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FEDERAL INCOME TAX: UNITED STATES

Moderator: RICHARD S. ROBERTSON. Panelists: WILLIAM B. HARMAN, JR., RICHARD V. MINCK*

1. The current status of proposals to change the 1959 Life Insurance Company Federal Income Tax Act
2. The tax status of modified coinsurance
3. Other current tax developments

MR. RICHARD S. ROBERTSON: We have put together a blue-ribbon panel to talk to you about taxes. Richard Minck is the Executive Vice President of the American Council of Life Insurance, and in that capacity has been very deeply involved in the life insurance industry's effort to seek changes in the 1959 Life Insurance Company Tax Law. Dick will outline what the industry is doing, why, and how it is progressing.

Bill Harmon is a partner with the law firm of Sutherland, Asbill & Brennen, one of the leading law firms in the federal income tax area and in particular in life insurance company federal income taxes.

Our recorder is Jim Horein. Jim is Second Vice President of Lincoln National Life Insurance Company. One of his responsibilities involves putting together reinsurance arrangements which, among other things, impact the tax planning of life insurance companies.

Our plan for the presentation is to first talk about what is going on in the legislative area; then we are going to talk about the current status of the reinsurance arrangements that have been put together; and then as our third general area, we will spend some time talking about taxation of several of the new products being developed, including Universal Life and certain annuities. We will also talk about some recent tax rulings which involved wrap-around annuities.

MR. RICHARD V. MINCK: What I would like to do is lay out the problem as we saw it in the Council and give a quick review of what our proposals are for changes in the federal tax law.

We started looking over the federal tax law about three years ago. I think a conclusion of all of the ACLI committees is that the present law is outdated and badly in need of revision. We see it currently as seriously threatening the role of life insurance as a means of lifetime financial protection and as a major source of capital for the economy. The problem is that the '59 Act just does not work, responsibly anyway, in an environment that is carrying the kind of inflation rates as the one we are in. As the interest rates climbed, the tax burden on life companies grew much more

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rapidly than their income. Moreover, it has been significantly higher than for other industries. Now this tax burden has affected most of the lines of business we are in, but it has fallen most heavily on permanent life insurance. If we are to continue to be able to sell permanent life insurance at a fair and attractive price, we have to be in a situation where we can reflect current investment results at the fullest extent possible through lower prices. In order to do that, we have got to pass the reduction in prices through either in premiums or increased dividends. Of course, we have got to be able to deduct that reduction in price in arriving at taxable income. Unfortunately, we cannot do it under the law as it stands; and as a result, the price reductions are not anywhere near their potential. Consumers, therefore, are being discouraged from buying lifetime protection through permanent life insurance and a capital source that the economy needs is being severely threatened. Some companies have over the last several years been able to mitigate this adverse tax impact by changing either product design, their mix of sales, or using a tax election provided by the Internal Revenue Code available for some types of reinsurance arrangements. Such an indirect approach is inadequate to deal with the significant defects that exist in the 1959 Act, so that even if Congress were to say to us tomorrow, "Look, you guys, you have much too complicated taxation laws, but we will let you have MODCO as long as you like", I think the right answer would be, "We have really got to do something about the tax law".

Just to put a couple of numbers together to illustrate why we think the '59 Act has not worked responsibly: If you look from 1960 to 1978, the industry taxes went from $.5 billion dollars to about $3.2 billion (i.e., over a six times increase). For the same period, our gains from operations after taxes in the industry increased about four times. The amount of permanent business went up about two and a half times if you measure it by premiums or reserves. If you measure it by in-force, it went up three and a half times. The assets of our business outside of the pension area went up about two and a half times, that is in contrast with our six times. The after-tax income of all corporations went up four and a half times, again contrasted with our four. The gross national product grew four and a half times, personal income grew four and a half times, most measures of economic activity grew about four and a half times. I think the figures illustrate, at least on a prima facie basis, that the life insurance business has taken an ever increasing share of the general corporate tax burden that went from 2.4% of the total in 1960 to 4.2% in 1978. The taxes on our business grew faster than our gains from operations.

Permanent life insurance grew at a much slower rate than most any other measure of economic activity. We think that permanent life insurance is very significant for our economy. In 1980, the companies added $9 billion to their reserves for permanent life insurance. This is an in-flow of capital funds and it would have been about $18 billion that year if reserves had kept pace with GNP during that period. The companies in 1980 provided about 30% of all the funds that were raised by American business through corporate bonds or commercial and industrial mortgages. Having a much smaller than normal in-flow, made it harder for a lot of businesses to do things they ought to have been doing for the economy to recover.

