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UNIVERSAL LIFE

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MR. SAMUEL H. TURNER: The Universal Life product is viewed by most as an evolutionary product, not as a revolutionary product, in terms of its design and structure. Consider some of the characteristics of flexible premium annuities: flexible premiums; disclosure of loads and expense charges; crediting of current interest; and annual reports. Also consider features of the Minnesota Mutual Bankers Life "Adjustable Life" product like the adjustable face amounts, the ability to make unscheduled premium payments, and prospective nonforfeiture compliance demonstrations. Combine these features and you essentially have a Universal Life contract.

MR. BEN H. MITCHELL: Traditional plans are fairly simple in their structure. One can look at their premiums, their cash values and their dividends, if there happen to be any.

Universal life presents something of a paradox. The operation of a Universal Life contract is very straightforward and easy to understand for the man on the street, but is more complicated than a traditional product for us as technicians. One of the strengths of the Universal Life product is that this complexity stays within the company, and the product looks very simple to the consumer.

The complications begin with a very simple question: What's the premium for Universal Life? It could be almost anything. Then what's the cash value? That depends on the premium. It is the relationship between the premium and cash value that determines the product characteristics of Universal Life.

Let's review the basic mechanics of Universal Life. The first thing that has to occur is a premium payment. A premium may be paid at any time and in any amount desired. Whenever a premium is paid, loads are deducted from that premium. The balance is added to a fund. On a monthly basis, cost

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of insurance charges are deducted from the fund. Expense charges may be deducted from the fund, especially in the early policy years, and interest is added to the fund on a monthly basis. The cash value changes each month based on the net impact of the income and deduction transactions.

The cost of insurance and interest rates are guaranteed in the contract, but the company may pay more interest and/or charge lower cost of insurance rates.

The policy does not lapse if a premium is not paid; rather, it lapses if the fund balance becomes too small to pay the next month's cost of insurance.

Policy loans are handled differently on Universal Life contracts. A reduced rate of interest is credited on any cash value that is offset by a policy loan. Most companies pay only the guaranteed interest rate on loaned funds; some pay a rate which is higher than the guaranteed rate, but less than the current rate. This has the effect of making the policy loan much less attractive to the policyholder than it is on traditional policies. In addition to paying loan interest at 6% to 8%, the Universal Life policyholder will also forego a substantial amount of excess interest, maybe 6%-8% as well, making his total cost much more in line with market interest rates. Minimum deposit on Universal Life is not likely to be a very attractive proposition and one would expect loan activity for Universal Life contracts to be substantially below our traditional experience.

There are between 30 and 50 Universal Life products being sold in the marketplace today. The charts below show information on four of these products.

These products were selected to use as typical examples of current products and are not necessarily recommended or endorsed. They are just good examples to look at.

Let's look briefly at the loads as shown in Chart I. The loads take one of three forms, percentage of premium loads that generally apply to all policy years, per policy loads and per thousand loads, both of which generally apply only in the first policy year. Plan A might be called a traditional universal life if such a term makes sense. It uses all three types of loads with the timing described above. Plan B drops the per policy load from the structure and replaces it with a large per thousand load which varies by individual issue ages. This large per thousand load drives the minimum premium that represents something in the range of a whole life premium. Plan C replaces the per policy load with a percentage of premium load, with a higher percentage being applicable to the first dollars of premium coming into the contract, reducing at some point to a lower level. Plan D is a very low loaded product, using only a level percentage of premium loads.

At the bottom of the chart, high and low values are shown for other policies that are offered on the market. There is a very tight range of loads on a percentage of premium basis and considerably greater in the other types of loads.

You might ask do we really need all these different kinds of loads? In general, I think the answer is at least a conditional "yes". The policy load contributes to a grading of the contract by size which most find desirable. The per thousand and percentage of premium loads allow the contract both to compete and to be profitable as a low premium, term type of contract and as a savings type of contract. It should be noted that some plans recently have been introduced which replace or supplement the front end loads with substantial surrender charges.

The interest items shown in the middle of the chart show a very tight grouping on guaranteed interest rates. There is a fairly tight grouping of current rates except for Plan D which links its interest rates to T-bill rates. Most of the products are using an excess interest exclusion which is used to get an administrative expense allowance coming to the company in all years. Some companies are not doing this and are paying excess interest on the full cash value.

