted, this proposal would resolve the life insurance company tax problem for a two-year period and allow time to develop a more permanent solution. On April 1 of this year, the life insurance industry's stopgap measure was introduced in the U.S. Congress as House Bill H.R. 6045 and Senate Bill S. 2353.

Throughout this whole process, representatives of various interests within the life insurance business have displayed a remarkable degree of statesmanship in placing the common needs of the industry ahead of narrower company concerns in the face of the very serious challenge. Continued unity as we move forward in resolving the life insurance company tax question is essential if we are to achieve a tax formula that works reasonably for all of us. Without unity, we are easy prey, not only of those who seek to increase Federal taxes beyond reasonable limits, at the expense of our policyholders, but also to competing financial institutions, who would be eager to take over markets of a debilitated industry.

We do not intend to discuss the stopgap proposal this morning. Instead, our discussion will focus on some of the very basic issues of taxation of life insurance companies and products that might be considered as we begin planning for the longer range, permanent solution. The views expressed subsequently by the panelists and the moderator are drawn from each individual's own experience without any attempt to be sure they conform with either an industry or a company position. These views are not intended to be a commentary on the industry's stopgap measure. Rather, they are an expression of ideas, some conflicting, which can stimulate discussion and thought on possible, permanent solutions to the life insurance company tax question. We hope that today's discussion will prove useful to those who will be working on that permanent solution.

MR. GENE W. BUCHTER: The realization of tax parity among insurance companies, particularly as between stocks and mutuals, requires that all companies be permitted to make discretionary transfers from their corporate income for the benefit of their policyholders, and that the transferred income be exempt from taxation, unless and until it is constructively received by the policyholders or it is returned to corporate income. Such transfers should only be permitted within an acceptable framework of tax standards and conditions, which insure the maintenance of tax revenues from the life insurance industry and which specify acceptable criteria for the identification of discretionary incomes and their amounts.

Historically, policyholder dividends have been the most important form of these transfers, and they probably still are. However, other systems are rapidly developing which make extensive use of excess interest, price adjustments, and other techniques. These systems may involve discretionary transfers, but such transfers are not inherent in these systems as they are in policyholder dividends.

Any policyholder taxes resulting from such transfers should be paid by the companies as proxies for their policyholders, it being impractical and in most cases impossible to identify such income for tax collection from policyholders. One reason for this is that policyholder taxable amounts can be determined in total but not necessarily at the policyholder level. Another concerns the difficulties in identifying specific policyholders as taxpayers. The proxy tax should be determined at an appropriate individual tax rate, suitably discounted for collection expense saving. A dual tax base results from permitting income transfers. One part of the tax, corporate income, net after transfer, is taxed at corporate rates. The other part is policyholder income which results from the transferred corporate income and is taxed at individual rates.

The maintenance of adequate tax revenues requires that limits be placed on the amount of corporate income which companies may, at their discretion, transfer in this manner. These limits should recognize the total tax revenues generated by both parts of the tax base. Tax parity among companies requires that this limit be imposed on income which is formed in the same manner for all companies. If policyholders receive transferred income at the time of transfer, a normal policyholder tax should result; but if they receive it later, both the normal tax and a surtax should apply to the income and to its accumulation. The purpose of the surtax is partly compensation for the time lag in payment and partly a penalty to prevent policyholder manipulation of tax-sheltered income. The potential for policyholder taxation to occur after transfer requires that transferred income and its accumulation be separable from other policy values. If this is not possible, the tax should be paid at the time of transfer.

For policyholder dividends, these standards would result in different tax treatment according to the type of option to which the dividends are applied. Dividends paid in cash would cause policyholder taxes at the time of payment because they are actually received then. Dividends applied on premiums would also be taxed at the time of payment, because they are not subsequently separable from other amounts. Dividends applied to paid-up additions and one-year term insurance would not be taxed at the time of payment because they are not received by policyholders, and they are subsequently separable.

The application of these standards to excess interest produces similar results. Excess interest can be either a discretionary income transfer or a non-guaranteed benefit to policyholders, depending upon the time period covered by the excess interest guarantee. For example, a daily excess interest guarantee would obviously be an income transfer, but a 20-year interest guarantee should qualify as a non-discretionary benefit. Where the dividing line is drawn is a matter of opinion and judgment, but I believe it should probably be at two years, splitting the interest guarantees into short-term and long-term. Long-term interest guarantees should not be regarded as an income transfer, but short-term guarantees should.

Policyholder taxation of interest income resulting from short-term interest guarantees would follow the general standards for income transfers. The interest would be taxed when earned if the policyholder received it then or it could not be subsequently separated from policy values. Otherwise, it would be taxed later, when and if the policyholder received it.