The '59 Act is not working because when it was drafted, frankly, nobody anticipated interest rates of the sort we currently have, with new money rates at 15%, or 20%, or 25%. The problem is that the rate of tax grows as the difference between new money rates and the valuation interest rates increase. I think another number, the investment income earned on reserves for permanent life insurance that is taxable, has increased about two and a half times since 1960. One way of looking at it is to say the taxable share of investment income from insurance reserves is the sum of the surplus share (which was about 10% in 1960 and is about 10% now of the total income) plus whatever the Menge adjustment throws out. The Menge adjustment threw out about 11%, the remaining 90% of investment income in 1960. The Menge adjustment threw out about 45% of the income in 1980 because, again, at that point, the portfolio rate for life insurance company tax purposes had gone to where you had a 4-1/2% spread with your reserve rate. That meant that the combined taxable share of your investment income went from about 20% to about 50% in that period of 20 years.

Having said that we are in serious trouble, and something had better be done about it fairly promptly, a committee of chief executive officers of our member companies was appointed by the Board of Directors of the Council; and they developed a program. The program was designed to try to attack the problems in the individual life insurance area, corresponding problems that had crept up in the areas of pension and group insurance, and problems in the investment area where the so-called Atlas decision had made investments in municipal bonds, or in corporate stocks, not as attractive to insurance companies because of the tax consequences as they were to other investors. This led to a six-part program.

When the '59 Act was written, what it represented was a reasonable balance of the interest of the government and the various segments of the life insurance business, including mutual companies, stock companies, big, small, etc. The features of the law then enacted produced reasonable results for a period of time and the committee of the Council dealing with it felt that basic design could be maintained and a reasonable result still obtained by making a few changes. Therefore, the package that was developed did not make fundamental changes in the statute. You would still be left with a three-phase tax act, for example; but it would attempt to correct those parts of it that have gone seriously wrong. Moreover, it would attempt to maintain a balance between companies in different situations rather than shift that balance and create competitive difficulties among different types of companies.

To summarize the changes, the first set of changes deals with the over-taxation of investment income. It would include a mathematical improvement of the approximation formula, the so-called Menge Formula, first to revalue the statutory reserves to a current-earnings rate basis in order to calculate taxable investment income, which would still be used for the same two basic purposes; namely, defining what extent dividends and other deductions subject to limitation can be taken and in defining underwriting gains for the deferral of half of underwriting gains that the law permits. The second change we are proposing is the liberalization of the limitation on these special deductions for dividends to policyholders, non-par contracts, A&H, and group insurance. We would propose that of the amount of deduction that you are currently losing, you would be allowed to take an additional 40%. That is if you lost 50% of your deductions, you would get to take 40% of that lost amount and you would have an effective deduction of 70% of the potential deductions. No matter what else happened, you are entitled to an aggregate of at least 70% of those deductions. In the first place, some companies are in a tax situation that they are currently losing

100% of their deductions. The normal operating losses are sufficient to drive their gains from operations already below taxable investment income and none of the deductions subject to limitations are they allowed to take. In the jargon of the tax business, they are in a so-called Phase II negative tax situation. In addition, none of the members of the committee, nor the tax experts working with them, felt confident enough about the future to be sure there would be no combination of events that would result in losing more than 30% of those deductions in the future. They felt that having some sort of safety net would be a useful thing to have.

Another part of the proposal is an increase in the special deduction for non-par contracts; basically doubling it. The reason being that the level of assumption currently used in pricing non-par contracts seems to be a lot more hazardous than was in existance in 1958. We propose a change in Phase 1 so that the amount of special deductions for non-par, A&H, and group insurance would not be added to that base. A specific interest paid deduction in Phase 1 is proposed for amounts in the nature of interest credited during the deferral period to individual annuities. It would be made clear that excess interest credited to the annuity holder is not a dividend to the policyholder for tax purposes. Another point of clarification is that for purposes of preparing a consolidated federal income tax return for a group of life insurance companies, the basic point of consolidation would be the life insurance company taxable income of each member of the group, rather than to include them item by item, line by line, or section by section. This would ensure companies with losses from operations that they would not be taxed on investment income as a result of consolidating tax returns with other companies in the fleet. Finally, the last part of the change dealing with the question of how much investment income is being taxed, is the treatment of new products including products with varying premiums and varying benefits. Examples include Universal Life and adjustable premium life. We are working on a proposal and we will present it as part of the package as soon as the work is complete.