Cost of insurance rates are shown. I don't think we need to get into them at any length this morning. Generally they vary by attained age only. Most recent forms have gone to a smoker and nonsmoker basis for the cost of insurance. And there is considerable variation in the level of charge between different companies.

Now, let's look briefly at agents compensation. Agents compensation on universal life may take various forms. A key consideration in the design of universal life plans is the opportunity to match front end expenses and compensation with front end loads. No plan is likely to be fully matched, but in general the closer the better. Chart II shows the compensation factors for the four universal plans, A through D. Note that Plan D shows writing agent compensation only due to some difficulty in getting good information on the GA level of compensation. All the plans have renewal compensation at low to moderate levels in all years. However, first year compensation is much more interesting. Plans A and C pay compensation based on per policy, per thousand and percentage of premium. This is similar to their load structure if you'll remember. Plans B and D try to simplify the compensation by expressing it all as a percentage of premium. Note that the level of compensation is quite different in these two cases and the compensation drops to renewal levels after a premium limit has been exceeded. All plans try to have low loads and low compensation on extra premium dollars, to make the savings element of the contract attractive.

Now, let's look at Chart III to see some sample loads and commissions calculated for these four plans. Two sizes are shown for each of two ages. Again, renewal is shown but first year is more interesting. In all cases, loads and commissions show obvious relationships but all commissions exceed the loads even while not including external expenses. So none of the products are fully matched. The total compensation for all levels of agents ranges from the high 80's to the mid 40's. Remember that some gross estimates were used for Plan D. Plans A and C which use per policy components vary the compensation in relation to premium by the policy size and the age. This is in line with a point of view that says the compensation should be proportional to the effort involved in making a sale and the effort to make the sale does not increase proportionately as size goes up. Plans B and D without any per policy components, show no variation by size and considerably less variation by age.

Clearly compensation is paid on universal life plans in various ways and at levels which vary significantly. Are compensation levels low or high? Well, that depends on what you compare against. They are generally low compared to traditional whole life compensation which is likely to run in the 100+% range. However, they are much higher than a similar combination of ART plus a flex-annuity which might run in the 20-25% range. So whether commissions are high or low depends on what the agent thinks he would be able to write as an alternative product.

Now just a few comments about riders that might be offered under a universal life policy. Many policies have come out without any riders, possibly as a simple expedient in some cases, and for other reasons as well. Lately more people have been adding riders to their contracts and a large number are being used. A common rider is a rider that allows multiple lives to be insured under the same contract. The other insured would have level term insurance and no cash value. One, two, or more insureds may be linked into the contract along with the primary insured. Another type of rider that is being used increasingly is a cost-of-living adjustment rider. The provisions of this might be to cause the face amount or the specified amount of the contract to be automatically increased on a periodic basis based on changes in a cost-of-living index, probably the Consumer Price Index. The period might be 1 to 3 years and the policyholder will continue to get his increases so long as he took all the ones that have been offered. If he declined an option, then generally he would be dropped from further options. Another kind of rider that has received a lot of interest is a waiver of premium rider. This gets back to our first basic question. What's the premium or what are we going to waive? Well, there are several different answers to that: in general either waiving the cost of insurance or some form of gross premium. There are many considerations in that area. Other riders that are being used that may be more straight forward are accidental death riders, guaranteed insurability, spouse rider, child rider, and maybe a few others. But those are probably the major ones.

MR. ERNEST L. JOHNSON, III: Referring to the excess interest exclusion, are states now requiring this to be included in the policy form, and are any companies designing products where a reduced rate, not all the way down to the guaranteed rate, is paid, in an effort to reduce the charge?

MR. MITCHELL: I believe there is one state that has stated verbally, but not in writing, that they require disclosure in the contract.

MR. TURNER: Based on my impressions, the answer to your second question is "yes". There are a lot of variations from company to company.

MR. MITCHELL: I think there is room to design contracts without the excess interest exclusion and I would be inclined to recommend doing so. I think this is an area where misunderstanding can arise and may just as well be avoided.

MR. TURNER: Had there not been any nonforfeiture compliance problems, my personal inclination would have been to pay no interest on the first $x of cash value. This is consistent with the practice you see in the banking industry, i.e., a minimum balance.