Turning now to tax allowances for stockholders' equity, I assume that this refers to the equity interest which policyholders, as stockholders, have in the surplus and after-tax income of a mutual company. It is axiomatic that a company may make payments from a surplus account without incurring any additional corporate tax liability, but the amounts so paid are taxable to the payee. Applying this standard to after-tax income and surplus amounts, including policyholder dividends, requires that a policyholder tax be paid. It is appropriate for mutual companies to pay this tax as proxies for their policyholders. This can be accomplished within a framework of discretionary income transfers by reducing the amount of a mutual company's transfer limit by the amount of surplus and after-tax income included in its policyholder dividends. The 1959 Act does not provide for such a tax. This results in mutual company tax preferences to the extent that surplus and after-tax income are included in policyholder dividends.

Regarding the nonparticipating deduction, participating business tends to transfer corporate income resulting from premium redundancies and their accumulations to policyholders by using redundant statutory reserves which are developed at lower interest rates than those used for nonparticipating business. A compensating adjustment is needed for this systematic income transfer difference so that all companies may form their income on an equal, or at least a more equal footing. It would be better to make such an adjustment in the statement of a mutual company, rather than that of a stock company, so that the amount of transfer could be subjected to an appropriate limit. The nonparticipating deduction of the 1959 Act is an attempt to provide a compensating adjustment to Phase II stock companies for deductions which Phase II mutual companies have and to provide the same tax treatment for the adjustment as is given to dividends. The nonparticipating deduction represents only partial tax parity with respect to these redundancies and other aspects of Phase II dividends for at least two reasons. First, stock companies may not use a nonparticipating deduction for the benefit of policyholders. They can only use it to pay stockholder dividends and then only with a tax. Second, and I have already mentioned it, there is no provision for identifying the amount of income transfer included in the redundant participating reserves so that this income can be included in a mutual company's transfer limit.

MR. JAMES C. HAMILTON: The history of life insurance company taxation, and in particular, issues and rationale surrounding the 1959 Tax Act, underscores the fact that, quite apart from the recent innovations in product design, such as Universal Life and wrap-around annuities, and the volatility and marketing imbalances caused by inflation-driven high interest rates, the fundamental issues concerning tax parity have remained relatively unchanged since adoption of the Act. What has, perhaps, changed are our current economic and social priorities and the products through which these issues presently manifest themselves. Nevertheless, the criteria or principles relevant in evaluating tax parity today are directly derived from the principles that framed the development of the 1959 Tax Act.

First, all sources of income should be included in the tax base. Many of us emphasize the "differentness" of life company taxation from other corporations in dealing with the 1959 Act. However, the 1959 Act calls for life companies to be taxed on the same base as other tax-paying corporations, i.e., net profits. The "differentness" accorded life companies derives from certain characteristics of the business--chiefly, its long-term nature--and tax adjustments made to reportable net profits in consideration of these characteristics. This concept of total income as a tax base must be preserved in any discussion of tax parity, both within the industry and more importantly, with respect to other institutions taxed as corporations.

Secondly, if two life companies, or for that matter two financial institutions, write the same product, then no competitive advantage should accrue to either one solely because of its corporate structure, stock or mutual, nor should the tax law mechanics result in differing tax treatment of the product. In today's world, it is this principle which is perhaps in greatest jeopardy. Increasingly, we are seeing situations where a company's basic method of doing business is becoming dominated by tax-driven considerations. Of course, the same principle of tax neutrality applies to life companies versus other financial institutions writing competing products of essentially identical design. The recent revenue rulings on wrap-around annuities are good evidence of the fact that if two products are essentially identical in substance, the IRS will impose identical tax treatment.

Thirdly, any consideration of taxation at the product level must reflect an analysis of both company and policyholder tax situations. As an industry, we have often attempted to address the company and policyholder tax issues surrounding a particular product as totally divorced from one another. For the types of sophisticated products we are dealing with today, I do not believe tax parity can be achieved without examining the entire lifetime of financial transactions relative to a given contract. This entails looking at the taxation of "income" in the hands of the policyholder, the company, and company owners, be they shareholders or policyholders.

Fourthly, the Congress, the Treasury, and to a certain extent the industry must develop a better appreciation for the revenue generating potential of the business, and most significantly, that it is probably declining at least per dollar of premium. Statistics indicate that the life insurance industry has contributed an increasing share of total corporate taxes over the last 20 years. While some argue that this result indicates that the industry is and has been "overtaxed", my concerns lie more with what we can expect from the future. The industry certainly has a responsibility to assume an equitable share of the total corporate tax burden. However, in projecting dollar revenue expectations, we must recognize that the insurance industry is intensely competitive and that current directions in product development have led to and undoubtedly will continue to lead to shrinking profit margins. Future tax revenues will likely not grow in proportion to historical results.