The second broad area is in the area of permitting life insurance companies to buy municipal bonds at reasonably attractive rates. What we would do is establish a capital investment account and the earnings on that account would be given the same tax treatment as that received by similar investments held in any other type of corporation. The assets assigned to the account could not exceed capital and surplus. This would assure that any special tax features would not overlap the deduction allowed investment income for policy and other liability requirements.

We have a set of plans in the employee benefit area. They are aimed at removing the residual taxes that life insurance companies pay because of writing qualified pension plan business and putting employer sponsored group life and health plans on the same tax basis if they are insured through a trust or an uninsured basis.

The high point in tax revenue was a little over $3 billion in 1979 and may have dropped to $2 or 2-1/2 billion in 1980; 1981 estimates might be somewhat lower than that. If our package were to be enacted next year and if something were done so that modified coinsurance no longer produced the same results in your taxable income, we believe the tax results would be something in excess of $3 billion. Now that would mean an increase in revenue for the federal government in 1982 as contrasted with 1981. From our point of view, what we would be getting out of it would be a tax act that was stable and would not grow at the sort of rate it has been growing, even if an inflationary economy were to continue.

There have been two activities that relate to where we are going with this package. We were lucky enough two years ago to be picked out by the General Accounting Office as the very first industry on which they would do a tax study. They had concluded that they had a unique set of advantages to offer congress (of course they are an arm of congress), that they had expert staff and people who had time to do a thorough and careful investigation of different parts of the tax act as it effected different industries. congress did not ask them to do such a study, but they felt a series of such studies would be of great benefit to Congress; and in particular, to the tax writing committees. After a couple of years of study, they produced a report that was exposed in the summer and actually published early this fall. It was a lengthy report and it came to three conclusions on which they recommend action and five or six areas that they recommended Congress look into.

The three areas that they recommended were: first, they felt they ought to review the way the Menge Formula works to produce taxable investment income and they offered two or three alternatives. At one extreme, from the point of view of revenues it produced, it was something fairly close to the proposal in the Council Tax Package. The other recommendations they made were to observe there was another approximation to the tax law that did not appear to be working with perfect accuracy at this time; namely, the reevaluation approach used for transforming preliminary term reserves into net level reserves with the approximation in 818C. Their first draft indicated that instead of an adjustment of $21 per thousand of reserve for permanent insurance and $5 per thousand of term insurance reserves that are eligible for such change, a more appropriate number might be $12 per thousand for permanent with no mention of term. Shortly after they had surfaced this example, it was pointed out to them that their calculations were wrong. They looked at it and agreed that they were, and their final report suggested $15 per thousand for permanent and $5 per thousand for term. The third area where they recommended immediate action was in setting aside half of the underwriting income, to take care of future adverse fluctuations. They felt that Congress had set up something that was perhaps too liberal for mature stock life insurance companies. They looked around and felt that there had been very low failure among mature stock life insurance companies and that, in fact, their income had held up remarkably well in the 20-year period and, therefore, it would be appropriate to retain that item only for young companies that were critically in need of it and to whom adverse future fluctuations were a real threat. Most young companies have gains from operations which are probably somewhere below taxable investment income; that is, they are in a Phase I negative situation so they would be allowed to defer all of this, but they would not have any. The companies that were in the Phase II positive situation, the more mature companies, would have it but would not be allowed to defer it.

The President and the administration have gotten through Congress one of the most remarkable bills that Congress has enacted in the period of time I have been watching them. This reduced taxes for individuals and corporations by about $750 billion over the next five years. A remarkable lobbying achievement and one that I think people would have been willing to bet against before Congress started. Unfortunately, in doing it, they were in a sense too effective. They included a lot of reductions in the closing days of getting the bill through that resulted in projected budget deficits with which they were uncomfortable. So late this summer, they instructed the Treasury they needed to have a bill that would raise approximately $3 billion of additional revenue in fiscal 1982 with somewhat larger amounts in the two succeeding fiscal years. This, in conjunction with about $13 billion in expenditure cuts that they would like to have Congress enact would have kept the budget deficit in the $40 billion level as they now estimate it. The size of the tax cuts they enacted is sufficiently uncertain that they cannot really tell what that deficit is going to be, but they thought they would fine-tune it to the extent that they would get at least an additional $3 billion in revenues. The Treasury was asked to pick up a couple of things that would not be too controversial and they reported on a list of items, one of which was the repeal of the election of Section 820 for modified coinsurance.

We then called on the Treasury to try and reassure them about two things; one, that it would be controversial; and second, that we had a serious set of problems we had been working on for some years and a specific set of proposals. We had asked them earlier and they had told us to come back after the main income tax laws were enacted when they would have a chance to go over it with us; so we said fine, and here we are, we would like to go over it. We also made the argument that it would be in no one's best interest if they were to take up every problem they had with the life company tax act one at a time.