MR. IAN MCINTOSH: Are these contracts issued on both participating and non-participating basis or are they always non-participating?

MR. TURNER: There are at least three mutual companies that offer universal life. I believe at least one is a par contract paying.

MR. MCINTOSH: Turning to the non-par policies, is there some form of guarantee in the policy as to how the current interest rate will be calculated?

MR. TURNER: Some yes, some no. T-plan, for example, is contractual. Life of Virginia is indexed, but we do it another way. We use a resolution of our board, communicated in writing to each policyholder. We have legal opinions saying that's a legally binding commitment. But index is not in the contract simply because it would take three pages to describe it; others appear to guarantee a fixed rate for a year in advance.

I would now like to go into the next segment, marketing support and state regulatory matters. One comment I would like to make is that it is difficult to balance the market pressure, i.e., the pressure from your agents and brokers, to illustrate the highest possible rate at the level that you feel comfortable with as a professional. I would admit that probably that there have been some abuses. I will make two comments. The first deals with typical mutual company illustrations of current dividend scales. I would guess that interest rates used in computing current dividend scales are somewhere between 7.25% and 8%. If you gross those up to a pre-tax basis you also get fairly high rates, or an inputed assumption of future interest rates at a rather high level.

Some of those are "new money". Some are "portfolio". Yet neither of these specific rates or the basis on which it is to be determined is typically disclosed at point of sale. So some problems occur in areas other than universal that we have to deal with as professionals. Second, in the universal area, I can only relate what we have done. In all our computer proposals we illustrate at three interest rates. We illustrate it at 4%, we illustrate at 8%, and we illustrate at the current rate another rate selected by the agent generally. Now let's hear from Mr. Odell.

MR. LEONARD E. ODELL: Due to the unique nature of universal life products, a number of states have issued guidelines governing the sale of such products. These guidelines address contractual requirements as well as policyholder disclosure procedures. To date, South Carolina, Nevada and Pennsylvania have issued guidelines and the California department is in the process of putting together their own set.

The principal requirements in South Carolina are:

1. Sales material must be submitted with the policy filing.

2. The Policy Summary must contain a prominent statement to the effect that contract values may materially change due to variations in the mortality, interest, and expense charges and also the timing and amount of premium payments. The Policy Summary must further indicate when the policy will terminate based on guaranteed assumptions if such is the case.

3. All requirements of the State's Indeterminate Premium Guidelines must be satisfied.

4. The contract must give the owner the right to purchase paid up insurance at rates not worse than those guaranteed in the contract. Paid-up insurance amounts in excess of the current death benefit may be subject to evidence of the insurability.

5. A 60 day grace period commencing at the beginning of any month when the cash value is insufficient to cover the monthly deductions is required. Further, it is mandated that a 30 day written notice be given to the policyholder prior to that contract being allowed to lapse.

6. The contract must guarantee that an annual report showing the transactions during the preceding year will be sent to the policyholder.

7. The company must adopt a plan for notifying the policyholder of the expected future results. The department has suggested three types of acceptable plans:

   (i) Furnish a new long term projection on guaranteed and current assumptions with the annual report.

   (ii) Alternatively, a company could choose to furnish a one year projection based on current assumptions together with an offer to provide additional information.

   (iii) The final choice would be simply to include a notice with the annual report informing the policyholder that he has the right to request the projection free of charge.

The Nevada guidelines are less comprehensive than those of South Carolina. Insurers are required to submit the sales materials with the filings and an annual transaction report is required. However, there is no requirement that insurers furnish projections to in-force policyholders. Rather the company must simply agree to provide such projections upon request and presumably companies have the option of imposing a charge for this service.

The Pennsylvania guidelines specify a number of contractual requirements and set forth the manner in which the state's cost disclosure and replacement forms are to be completed for universal life. Contractual requirements are:

1. An annual transaction report containing a "future projection" must be supplied free of charge. The policy specifies three permissible types of future projections:

   (i) A statement indicating the date the contract will terminate if no further premiums are paid.

   (ii) A new long term projection on guaranteed and current assumptions utilizing a specified premium appropriate to the contract.

   (iii) A one-year projection based on current assumption showing what the cash value will be at the end of the next year.