These four points--preservation of total income as the tax base, tax neutrality, comprehensive perspective, i.e., company and policyholder, and understanding of revenue generating revenue potential--form a back-drop against which I would like to explore some of the specific areas which this panel was asked to address.

The stock/mutual issue is one of the most fundamental questions concerning tax parity. If general principle mandates that no competitive advantage should accrue to either stock or mutual because of tax preferences emanating from its corporate structure, then the policyholders of a mutual company must be construed for tax purposes in the same fashion as they are for management purposes--namely, as both shareholders and policyholders. From a theoretical perspective, since we have postulated that the tax base should be "profits", we need to determine what that term means for a mutual company.

One possible basis which assumes the existence of normative premiums and reserves, based perhaps on stock company pricing and reserve assumptions, would be first, contributions to surplus, plus second, contributions to reserve redundancies, plus third, policyholder dividends less that portion of dividends representing premium redundancies. In essence, to the extent that dividends represent interest earned on surplus funds held by the company and accumulated in prior years or interest earned on policyholder reserves in excess of requirements to maintain these reserves, they should be taxed to someone (although perhaps the policyholder rather than the company in at least the latter case). "True" current year premium redundancies should be fully deductible. The present limitation on dividend deductibility does not take a rigorous approach to analysis of the source or nature of distributions, but rather opts for an arbitrary limitation tied to taxable investment income. Since the characterization of dividends is a critical issue for tax parity, and in view of the increased sophistication of the marketplace, perhaps we will need to rethink the dividend issue along the lines outlined above.

The nonpar deduction was another feature of the 1959 Act designed to place mutuals and stocks on a more equal basis, by compensating stocks for the additional risk inherent in writing guaranteed cost insurance. Today's innovative non par pricing practices have significantly altered the nature of these risks, thus necessitating that we re-examine the size and role of this deduction in concert with analysis of the components of mutual dividends.

MR. DALE R. GUSTAFSON: There should be no competitive advantage because of a company corporate structure's impact on taxes. We all three agree on this platitude, but our ideas for real implementation are quite different. With regard to tax allowances for stockholder equity, they should be present, if at all, only to that extent which is consistent with maintaining competitive parity between stock and mutual. Finally, the present nonpar allowances have become unreasonably advantageous because of the limitation on special deductions of which only dividends have economic substance.

Jim has referred to "the principles that framed the development of the 1959 Act", and Gene has developed an elaborate set of theories seemingly based on the assumption that we all agreed that "discretionary transfers should be exempt from taxation until constructively received by the policyholder or returned to corporate income". The 1959 Act was developed when IRS said, in effect, "We give up, you, the industry, bring to us a tax approach that will yield $500 million in revenue in 1959 and corresponding amounts in future years." The Act was hammered out in negotiations among the companies and was cloaked in psuedo-theoretical rhetoric to make it look better. It was purely a political compromise. I am not aware that the mutuals agreed that the nonpar allowances reflected sound principles.

Both Jim and Gene have referred to "reserve redundancies in mutuals that call for extra taxes". I am completely puzzled by this. For example, the latest Best Review indicates that Southland's current reserve basis is preliminary term 3 1/2% changing to 2 1/2% after a certain period. Northwestern Mutual's current reserve basis is preliminary term at 4% with one major plan at 4 1/2%. Moreover, two-thirds of our in force has been amended to a 4% reserve interest rate. What is this nonsense about reserve redundancies?

As for Gene's elaborate theories about taxing amounts as they are received by the policyowner, I will ask only a simple question. If you gave your wife $20 to buy groceries and she returned $5 to you because she did not need to spend it, you would be most upset if that $5 was construed as taxable income to you. I accept none of the alleged principles just expressed by Jim and Gene. I believe that the major emphasis in any serious attempt to develop a tax basis for life insurance will be on pragmatic political considerations. It has not been and will not be essentially a theoretical actuarial matter.

MR. HAMILTON: I did not know that Northwestern Mutual had a totality of all participating reserves.

MR. BUCHTER: I would like to comment on my wife coming home with more money than I thought she would. If that occurred, it might be the result of some sort of contest which produced some income, thereby permitting her to buy what she set out to buy. If that were the case, I would not be too unhappy about paying a tax on it, which I think is a closer parallel to the dividend situation.

MR. BOOTH: What about tax parity between participating policies and adjustable-price nonparticipating policies? Gus, what are your thoughts on that subject?

MR. GUSTAFSON: Again, a platitude. There should be no competitive advantage to par or adjustable-price nonpar because of the product design's impact on taxes. As for the difference between a price adjustment and a dividend, I believe there is no difference in economic substance if management retains any material degree of discretion in determining future price adjustments. Finally, should the tax code recognize any difference? No.