The administration has been advised by members of Congress that there were likely to be some flaws in the proposals they had surfaced. One of the other problems was that one of the noncontroversial items was something involving the completion of contract rules for defense contractors. That has provoked severe protests by defense contractors in every part of the Country. For the period of a couple of weeks after this first surfaced, I think members of the Republican Party in Congress were attempting to persuade the administration that there ought to be some better way to do it. One thing involved was that the Democrats, particularly Mr. Rostenkowski and Mr. O'Neal, were terribly unhappy about what happened to them this summer and if another major tax bill were brought up, they were of the opinion it would be their turn and that a lot of things that they did not like losing this summer, they might get back this fall.

There was a meeting over the weekend. I do not have reliable reports from Washington yet, so all I know is what I read in the newspapers, which in effect, said that the administration had changed from a $13 billion cut in expenditures to about half of that and an increase in additional tax revenues from $3 billion to about $8 billion so that they would end up net the same position; and among the items listed for an increase outside of possibly some tax loopholes, were increases in tobacco and alchohol taxes which are always popular items to increase when you cannot get revenues anyplace else.

I would be very surprised if more tax legislation were actually to be enacted this year. Congress has had a very busy and a very difficult year and is likely to go home shortly after Thanksgiving. In order to get the money they need in the fiscal 1982, they are going to have to pass the bill pretty early next year. I think the spring will be quite active and I would not like to wager one way or another as to just what form the legislation will take.

MR. WILLIAM B. HARMON: I think that Dick's reading of Washington is essentially the same as mine. I think the big issue is whether or not MODCO gets included in any administrative package. The feeling I get is it will not be enacted this year and as they are trying to find more sources of revenue, MODCO appears to be the single item that produces several billion dollars of potential revenue. Some of the others, like changing the accounting methods for defense contractors can produce a billion or so. Some of the industrial development bonds could produce revenue, but then you are taking on fifty states and their elected representatives that like industrial development bonds. Dick's package will depend really on what happens to MODCO, as far as the timing of it.

MR. NORMAN PECOR: We have been measuring this projected federal income tax revenue from the base 1978-79. It is projected to be about $4 billion a year in normal circumstances. If the Treasury were measuring on the basis that we were going to pay $4 billion, all the MODCO arrangements would be likely to drive that down to $2 billion. Isn't it incongruous that they would try to raise that amount with the repeal or elimination of MODCO on the basis they would be getting back what they thought they were going to get anyway?

MR. MINCK: The business of estimating revenues is an odd sort of business. You normally start with your current receipts--not necessarily what you think you should have received or what might be payable under various assumptions. You are also working essentially on a cash basis, and what they were looking for was money to come in next year; so it is quite in their frame of reference to compare, on the one hand, this year's cash receipts and, on the other hand, what they estimate would be the cash receipts next year under the change in the law. In fact, it would be extremely rare if the people doing the estimating were to ever go back and see what was actually received compared with what they thought they were going to receive. And, of course, the matter has to be somewhat speculative if you deal with anything other than cash because if you start with 1978 and project, you would have to know not only what companies have done in the way of reinsurance, but also what has happened in the mixture of business, and a whole series of other things.

MR. ROBERTSON: I am going to speculate that the Treasury estimates did not take into consideration the reduction that will take place from reinsurance; and, also, they did not take into consideration the acceleration of taxes that is being caused by higher investment income.

MR. MINCK: The General Accounting Office did not share my view about the increasing burden of federal income taxation on life insurance companies. The first edition of the GAO Report reached the conclusion that taxes on life insurance companies were remarkably stable as a share of total corporate taxes. The reason they reached it is that they used, as the base, not the taxes actually paid by corporations to the federal government, but rather the taxes reported on the income tax returns before foreign tax credits. Now that meant that in the case of oil companies starting about 1973, they had a spiraling share of the corporate income tax--not the corporate income tax actually paid to the federal government, but the corporate income tax on tax returns. It is offset by what they were paying as foreign taxes. That meant that if you threw out the oil companies, our share would have grown dramatically as I indicated. Correspondingly, if you left in oil companies and excluded the impact of the foreign tax credit, our share increased exactly as I said. We talked to them after they presented their draft report and they agreed with us. They took the section out of their report. They did not go so far as to adopt a section saying that our share had grown.

MR. BRUCE NICKERSON: I would appreciate it if you could elaborate a little on the claim that you made in your most recent discussion with the Treasury about holding the package together.