2. The contract must further give the policyholder the right to request projections at any time and the insurer may impose a reasonable charge for this service.

3. Thirty days written notice to the owner is required prior to policy lapse.

4. The contract must contain a table of guaranteed non-forfeiture values. A number of other states, while not having specific guidelines for universal life, also require the contract to contain a table of guaranteed non-forfeiture values.

With respect to the completion of cost disclosure and replacement forms, the Pennsylvania guidelines require that the policy description disclose the adjustable nature of the coverage, the protection period, the existence of the accumulation value and how such values are affected by mortality, interest, and expense charges. In the event that the contract will lapse before the maturity date, the expected termination date must be disclosed on both forms. With respect to cost indexing calculations, Pennsylvania mandates that current assumptions be utilized. Presumably cost indices on guaranteed assumptions may also be shown.

The California department recently released a discussion draft of a proposed universal life regulation. The proposal contains requirements to ensure adequate policyholder disclosure but is principally concerned with the implications to the company of offering universal life products, particularly products featuring index linkage. Companies would be required to submit forms for reference purposes and explain how the company anticipates backing any interest rate guarantees in excess of the maximum rate of interest specified in the standard valuation law. With respect to indexed plans, companies would be required to submit a description of the investment strategy they plan to use to implement usage of the index. The description would include an explanation of how this strategy and other policy design features minimize the indeterminate future risks inherent in such product designs. If the company could not convince the Commissioner that it has the ability to immunize itself from these unknown risks, then the company would be required to establish additional reserves the magnitude of which would be dependent upon the company's inability to immunize.

A couple of ACLI groups have also been studying various aspects of universal life insurance. The Council's Subcommittee on Cost Comparisons has proposed that cost disclosure requirements for universal life plans be generally similar to those for traditional life insurance plans as provided by the NAIC Model Life Insurance Solicitation Regulation. In addition, the Subcommittee is recommending disclosure for universal life plans in accordance with the "non-guaranteed cost element" concept endorsed by the Council as a modification to the model regulation. The only special requirement recommended for universal life plans is that the Policy Summary indicate when the plan will terminate based on guaranteed assumptions. No post-sale disclosure requirements were deemed appropriate at this time.

The Council's Indeterminate Premium Task Force at the requst of the NAIC (C4) Technical Subcommittee, has been examining the valuation and nonforfeiture aspects of universal life. After studying this matter for several months, the Task Force concluded that, since universal life policies are in such an early stage of development, it would be inadvisable to promulgate

minimum valuation and nonforfeiture requirements in the immediate future. It was felt that any such requirements might fail to take into account products that are now being developed or will be developed in the very near future. Consequently, the Task Force decided to furnish the (C4) Technical Subcommittee with a paper concerning universal life valuation and nonforfeiture concepts which reflected the group's discussions to date.

As a member of the group that prepared this paper, I would like to conclude my remarks by briefly commenting on these concepts.

The valuation concept defines the Commissioners Reserve Valuation Method for universal life insurance. The group decided to define a CRVM reserve in order to leave open the possibility that a company could make use of an 818(c) reserve adjustment.

The nonforfeiture concept suggests that a retrospective method be used as the basis for minimum values. Under this concept, surrender charges would be permitted as long as the minimum cash surrender value requirements were met.

I must emphasize that both the valuation and nonforfeiture concepts were heavily influenced by the structure of universal life products being sold today. It is my opinion that it is very likely that future product designs will require appropriate modifications to these concepts. I urge those interested to review the paper and submit their comments.

MR. MITCHELL: A couple of quick comments on the various state approvals at this time. I believe it is true that 49 states plus the District of Columbia have approved universal life policies now being written. The sole exception is New York and I do not suppose that surprises anyone. And I understand they are working on guidelines and hope to be in a position to do something early next year. In addition to the states that Len mentioned with published guidelines, there are another dozen or so that have some specific requirements that they are implementing for universal life though they haven't been able to write them down.

One of the things that goes into universal life filing is the nonforfeiture and reserve demonstration. The nonforfeiture demonstration generally is in three parts.

1. First you show that the formula used for the retrospective development of universal life cash value is mathematically equivalent to the traditional actuarial formula.