Much has been made, not here but in general discussion and perhaps a little later here, of the difference between retrospective and prospective. As an actuary, I am embarrassed that other actuaries seem so uninformed about how we go about determining dividends in a mutual, and I am further embarrassed that some actuaries seem to be saying that price adjustments are not derived from, nor related to, the company's actual experience. In simplified form, at Northwestern, we very carefully examine our experienced mortality expenses and investment returns. Then we project these factors into the middle of the expected period that the dividend scale might hold for--that is usually 18 months or 2 years. Of course, this is closely related to present and future surplus needs. From an actuarial point of view, there is not any reason why we could not guarantee these dividends for 2 or 5 years.

The basic process involved in deriving the current premium under an indeterminate premium contract is the same. The premium certainly cannot be based on some other company's experience. There is one small difference, that is, one year's discount, because the indeterminate premium is at the beginning of the year and dividends are at the end. That is not a substantive difference.

If a guarantee is for the life of the contract, either in the traditional nonpar sense or because the pricing factor is linked to an outside index or precisely defined formula for the life of the contract, then you have a nonpar contract. What about a five-year guarantee? That used to be fairly common years ago. We called it quinquennial distribution. The practice was outlawed with the Armstrong investigation.

MR. BOOTH: Jim, your company was one of the earliest in marketing adjustable or indeterminate premium life insurance. What are your comments on this?

MR. HAMILTON: Taxation of participating policies versus adjustable-premium policies is one of the current issues where I believe some of us have tried to force our preconceived positions into the definitional molds of such terms as "dividend" and "return premium", rather than examining the actual risk characteristics of the products involved. From the product design perspective, a price adjustment under an adjustable-premium policy, at least as we at The Aetna have designed our product, reflects a purely prospective re-estimation of anticipated experience, whereas a participating dividend results from both a retrospective analysis of actual experience and a prospective re-examination. Hence, the adjustable premium nonpar plan involves the traditional, although perhaps reduced, risk that future experience will not conform to pricing assumptions, and the risk is borne by the shareholder with the potential for a non-recoverable loss. Under the participating option dividends can be adjusted to reflect all actual emerging experience. I would agree that, in the absence of this latter ability to reflect directly what has actually occurred, the two policy forms are very similar. I would also agree that the risks inherent under an adjustable-premium nonpar plan are reduced, and that this needs to be recognized, perhaps through a reduced nonpar deduction. However, to construe the difference between the guaranteed maximum premium and the current premium on these policies as a "phantom" dividend would understate their risk potential compared to a par plan and undermine tax parity.

MR. BUCHTER: There is nothing inherent about products with adjustable premiums that makes them automatically produce dividends. They may or may not operate so as to produce income transfers or dividends. We need standards and criteria in order to determine when a transfer occurs in connection with repricing, and if so, to what extent it does occur. Those standards for the determination of the occurrence of the transfer should be based on the period of the price guarantee and the direction of the price change. If the repriced premium has a short guaranteed period and if it is less than the premium previously paid, it should be deemed to produce an income transfer, but all other repricing situations should be deemed to be free of any income transfer. What constitutes a short guaranteed period, of course, is a matter of opinion and judgment. Here again, I think two years is appropriate. Under this approach you can regard the price of adjustable plans as going through a transition year when their premiums are reduced relative to existing premiums and when short-term period guarantees are given. Income transfer occurs in that transition year to the extent of excess interest on the policy reserves. No other pricing situation should operate to produce a dividend situation.

MR. BOOTH: Jim, what are the consequences of failing to achieve tax parity among different products?

MR. HAMILTON: Most of the potential results are obvious or have been well documented by others. I would like to highlight, however, the particularly insidious effects of replacement, because I feel that concern for equitable treatment of existing generations of insureds sometimes has a tendency to be swept aside by whatever the "new" products of the future happens to be. To the extent that tax inequities contribute to massive replacements, potential ramifications include first, the replacing policyholder may get a poorer product from every perspective, except taxes; second, the company is selected against through the operation of capital churning and anti-selection with respect to the quality of the remaining inforce; third, the company and policyholders incur additional costs to effect the replacements without cultivating any "real" new business in the aggregate; fourth, from overall public policy perspective, tax inducements may have created a transaction with no social justification and no real value in terms of real economic growth.

MR. GUSTAFSON: The three of us are closer to comfortable agreement on our answers to these questions than on the earlier questions, although we differ on what the platitudinous things we agreed to mean.

As to the consequences for new sales, if a particular corporate structure or product design has a material tax advantage, then all business will over time shift to it. For equity among companies, those on the less advantageous basis will suffer unfairly unless and until they can shift their operation to the tax advantageous basis. If they cannot shift because of statutory or regulatory prohibitions, or because of operational infeasibility, they may well be destroyed. For replacements, a massive increase in replacement activity will bring attendant confusion and cost, all borne, of course, by consumers. The greatest cost would be paid by those no longer insurable because they would be unable to replace. A similar problem would exist for those whose underwriting classification has deteriorated. For equity among different generations of insureds, the same answers as for the previous three questions, but here the effects of changes in the tax basis might well be ameliorated to some extent by update-type programs where they are feasible.