MR. MINCK: Our view of the 1959 Company Tax Act is that it has got many different sections, but you cannot really fiddle with one and know what you are doing to individual companies without going through the calculations almost item by item, and that a number of things that are in it appear to be there for one purpose; but if you remove them, you will get repercussions in a lot of other places. We think that the Act has to be revised. We think we have established what is clearly wrong with it and if Congress were simply to repeal modified coinsurance, or the tax treatment afforded by Section 820, and do nothing else, but say, "Okay, we will start looking at it, and we will get to it with all deliberate speed", we would then be faced, assuming nothing else were done, with taxes that we think would probably kill the product. I think that we could not face up to that situation in any way except outright opposition to such a bill. We think, also, what they would be doing is strangling one symptom but leaving the disease still raging.

MR. HARMON: At least it is my view that there is very little administratively that the Revenue Service and Treasury could do to upset the existing modified coinsurance arrangements. From a judicial standpoint, what could the Revenue Service do? They could litigate it. I think the Courts would uphold most of the modified coinsurance agreements. I feel that if there is a problem with your modified coinsurance and Section 820, it is essentially one of tax policy. Then the only real solution is legislation and that can take various forms. Let me comment on why I say administratively I do not think there is very much, if anything, the Revenue Service can do. One, I think that most of the agreements we are familiar with comply with the existing law. Perhaps the law never contemplated the size of these arrangements. Perhaps the people never worked through the three-phase system completely to analyze how you can put together companies in differenct phases, using reinsurance arrangements, to minimize taxation. I am not sure the industry really got into it until the past four or five years.

Areas where the Revenue Service may have some questions should be mentioned. A question as to allocation of capital gains—does the law permit a ceding company to pick and choose? For example, to allocate only long-term capital gains under the reinsurance arrangement and not short-term gains? I think that the statute is somewhat ambiguous when it speaks to what you can allocate. Another area they have looked at is the allocation of investment expense. There could be minor changes here. Let us say that 10% of your investment income was properly allocable, does that mean that 10% of your investment expense has to be allocated, or could you use some other reasonable, approximate method of allocating investment expenses? Some agreements may allocate investment expenses on one-half of one percent of the assets that were involved in the reinsurance and that may not work out to the exact 10% number. I could see reasonable differences between the Revenue Service and companies in that account of allocation. To what extent would an investment-year method be appropriate? I think an investment-year method, personally, as long as it has been properly defined, is appropriate. I conclude these are very minor differences that probably would not affect the whole transaction.

Now the Revenue Service people have looked at certain items. They have looked at the experience refund and raised a question as to whether it is properly taken off of the top of the reinsurer's income, or is it more like a dividend to policyholders which would mean it would be subject to the limitation. I think the law is as close to being 100% clear in this area as in any area under the '59 Act. Namely, that experience refund came off the top as a return of premium.

There is an age-old question that arose in 1959 when people dealt with how to limit dividend deductions. One approach was to get the insurer to tell what piece of the dividend came from investment income, mortality savings, and expense savings. The answer in those days was it was impossible, and I suspect that if that were a true answer, then it is still impossible today.

I see no way they can attack the substance of these transactions. I think the form is good, the substance is good, there was a risk transfer, there was an economic benefit being bestowed upon the ceding company, the reinsurer was taking a risk. We have been asked questions as to how great a risk was involved. That leads you back into some of the people's thinking in the government; namely, that the only way you could prove to them that an insurer or a reinsurer incurred a risk was to show that that particular insurer or reinsurer actually had a loss. If you could show a loss, obviously, you had a risk; then you have to explain that there are some companies that are still in business after a hundred years, now how much risk could they take if they are still in business. I think it is a falacious task trying to measure the amount of risk and then seeing if the risk was substantial.

This leads me into the judicial attack. I suspect if they would decide to attack it judicially, and to date they have not made any such decision, risk sharing would be the basic line of attack. The government litigated several reinsurance arrangements involving credit life and credit accident and health. First was the so-called ALINCO Case in the Court of Claims in 1965. Briefly, ALINCO, Associates Life Insurance Company, a subsidiary of Associates Investment, with Old Republic writing the business, reinsured into ALINCO. The question presented was, "Was ALINCO a life insurance company and how should they be taxed?" The Court held it was a life insurance company. This reinsurer, ALINCO, had less than one full-time employee (this is all in the Court record). The employee worked less than twenty hours, basically depositing the check from Old Republic and then passing the dividend to its parent. The Court held that it was a life insurance company. A footnote in the case points out that there was reinsurance, because there were two risks. There was a catastrophic risk that Old Republic was protecting themselves against and also a war risk loss indicating those two were more than sufficient to constitute a valid reinsurance agreement.