2. It is then argued that if universal life cash values can be shown to be greater than minimum when the guaranteed mortality and interest bases are used, then the use of nonguaranteed higher interest rates and lower cost of insurance rates will produce larger universal life cash values which must also be greater than minimum.

3. And then third, you show that the loads deducted from universal life cash value accumulation are not greater than the maximum expense allowance provided by the standard nonforfeiture law. This comparison if possible should be done on a worst case basis. If it can be done on this worst case basis, then there is no need for assumptions such as the typical plan that will be written or average age or average

premium which would be assumptions that would require continued monitoring.

On the reserve side, less elegance is generally involved. Three approaches have been used. Some have argued for no requirements for future premiums. They think of it as paid up and say the reserve is equal to present value of future benefits. A more general approach would say that future premiums are possible and then argue that the cash value is equal to the present value of future benefits minus the present value of future premium regardless of what those future premiums may be. And then some directly show that the reserve is greater than CRVM in an approach very similar to the nonforfeiture demonstrations, showing that the charges deducted are not greater than the allowances provided by the Standard Valuation Law.

MR. P. RANDALL LOWERY: Regarding use of a policy fee and the nonforfeiture law, our contract provides for a monthly policy fee equal to the lessor of $2 or the excess interest credited for the month. This provides a policy fee which does not fluctuate as the current interest rates change.

MR. LESLIE J. LOHMANN: I am quite interested in the comment made about the 818(c) election and the relationship to the CRVM reserves -- a little more perhaps on the theory behind it.

MR. ODELL: The reserve is composed of the sum of "A" + "B" if you will. "A" is the value of future guaranteed benefits less the present value of future valuation net premiums. "B" is the amortized difference between the actual first year expense charge and the expense allowance allowed by the CRVM method. If a company has a very large actual first year expense charge, it would be required to hold a reserve larger than the cash value by the amount that the actual charge exceeded the allowance of the CRVM method.

MR. CARL L. SHEPHERD: My comment is in regard to Ben Mitchell's discussion about the nonforfeiture demonstration. What seems to be missing is that according to Standard Nonforfeiture Law, the initial expense allowance would have to be amortized over the lifetime of the policy.

MR. ODELL: In our council group, we have really struggled in the nonforfeiture area with the proper treatment of the first year expense allowance. The concept that we presented to the NAIC allowed, as a deduction, the actual first year charge, which is accumulated forward. The unused portion of the initial expense allowance allowed by law is amortized. Under the Standard Nonforfeiture Law today for traditional life insurance, the plan of insurance is known and the expense allowance for the plan is known and is amortized over the life of the policy.

MR. TURNER: Some of the problems in this area are not dissimilar to those dealt with in Adjustable Life. You are trying to deal more with the intent of the standard nonforfeiture law than the letter.

MR. JOHN W. TOMLINSON: I would like to ask how companies study their mortality experience and their lapse experience under universal life. At a given moment of time, the policy has a specified amount, a cash value, and a death benefit. Each of these amounts can change at any time during any given policy year. What do companies use as their exposure to determine their mortality experience? Also how do they define a lapse and what do they do to study their lapse experience? I would also like to ask, are companies having success doing asset share studies of universal life?

MR. TURNER: There is no such thing as a lapse as you would traditionally think of it. You have a discontinuance of premium payment as a rate of decrement, and also a rate at which cash is actually pulled out. These are the same kind of decrements you deal with under variable annuities. You are dealing with the rate at which people quit paying premiums and a rate at which people in the inactive group withdraw cash. I think most companies, particularly those that have done any sophisticated type of pricing, are trying to set up systems to monitor both of these lapse rates.

In the mortality and lapse areas, much is going to depend on the computer systems available. On the mortality side at least, our systems monitor the exposed net amount at risk. That's the basis on which we reinsure, and it is also the basis on which we calculate the cost of insurance deduction.

Ben, could you comment on profit studies or profit measures that you have seen?

MR. MITCHELL: In the pricing work we have done for a considerable number of companies that are marketing universal life, we have used a modification of our normal profit testing programs. The modification primarily is putting a new program in front of the normal profit test program. The new program calculates the unique universal life numbers - the cash values, the reserves, and the commissions are the primary numbers although there are a couple of others that show up here and there as well. This information is passed to the normal profit test program and then is combined with the regular experience assumptions of mortality, lapse, expense and interest. As Sam was describing, both the discontinuance of premium and the removal of cash can be reflected within the program as well. So it's similar to the normal profit testing we would do on a traditional policy but it does have a number of unique characteristics that require special handling.