Now a general comment, showing where our disagreements lie: If you listened carefully to Jim and Gene, you realized that indeterminate premium and flexible-factor policies with two-year guarantees would essentially escape taxation, while traditional participating business issued by mutuals would be heavily taxed. We would have no choice under these bizarre alleged theories but to switch to the tax-favored product, including rolling over all of our inforce. Then what would the aggregate revenue potential be? Near zero. Then what would happen?

MR. BOOTH: Maybe what would happen would be a much more onerous tax proposal such as that recently brought forth in Canada.

MR. BUCHTER: I reach about the same conclusions as Jim and Gus. If tax parity is not achieved, new sales can be expected to move to those companies who do have tax preferences, as they bring products to market which transfer some or all of those preferences to their portfolio. The industry tax burden would be shifted to those companies without tax preference. The companies without tax preference would be expected to move to get them. The Federal Government, faced with static or shrinking revenues, could be expected to move to increase taxes, thus increasing the burden on non-tax preference companies. The surviving companies in this type of market would be primarily tax dependent and would produce very little tax revenue. The ultimate delivery of insurance benefits to policyholders would be dependent upon the continuation of the tax preferences. Perceptive state regulatory authorities would probably find it necessary to intervene at some point in the interest of industry solvency or be forced to do so because of the operation of their guarantee laws, as companies are forced out of business because of the federal tax situation. They might also be expected to intervene for competitive reasons. When they intervene, they can be expected to attempt to remove the benefits obtained by tax preferences in some manner.

Tax preferences create income for companies that is not earned by operating efficiencies or good management. This results in loss of equity among companies and in encouragement of operating and management inefficiencies.

Tax preferences may act to produce artificially low prices for new products and may serve as an additional incentive to replace existing products with new ones. The ultimate delivery of the benefits contracted for in the tax preference new products would be contingent upon the continuation of the tax preference or upon later replacing those preferences with price increases.

MR. BOOTH: One of the problems in achieving tax parity is that what have previously been regarded as different kinds of products are now competing in the same marketplace. How can tax parity be achieved between these various products?

MR. HAMILTON: The lines of demarcation between life insurance and annuities are eroding, as well as the lines between life insurance products and those savings or investment products sold by other institutions. Preservation of existing tax treatment for life insurance and annuity products requires that we establish reasonable standards to differentiate life insurance from annuity products and to set both apart from investment-only vehicles.

One approach would be to apply a cash value test annually to Universal Life and other current flexible life insurance products to determine how the policy is to be treated for tax purposes. In contrast to current practices under which a contract is taxed wholly as an annuity, a life insurance contract, or a debt instrument, this approach would divide a single contract for tax purposes into one or more categories. Specifically, provided there is a reasonable relationship between the cash value and the policy face amount, the contract would be treated as 100% life insurance. Should the cash value exceed a specified limit, for example, the net single premium at the insured's attained age, then the policyholder could either increase the face amount to the point where the limit would no longer be exceeded or the excess would be treated as an annuity or a deposit at interest. The distinction between an annuity and a deposit would be based on whether there are permanent annuity purchase guarantees. Taxation at the company and policyholder level would be consistent depending upon categorization.

Another approach that might be used to differentiate annuities from other investment alternatives would be to develop a statutory annuity definition for tax purposes and to revise the provisions of Internal Revenue Code Section 72 dealing with taxation of distributions other than as an annuity. For example, one could treat withdrawals as involving pro-rata distributions of capital and interest versus capital first and impose tax penalties for withdrawals during the first five or ten years following issue. Coupled with this would be a statutory definition that would codify traditional annuity attributes and probably emphasize long-term accumulation and periodic payment liquidation.

MR. GUSTAFSON: Tax parity for new and creative life insurance and annuity contracts can be achieved by treating all contracts, both life and annuity, with discretionary price adjustments as participating.

On a related matter that does not seem to fit anywhere but here, reference is sometimes made to a New York regulation to the effect that losses under an indeterminate premium contract may not be recouped from that block of business. I believe such a regulation to be unenforceable and probably unconstitutional. Consider for a moment a simple company that issues only indeterminate premium, individual policies, which feature a five-year guarantee. The company considers its needed surplus level to be 5% of reserves and has been roughly at that level for some time. It seriously misjudges and loses heavily during the current five-year guarantee period. Surplus drops to 2 1/2% of reserves. The New York regulation would prohibit recouping that surplus loss from the inforce business and, in effect, would require that surplus be recouped by an added profit factor in new business. But this amount is so large that the new business price would be disastrously uncompetitive. Now what does the company do? It cannot continue to operate at this low surplus level. It cannot recoup from the policies that have received a price break in the past five years. It cannot remain viable in the new business market with the necessary, uncompetitive price. I guess it will just have to go out of business and seek a merger or buyout. Moral: Apparently, you do not dare risk loss under a guaranteed price adjustment contract.