The government stopped pursuing that line until the '70's; and the Supreme Court in 1978 had three ases that were combined involving credit life and A&H, the so-called Consumers Life Case. There again you had reinsurance coming from the larger company into the captive reinsurer. The Supreme

Court got into this issue, and, in fact, the government even used modified coinsurance as being an argument that the risk and the reserves had to stay together because in some of the credit A&H, the risk was one place, but the reserve may have been in another company. The government, if you look at the briefs, made the same argument, there were not sufficient risks being passed, etc. The Supreme Court upheld these agreements as valid reinsurance. Now from the facts in these cases, the loss ratios may have been in the 14-20% of the gross premiums. You have a whole lot more insurance in current life insurance MODCO transactions because in these you are reinsuring your ordinary life or annuity business. I submit that if working from the base that credit life and the credit A&H were sound, then I would think that life modified coinsurance transactions are in a more sound position. So judicially, I come up thinking that they would be upheld and that the government would have a very difficult time upsetting current reinsurance transactions. There is a clear statute, there is economic purpose, there is an actual shift of the risk, and I do not think that many judges would want to get into measuring how much risk is necessary to constitute either a reinsurance agreement or an insurance agreement. So, judicially, I came out thinking that these agreements, or those that I am aware of, will stand up.

MR. JAMES R. HOREIN: What we have observed in the industry in the last two or three years is that most reinsurance arrangements have been built around a business need or a business purpose; assessing a risk, looking at and selecting a form of reinsurance that, for the most part, stayed with traditional methods; and if the modified coinsurance with the election of Section 820 program was built in that basic sequence, it is a sound program and we should have every reason to expect it would be a long-term program. A second observation might be that even in the early stages of these programs, most people knew or expected that Section 820, or the Federal Income Tax Law as we know it today, would not be a permanent institution. Maybe we should catalog as an expected sequence of events, the meeting that took place between the ACLI and the Treasury of three weeks ago. I would offer that we have not necessarily seen any changes in approach or panic as a result of the perceived repeal of Section 820. To the extent you do lead yourself into doing something quickly without a carefully prepared busines purpose, you open up a wedge that Bill was trying to identify.

MR. ADIAN GILL: Let me ask Bill Harmon about MODCO without 820 with the dividend passed to the reinsurer. Would those be challenged?

MR. HARMON: The service is not ruling at all under MODCO with the election, or MODCO without the election, or on any reinsurance that involves an experience refund. Once they make up their mind under the MODCO with the 820 election, they should be consistent on MODCO without 820. If the experience refunds work the same way for straight coinsurance, experience refund under YRT, experience refund under 820 with or without the elction, it will all be off the top; and we think that is appropriate.

MR. WALTER SHUR: Bill, could you comment a little on business purpose. Is it possible, or is there any basis, for the Treasury on audit to come in and say we recognize it is a legitimate agreement; we recognize that there is some risk shifting involved, although be it not very much; but in our judgement, the sole purpose of the arrangement was to save taxes and, therefore, we disallow it—is there any precedent for that?

MR. HARMON: You can find some, even though the Supreme Court stated that the major purpose can be tax savings. Where the Supreme Court has knocked it down was where there was no economic substance involved. At least, as we analyze MODCO, there is economic substance, there is a risk, practically all of these are between unrelated parties so you do not have that issue, and while tax savings may be a major motivation, there are sufficient other motivations. Clearly the risk, even though it may be in the catastrophic area, that risk is present; and if the price has been paid for that, that should justify the agreements. You can get into others we have seen where it has served to level out a dividend to policyholder, has served to free up surplus because whatever reserves the companies were keeping for contingencies could now free up, etc. You can build up arguments in the pension area that competition, both your own group department as well as competition ouside the life business, was a motivating reason. I think that in most of them, if not all, they are sufficient business reasons to justify them as being valid agreements from a tax standpoint. I recognize there could be difference of opinion on it.

MR. LOU GARFIN: One of the legislative alternatives is simply to repeal Section 820. It is my recollection that that provision was incorporated into the law because of the need to avoid double taxations on modified coinsurance. Is there any alternative to repeal that anyone is thinking or talking about?

MR. MINCK: It will the be the Treasury that will make the proposal, and they might think of various alternatives. My guess is if they were going to be forced to do something to the statute in a very short period of time, repeal is what they would come up with. One thing that we looked at in attempting to develop arguments to oppose simply the outright repeal was what impact it would have on existing modified coinsurance treaties of the sort that had been in existance prior to 1978; and I do not think the reinsurers we talked to were able to come up with anything much in the way of double taxation tax impact if the thing were to be repealed.