MR. TURNER: It also requires significantly more sensitivity tests than orthodox products. Now let us open up the issue of taxation - policyholder and company.

MR. WILLIAM B. HARMAN, JR.: The Hutton ruling covered policyholder tax issues. The first issue was whether or not the death benefits qualified under Section 101 of the Internal Revenue Code. That section is one that simply says that benefits from life insurance contracts are not income to the beneficiary. The revenue service raised the question, "was the universal life design a side fund with term insurance, or was it like the traditional life insurance contract where the cash value is an integral part of the overall life insurance contract?" They decided it was an integrated contract, and that it would qualify under Section 101.

The second issue was whether there was any constructive receipt of the interest credited to the policy. Since this policy was viewed by the Revenue Service as essentially the same as traditional life insurance, they ruled that there was no constructive receipt. The Revenue Service issued the Hutton ruling in January. It is interesting to note that they issued another similar ruling in May, 1981, where the death benefit was the face amount, or the cash value plus the lesser of 5% of the cash value or $50,000.

Subsequent to the issuance of the Hutton ruling, additional discussions were held with the Revenue Service. Two questions were raised. First, inquiries were made at the Revenue Service involving the question that perhaps the net amount at risk was too small under the contract. That seemed to worry some people at first, but I get a feeling that perhaps it does not bother them so much now. Frankly, it's an insolvable problem to define what a life insurance policy is if you get into how much net amount at risk do you need. Do you test it at the beginning of the policy, during the policy, or do you test it near the end? For example, a traditional life policy as it approaches the endowment age of 100 will not have a great deal of risk. Universal life designs to date would always have more risk because when they endow they still have some net amount at risk. That issue I think is one that I believe is beginning to diminish.

Now, as far as the company side of it, there are several issues. The basic issue is whether the excess interest guaranteed in advance is a dividend to the policyholder subject to the policyholder dividend limitation, or whether it is a benefit guaranteed in advance and therefore properly deductible as an increase in reserves. Several rulings have been filed on that issue, some arguing that it is a reserve increase and one taking the position that it is a dividend to policyholders.

This is not a new issue with the Revenue Service. It is the same issue as under the excess interest types of annuity. That issue has been pending for close to three years at the Revenue Service. Arguments have been made by people in the Service that excess interest is a dividend. The Hutton ruling describes the concept that the retrospective reserve valuation and prospective reserve valuation must be the same. Based on that theory, the actuary at the Revenue Service takes the position that excess interest in the annuity area is a dividend. We have had more success convincing lawyers who do not see the magic in this retrospective and prospective reserve valuation.

The Revenue Service now has apparently packaged the excess interest issue with the question of whether there is any dividend involved under indeterminate premium policies.

Interrelated to that same question is, what would be the assumed rate under Phase 1, or the required interest under Phase 2? As a practical matter, for Phase 2 companies, it makes very little difference whether or not the required interest under the Phase 2 computation is the current interest rate, may be 12% or the reserve valuation rate of say 4.5%. The only practical effect it has is the proration of income between policyholder and company. The Revenue Service, from our meetings in the excess interest annuity area, seems to be coming up with the view that the required interest assumed rate would be the reserve valuation rate. It is an important issue to a Phase 1 company as to whether the assumed rate is 4.5% or 12%.

The 818(c) election is another issue that is being looked at by the Service. In the Hutton ruling, the Service specifically took a caveat indicating that they were saying nothing with respect to this issue. One question that was discussed briefly was what was the plan of insurance? How do you know whether you have a permanent policy that qualifies for $21 per thousand, or a term policy that qualifies for $5, or perhaps some that qualifies for nothing. That is an unanswered question.