MR. BUCHTER: The achievement of tax parity at the product level depends on achieving it with respect to discretionary income transfers or dividends. This requires a system which permits tax-free transfers subject to the condition that the transferred income be taxable to policyholders, when and if it is received by them, and subject to the further condition that reasonable limits be set at the company level as to the amount of income which may be transferred. It also requires that a common gain from operations type of tax base be used. In particular with respect to Universal Life, these plans offer great potential as efficient mechanisms for providing insurance. Their use ought to be encouraged to the extent that they compete on the basis of those efficiencies, and they should not be burdened with tax penalties, nor should they be granted tax privileges. One of the controversial aspects of these plans has been their use of current interest guarantees to supplement the basic interest guarantees. The excess interest system I previously described can be used to split out short-term Universal Life interest guarantees and treat the income which results from them as a dividend. This would place them on tax parity with participating business. The mere potential for discretionary income transfer is not enough to make whatever occurs under that contract equivalent to participation. You need to look to what actually happened. Similarly, as regards annuities, the excess interest type of approach would be beneficial in maintaining tax parity.

MR. BOOTH: Currently, there is much talk about competition or the potential for competition between various types of financial institutions, including the possibility of savings and loans institutions, or banks, actually doing an insurance business. For example, we already see very strong competition among banks, savings and loans, and insurance companies for individual retirement accounts. How can we be sure that we have tax parity among competing financial institutions? How can that be defined considering the difficulty we are having in defining it for different types of life insurance companies?

MR. BUCHTER: A discretionary transfer system is useful for maintaining tax parity with other financial institutions. It identifies short-term interest guarantees as discretionary income transfers and requires a policyholder tax at the time of transfer if the interest is then received by the policyholder; and it requires a normal tax plus a surtax if a policyholder receives the interest at some later time. The imposition of a policyholder tax at the time of transfer parallels the tax treatment of non-qualified savings accounts. The imposition of a tax and surtax parallels the tax treatment of qualified savings accounts and establishes reasonable tax parity with other savings institutions as a consequence. Now, although life insurance interest developed in long-term and permanent interest guarantees is not taxed when applied to policy values, the tax parity is, nevertheless, maintained with other financial institutions because the interest is not constructively received at that time. Other institutions are free to attempt to offer interest on a similar basis if they choose to do so.

MR. HAMILTON: Tax parity between life insurers and other financial institutions competing with insurers for the savings dollar requires equitable tax treatment of institutions and customers with respect to annual earnings on funds accumulated for the ultimate benefit of the customer. This is nothing more than a restatement of two of the basic principles I espoused earlier; namely, tax neutrality and consideration of both policyholder and company tax. It sounds simple enough. Why might it be more of a problem today than years ago?

Historically, life insurers have offered life and annuity products designed to provide protection against two primary security risks--dying too soon, living too long. Many such products involve the accumulation of funds or reserves for future use, either to pay the excess of current mortality costs over level premiums in the case of level-premium life plans or to provide periodic payments in the case of retirement annuities. Tax laws governing such contracts provided for annual deduction to the insurer for amounts required to accumulate the reserves and a deferral of tax to the policyholder with respect to those amounts--the so-called tax deferred "inside build-up". The basis for such deferral has been public interest and the doctrine of constructive receipt. As long as interest rates remained low, and insurance contracts substantially limited the discretionary use of such accumulations without surrendering a valuable right, neither other financial institutions nor the U.S. Treasury were able to mount a serious threat to this insurance contract tax advantage. High interest rates, high and sustained inflation, and increasing competition for the savings dollar have changed all this.

In response to the changed economic landscape, a shrinking share of national savings, and consumerist preoccupation with rate of return, life insurers over the last five years have developed new annuity and life insurance products. These new products were designed to highlight the current return on premiums paid. Moreover, many provided the purchaser with increased control over the assets to be used to fund deferred benefits and liberalized withdrawal privileges. Attracted by the combination of higher returns and tax deferral and motivated by competitive pressures, brokers and mutual fund organizations actively sought out ways of wrapping annuity or life insurance contracts around their investment vehicles. Not surprisingly, these changes in products have not gone unnoticed by the U.S. Treasury. A series of revenue rulings in 1978, 1980 and 1981 on wrap-around annuities put the industry on notice that products offering too much investor control over the investment decision would not qualify as annuities. Recent meetings with Treasury and Congressional tax staff have made it clear that current products with investment choice flexibility and with liberal, small or no penalty withdrawal privileges, are perceived as "short-term investment animal[s] wrapped up in long-term investment clothing". This concern extends to both annuity and life insurance products.