MR. ROBERTSON: The traditional 820 arrangements were used to prevent double taxation when a company that is taxed on investment income (a Phase I company) is reinsured by a company that is taxed on the excess of gain from operations over investment income (the so-called Phase II positive companies). There are a few such companies in the reinsurance business these days. Most companies are Phase I on both sides of the transaction. We did spend a great deal of time considering whether there might be alternatives that would retain Section 820 in the Phase I reinsured to Phase II positive situation without maintaining it in other situations. Each alternative that we were able to identify created more problems than it solved.

MR. AL GREENBERG: When Section 820 was developed in 1959, the rates of interest earned by the company were fairly close to the valuation rates of interest of insurance reserves. I wonder if 820 might not be maintained today by developing a differential, if you will, between the transfer rate and the reserve rate. Currently, we have a reserve at 3% and your transferring 10-11% vested income. The results are very different than could have possibly been anticipated in 1959.

MR. ROBERTSON: If you took that approach, you would cause some damage to so-called traditional arrangements.

MR. HARMON: I would like to mention five basic product topics:

1. Annuity

2. Variable Annuity

3. Universal Life

4. Indeterminate Premium

5. Variable Life

You have these products which are creating problems taxwise, some from the policyholder's standpoint, some from the company's standpoint, and some from Dick Minck's ACLI package standpoint.

There was a recent revenue ruling issued last month, 80-225, that took the position that a wrap-around variable annuity, wrapped around a mutual fund where that mutual fund was also available to the man on the street, was not an annuity. That has severe consequences, as you can see, for the policyholder who thought that he had bought an annuity and was getting deferment of tax income. That ruling was no more than the third one in a series through several different administrations that have taken a very hard line on annuities.

Now, what about your fixed annuity? You have no real problem from the standpoint of the policyholder. It is an annuity deferment. But how about any problems from the company's standpoint? There is one question that is major from the standpoint of the company. What is the proper tax treatment of the difference between the so-called guaranteed amount and the excess interest? Is it a dividend to policyholder, which meant it is subject to limitation? Is it an increase in the company's reserves which would be 100% deductible under your Phase II or your total income approach? That question is pending. Dick mentioned earlier that the ACLI had taken the position that it would be a reserve increase under the total income 809 approach.

Let me define the indeterminate premium product. That is a contract where the policy says the maximum we will charge is $20 per thousand (for example). We have the right each year, in advance, to tell you what the premium is; it cannot, however, exceed the $20. Let us say we charge $16. The question is, "Is that differential of $4 premium income to the company, with the $4 being a dividend to policyholder?" That question has been pending for a year and a half at the Revenue Service. Is it a dividend, or is it not? That is a question the ACLI package is still wrestling with.

You have another question. You see all of these really revolving around, "What is a dividend to policyholder?" The next area in the life insurance area involves the so-called Universal Life design which you could say has the same basic problem as the excess interest in fixed annuity. The basic Universal Life design, speaking of the company side, may have a 12%, one-year guarantee but a lifetime reserve valuation rate of 4-1/2%. How is that excess to be treated? Is it to be treated as a dividend to policyholder or as a reserve increase? There are several rulings pending on that question. This is a later starter than the annuity issues, but there are several rulings that are taking the position that it is like the annuity, a reserve increase. There is one other ruling request which makes the argument that this is a dividend to policyholder. That issue is very active at the Service. The Revenue Service is concerned with these issues and having recongized that the fundamental question, forgetting whether it came in from an indeterminate premium or Universal Life and excess annuity, the real question one has to focus on is, "What is a dividend to a policyholder?" From what we have been told, these issues have been packaged because they first want to decide what is a dividend. In a variable life design, at least the three existing ones, where there is a contractual formula guarantee for the life of the contract that if earnings, this is not just pure interest, but earnings generally, then if there are earnings that get equated into increased benefits is a typical case, what is that increase? Is that a dividend to policyholder, too?

If you use dividend definition very broadly, you can reasonably say all five situations may be dividends. If you take a more legal approach that a dividend is declared after the fact and based on experience, then I can argue that these products I have described should have a reserve increase because it is guaranteed in advance. That is the argument people make and that is the one that has considerable economic significance.