Another area I would like to discuss is the ACLI tax package. The ACLI package, for fixed annuities, specifically provide that a reserve increase is fully deductible under S809 and provides that the rate guaranteed in advance is deductible in determining the taxable investment income base. I think you could make a strong argument that universal life should be treated in the same manner. The rate is guaranteed. The concept of the taxable investment income base, going back to 1921, is simply one of taxing at the company level the so-called "free interest." "Free interest" is defined as the difference between what the company has earned and what the company is committed to pay. Now under the universal life design it is committed to pay the higher rate. Any differential should obviously be taxed under the Phase 1 tax base and should also be taxed under the S809 tax base.

Questions have been raised under the ACLI package as to what tax, if any, a universal life product should pay.

The premiums under the S809 tax base are income. There would be a deduction for the reserve increase. Whatever companies are keeping between what they earn and what they credit would be subject to tax. All mortality gains would be subject to tax. Any expense savings would be subject to tax. To me, under basic tax principles as applied, either to life insurance companies or to others, this would produce the right amount of net income for corporate tax purposes. I think the problem is not nearly as difficult as many other people seem to find. The ACLI has been meeting for many months. I think it is too important an issue to be left unresolved. Certainty is desirable under tax laws, and I think that certainty is needed in this particular case.

The ACLI also has a study group that they have just started recently to look at, 818(c), and see what amendments, if any, would be needed in order to specifically provide that universal life receives some form of approximate net level deduction.

QUESTION: What is the tax base for premium tax purposes?

MR. TURNER: Premium tax is payable on the total gross premium.

MR. HARMAN: I would argue that the premium taxes should be payable on the amount paid by the policyholder to the company, not on the cost of insurance charges deducted each month. That I think is consistent with the idea that universal life is like traditional life insurance.

MR. ERNEST REYNOLDS: Do you anticipate there being a difference in the tax treatment on excess interest guaranteed, say one year in advance as compared to the excess interest not being for a guaranteed period?

MR. HARMAN: We have run into this problem in the excess interest annuity area. We have argued that a guarantee in advance is not a dividend to the policyholder. The Revenue Service people have pushed it to the ultimate to say it means that if you guarantee it one day in advance, that it is not a dividend. What they seem to be coming up with is that if the guarantee is for one year in advance, it is not a dividend. There is nothing magical about a one year guarantee, but that is what they seem to be coming up with. If they do ultimately arrive at that point, then I believe they will apply the same principle to the interest guarantee under universal life.

MR. PAUL O. KIRLEY: I would like to know if you can give us your opinion on the advisability of filing for tax rulings as a company?

MR. HARMAN: I guess in the early stages, particularly if you have any different features in your policy, it might be advantageous to submit a ruling request. Otherwise, I think that if you have a standard form, I would not see really any need for a private ruling. I do not think that it is a competitive situation as in the Section 79 market where it was almost a necessity for each company to have a ruling on its policy. On the company side they have issued no rulings. If you submitted one now, it would just sit there pending the ultimate outcome of this big question of what is a dividend. If a ruling was published, it would be fairly standard. I do not see a real need to request a ruling on the company side.

MR. BRUCE NICKERSON: The private ruling you refer to as the Hutton ruling did say there was no constructive receipt, but to my recollection it did not address the issue which is special to universal life of the partial withdrawal privilege.

MR. HARMAN: That has concerned the I.R.S. Section 72, the Section that covers life insurance, endowment and annuity contracts, provides by statute a cost recovery approach. We heard some arguments that under partial withdrawals there should be some bringing back into the income the interest credit. We gave them additional rulings, reminded them of the statute, reminded them perhaps that the Treasury Department in 1977 submitted to Congress a complete change in annuity taxation because the Treasury interpreted Section 72 the same as we did, namely it clearly provides for cost recovery. The Carter administration requested Congress to change the rules so that the first dollar paid was your income dollar rather than taking the cost recovery approach. That same question is present here and if it is an abuse, which Congress did not think in 1978, it is a matter I believe for tax policy and for Congress to change. If they wanted to change it, then presumably they would change it for all insurance, whether it is universal life, or traditional, or annuities.

QUESTION: There are many companies that have a surrender charge related to excess interest. How does that affect the reserve treatment of that excess interest?

MR. HARMAN: Most people selling fixed annuities or variable annuities have a back-end penalty on surrender. My feeling is that people have been taking a full reserve on that and I would think it would be equally proper to take the full reserve here. Under the banking system, if you surrender a C.D. early, there is a substantial penalty. My recollection is that banks take a full deduction and I would think that this would be handled the same way. I don't think it is necessarily a new issue.