Where does all of this leave us? At a watershed, I believe. If as an industry we persist in trying to call all products we sell life insurance or annuities, we run a real risk of losing the unique tax advantages our products have so long enjoyed. The more desirable course, it seems, would be to differentiate our products into life, annuity and investment categories and urge that taxation on the latter, to the company and the consumer, be identical to that for investment vehicles sold by non-insurers.

MR. GUSTAFSON: I actually agreed with every word Jim said!

This is probably the most important question on this program, and yet for good and sufficient reasons, mostly its difficulty, we have devoted relatively little time to it. It is far too complex for anything more than a glib generalization, such as aggregate tax burdens should represent similar proportions of comparable operating revenues for the different industries.

Finally, the program includes the parenthetic expression "including tax-qualified savings". I do not know what tax parity can possibly mean for tax-qualified savings. If it is tax qualifed, there should be no effective tax.

MR. BOOTH: Gus, that may refer to the fact that in some situations there is an effective tax on qualified pension plans within life insurance companies. That is another one of the defects of the 1959 Act that keeps coming up.

MR. E. J. MOORHEAD: Here are two questions for the panel. One is on a matter that you have discussed, where I have difficulty in accepting your unanimous conclusion; the other does not seem to have come up.

First, in an industry whose products the buying public has immense difficulty in understanding and comparing, can it properly be said that sales will move from the tax-disadvantaged to the tax-advantaged companies?

Second, from the buying public's standpoint, what does the stockholder of a stock life company contribute to that company's functioning that warrants aiming for tax parity with mutual companies? Would it not be preferable for the stock companies to mutualize?

MR. GUSTAFSON: I will give the other panelists a moment or two to think about the second question by commenting briefly on Jack's first question, why would all the business go to a product or a company that had a tax preference? We three are obviously in agreement that contrary to the many allegations by our consumerist critics, price competition, while maybe subtle and indirect, is very much alive and well in the life insurance business. If there is a substantial tax difference, it will be of such a competitive advantage that we would all eventually be driven to the tax advantageous product. Really the answer to your question, Jack, is because we believe price competition exists in the life insurance business. Now, did that give either of you enough time to think of an answer to his second question? I would not touch it with a ten foot pole.

MR. HAMILTON: We have historically had both stock and mutual companies, and the industry and the public have benefited from the two different forms. Much of the product innovation that has come out in the last few years has been induced by actions taken by, in many cases, small stock companies. The industry and public have benefited from different organizational forms and that would be lost by a move of all companies to become mutuals.

MR. BUCHTER: I think I heard two questions in one there. One concerned the justification for the existence of a stock company, and the other the justification for putting stockholders in both mutuals and stock companies in the same position. Is that a fair statement, Jack?

MR. MOORHEAD: Yes.

MR. BUCHTER: The second part seems obvious. If you have two corporations, they both have stockholders, and they both return after-tax income to their stockholders, it is an inequitable situation when one pays the tax and the other does not. I do think that needs to be rectified. As to the justification for stock companies, I think the mutuals benefit in many ways from having stock companies. The public benefits still more. Stock companies are not an anachronism. As a matter of fact, if you accept the scenario that in the future interest rates are likely to go down to some degree, then perhaps nonparticipating insurance offers one of the better buys in the market. Stock companies provide a risk function, though the bigger the stock company, the less the risk assumed. There is still a venture form of bringing innovative ideas into the marketplace, and there is a place for both.

MR. GUSTAFSON: As you perhaps could derive from some of my earlier remarks, I do not set much store by theoretical considerations of federal income taxation of life insurance companies. Insofar as I entertain any thoughts in my own mind about theory, with regard to that part of the industry that I am now most familiar with, mutual companies, I would be inclined to argue that a mutual company is like a farmer's cooperative. Then on the other hand, having said that, I also firmly believe that competitive parity is essential; and if it can be argued that to not tax the mutual on the basis of the theory I have offered would give the mutuals such a significant competitive advantage that it would extremely handicap the stock companies, then I come back to my pragmatic argument.

Let's work out what kind of an artificial and totally unjustified tax differential on mutuals is necessary in order to achieve this competitive parity that we apparently prize very highly, because I do share Gene's views that over its long history the life insurance industry has been strengthened by the existence of competing forms of enterprise. I believe the mutual companies have been strengthened by the competition that they have received from the stock companies.