MR. MINCK: A fundamental question: Suppose you have a company and they sell two contracts, one of which participates and one is non-participating. They both have a 4% interest guarantee; and in one case, they credit 8% interest each year by means of issuing a dividend; in the other case, at the beginning of the year, they guarantee they are going to credit 8% and credit it. Should the tax results be different? That is, should, in both instances, full deduction be allowed, or would you allow, say, deduction of 60% of the excess in one case and 100% in the other? If you come down with the conclusion that you ought to allow 100% in one case and 60% in the other, then how do you stop everyone from selling their contract all in the one case you allow 100%? I think the answer to that is, you cannot. This leads you to another tax policy question. If you set up a situation where, for the sake of argument, you permit excess interest to policyholders on the Universal Life contract to be completely deductible to the compoany, you have outstanding ruling that says the proceeds are life insurance so none of the interest accumulated during the lifetime of the policyholder will be subject to income tax, nor will he have any current income tax on the interest as you credit it year by year. That means you will have very, very large amounts of investments by life insurance companies in the forms of loans to corporation, the corporation deducts the interest; the life insurance company who receives it passes it on to the policyholder and nobody ever pays any tax on it. As a matter of tax policy, there are people in the Treasury and the Congress who would find that objectionable. Looking at it from the point of view of the tax receipts from the life insurance business, part of our package will remove residual taxes on qualified employee benefit plans. That essentially leaves individual life insurance to pay all of the taxes that have been collected from the life insurance companies and this product, if the companies were to be able to deduct excess interest, result in no taxes being paid except for whatever taxes you pay on ultimate corporate profit on the operation. That would mean a level of taxes that is far below anything we have accomplished so far; and, again, a matter of tax policy that I believe Congress would find questionable.

MR. LARRY MILLER: Are there any changes being proposed in the taxes for insurance companies other than life insurance companies?

MR. ROBERTSON: I cannot think of any. The Treasury so far is only looking at lost revenues because of various new products in the life area and reinsurance arrangements. I do not believe that they have gone into casualty products.

MR. PAUL LEFEAVER: Didn't the E. F. Hutton ruling create a third possibility for excess interest; that being a change in reserve basis subject to ten years?

MR. HARMON: That was a theory of an IRS actuary whose basic theory is everything is a dividend and then when he thought perhaps he was losing that he fell back to it was a reserve change which got so complicated because each year you had either a strengthening or weakening. That has been pretty well dropped by everybody.

MR. LEFEAVER: A second question revolves around the Section 101 question of Universal Life and similar products that I did not hear you refer to—E. F. Hutton rulings are very specific on one approach and I was wondering if you had any comments on that?

MR. HARMON: Our basic practical problem has been to try to prevent no change in the existing one without worrying about other products. I think you are back to the same kind of question that has been raised under the Section 101 Hutton Ruling, which is really how much net amount at risk do you need to have an insurance contract. That is present in all of these 820's once you raise it not in terms of net amount at risk, but how much risk is present? That is the same question that was raised after the Hutton Ruling came out as to how much net amount at risk do you need to constitute life insurance for Section 101 purposes? It is a nearly impossible one in my judgement. I think the Society has had people looking at it over the years. Do you test it at the point of the original sale? Do you test it at the last year where there may be diminimus net amount at risk? Do you have some specific dollar amount that is necessary? How much do you need? People may push it, for example, if you put $1 at risk on a $10,000 savings account that on death pays $10,000 plus $1—have I turned that into life insurance? I think most people would say no. Now, when you begin adding additional amounts, at what point do you have life insurance? I am not sure anyone really knows. I think that is the real question on the Hutton 101. You have had only one instance that a Court has looked at it. Your retirement income policy that they held was life insurance even though at 65 it crossed over and it kept going because a person kept working. There you had nothing at risk after it crossed over. There is a published ruling that says, in effect, once life insurance, always life insurance, which would mean that the test is at the point of sale. However, the U.S. Tax Court took the position that when it crossed over, it ceased to be life insurance. That is a kind of temrinal point without going into the in-betweens as to how much do you need at some point in the product.

MR. JOHN SMITH: I have often wondered about trying to keep balance between the stock and mutual companies. I can see short-range how the limiting of deduction of dividends makes sense. In the longer-range, why not allow all the dividends to reduce the cost of insurance?

MR. MINCK: I think from the point of view of the companies that pay dividends and the policyholders it would be a splendid idea. There are some questions, however, the impact on taxes would be at least what we have seen so far with modified coinsurance Section 820 so that there are serious revenue questions that Congress would have to address. Then from the point of view of companies who are having considerable difficulties competing now with the current tax treatment of participating policies are that there might be questions as to the impact on the market. I think it is fair to say that in the '50's, Congress was concerned that the tax package not result in a situation where there was severe disadvantages for the marketing of either participating or non-participating insurance. The idea that in some cases people wanted or were best served by guarantees of specific amounts and in other cases the idea of buying insurance at a merging cost was attractive, but that the tax law should not result in one or the other being driven out of the market.