MR. C. NORMAN PEACOR: I think one of the issues that I have not heard addressed here, and one of the reasons that Massachusetts Mutual made the request for a ruling, was the fact that we are quite concerned with issue of replacement. There could be substantial attempts at raiding the existing cash values of our policies by having them moved over to universal like types of products. We consider it not inappropriate to defend ourselves against that kind of a situation. The major reason that we applied for the ruling in the fashion that we did was that the E.F. Hutton ruling, by implication, indicated that excess interest would not be treated as a reserve

increment. It would seem quite appropriate to say that if you suggest that it is not one thing, then we will file a revenue rule suggesting that it is something else. And that is precisely the course of action that we took. We did not have anything to do with the revenue ruling with respect to annuities or with respect to indeterminate premium policies, but apparently the IRS has seen fit to combine them all in one package.

DAVID R. CARPENTER: An observation: We had a replacement problem in the industry prior to universal life.

I did want to make a comment so that no one is misled. Look on Chart I, for Company D, under the column that says "current rate, T-bill." That description could be misinterpreted because in our particular plan, which is so similar to this one, we actually guarantee the T-bill. It is a guarantee, not a current rate.

MR. MITCHELL: I agree.

MR. CARPENTER: Can I interpret what you said with regard to the integrated contract and Section 101 that you are not overly concerned that any other insureds could be covered by riders as was mentioned earlier? And secondly, we did not discuss specifically the issue of whether the difference between the guaranteed and current mortality rates is a dividend.

MR. TURNER: I think the spread of mortality rates is precisely the same as the issue in indeterminate premium policies and that is the reason for bringing together all three products on the same tax issues.

MR. HARMAN: I think my analogy to the excess interest annuity is on all fours with the excess interest on universal life. I think the principle there is equally applicable to the difference between the guaranteed mortality and the lesser charge. There is at least one product design where a company has a right to change the loads. I think that too involves the same question. I take universal life as being an integrated contract. If you don't accept that then I think traditional life insurance would raise all the same issues of being viewed as a side fund with term insurance. I think they are both the same and I think it is important that both be viewed the same. Otherwise, you take certain risks as to how you can look at traditional life insurance. There were several documents available in the early days, one of which was written by ACLI staff actuaries, which essentially concluded that universal and orthodox were indistinguishable as to any matters relevant to policyholder tax, and that attempts to dissect it and have it taxed in two pieces were in essence throwing rocks at glass houses, and would ultimately bring down the whole tax treatment of orthodox products.

Your other question is a more difficult one which is why I have been waiting until last to try and answer it. The Hutton ruling did involve spouse coverage and children coverage. The ruling held that those were Section 101 death benefits. There was no real discussion on that point. The Service seemed to accept the fact that it was appropriate to charge against the reserve the mortality cost of the other insureds, the same as you are charging the reserve with the mortality cost of the primary insured. I think we can find some support for charging the reserve for the mortality cost. In a joint-life policy one would compute the reserve and take out the both lives mortality cost. We thought that could be defended

in terms of traditional types of policies. I might add that we thought that the death benefit of a specified amount plus cash value could be justified because there were traditional policies that companies had written for a number of years where the death benefit was the same. When we got into the other benefits, double indemnity, for example, we had some question as to what reference point we could make back in history from a standpoint of traditional life insurance, because usually double indemnity has a separate premium and a separate reserve. We had some concern that if submitted, it would raise questions and it could give it an appearance of a side fund that you would be dipping into. Therefore in the Hutton filing, we did not include it. We have been somewhat cautious about how that should be handled. We are somewhat cautious about adding all of these benefits, especially benefits in taking money from the reserve. I think it can be defended. We are a little bit weak to date in finding precedents under traditional life insurance.

MR. TURNER: Many companies have elected not to offer some of the benefits of that nature, even though they have offered other-lives coverage, because you can go back to family insurance and contingent life and joint life and demonstrate that you had more than one pure cost of insurance being deducted from a common cash value. But you can't find anything like that in waiver of premium or double indemnity. We have made a policy decision not to offer those benefits until there is a ruling out on them. And it is not very hard to negate the need for those in the marketplace, particularly waiver and ADB.