MR. BRUCE E. NICKERSON: One of the points discussed repeatedly was the difference between the current premium paid by a policyholder and a maximum guaranteed premium. It was recognized that participating insurance has traditionally charged and guaranteed a premium that was intended to be more than adequate and has returned the excess over what was actually needed as a policyholder dividend. The suggestion seemed to be widely accepted that the same tax treatment should be applied to indeterminate premium and excess interest policies sold by stock companies. The idea is that by measuring the difference between the current premium and what could have been charged under the policy provisions, one can determine a "dividend" for tax purposes.

I have not heard the panel consider what I believe to be a plausible response by stock companies to such a rule--a response likely to be adopted by at least some companies. The response is to issue contracts without an ongoing guarantee. Without a guarantee, there is no difference to measure, and, therefore, no dividend.

In its simplest form, consider the difference between two annual renewable term policies. Under one policy the company guarantees a maximum premium for each policy year and also promises to guarantee a current premium one year at a time in advance of each policy anniversary. Under the other policy, the company provides no long-term guarantee but promises to renew the policy annually at its then current rate without change in mortality classification. The approach of the second policy could clearly be expanded to more complex policy forms.

Thus, if an attempt is made to base taxes on the difference between a long-term guarantee and current guarantee, one of the possible outcomes is a further elimination of guarantees from life insurance contracts. Too many companies have shortened or reduced guarantees already because of uncertain economic prospects. A tax law which gives further impetus to eliminating guarantees would be very unhealthy for the industry.

MR. BOOTH: Bruce is suggesting that a change in tax treatment of nonguaranteed features of nonparticipating insurance may lead to guaranteed renewable life insurance somewhat akin to guaranteed renewable health insurance.

MR. BUCHTER: We have that situation in health insurance and also in reinsurance. We should not be measuring the difference between the repriced premiums and the guaranteed premiums. We need to look at the price change relative to what we are already charging. In a high interest rate period like the present, the long-term expectation is that interest rates will go down over the life of the contract and that the premium will ultimately go up from the current price.

MR. BOOTH: How do we raise an appropriate level of tax revenue? We are almost back to where we were in 1959 when the industry was supposed to pay $1/2 billion. We start categorizing certain products, saying we will tax this one this way and that one another way, and then companies start changing products and practices and tax dollars slip away. There is always tax planning to some degree. North of the border, Canadian companies got themselves into roughly the same position as the U.S. companies in 1959. It may not be possible to establish a tax system for life insurance companies so that there are no loopholes. The tax dilemma has been summed up this way: If you have a tax rate of zero, you raise zero in tax, and if you have a tax rate of 100%, you also raise zero in tax. How can you determine the optimum tax rate and optimum method to determine taxable income so as to minimize the attraction of tax avoidance measures?

MR. GUSTAFSON: Classic participating life insurance is one of the most flexible and finest products that has come out of the creativity of the life insurance structure over the past 100 years. I am fighting for sufficient tax parity so that I will not feel motivated to go to my company and say we cannot afford to do that any more, we have to give up this marvelous product, and we have to switch to this new whizbang because it has a tax advantage. Yet, it seems clear to me that if the indeterminate premium and Universal Life type products in effect come out scot-free, the expectation that revenue is going to be achieved by applying taxes to the classic old traditional participating products will not be realizable. The only practical and pragmatic situation--a consistent mechanism that has as much soundness as the theories expressed by the two other panelists--is very simple to describe: If management has discretion to change the price after issue, the policy is participating.

MR. THOMAS K. GROSS: It has been suggested that only a reduction in premium from what you might call the current at issue premium is a dividend. If that were accepted, a mutual company might say that only that portion of the dividend which exceeds the original illustration should be considered a dividend for tax calculations. But if we continue with inflation like we have had over the last 25 years, we will reach a time when even that dividend will not be sufficiently deductible.

MR. JAMES GEYER: It is not surprising to me now to see why the industry has had so much trouble coming together on the stopgap measure. It bothers me, though, that Dale wants to stay away from theory, saying that the final answer will be based on pragmatics only. What got us into this trouble right now is that we have a 1959 Act that worked in 1959 and was a pragmatic solution that did not address the theory. If we come up with a pragmatic solution today, it may not fit the situation five years from now in a considerably different environment. I feel strongly that we really need to look at the theory and come up with something that we think is right.

MR. BOOTH: Certainly, a laudable objective. If anybody can come up with a theory of how to tax life insurance companies and get the whole industry to agree, it would be a marvelous achievement.

MR. GUSTAFSON: I do not actively oppose the concept of attempting to determine what a sound underlying theory is; rather I am giving a pragmatic view that no such attempt has yet succeeded in producing a theory that is both affordable and acceptable to the industry. Do not kid yourself into thinking that you have found a great answer because somebody has written down what looks like a good theory. Always check it out and double check it against what is going to happen in the real world. The focus is going to have to remain on the practical impact because it is unlikely that we can develop a whole theory in the time frame that we have.