RECORD OF SOCIETY OF ACTUARIES
1982 VOL. 8 NO. 3

TAX PARITY FOR INDIVIDUAL LIFE INSURANCE PRODUCTS

Moderator: PETER F. CHAPMAN. Panelists: JAMES B. DOX, DOUGLAS N. HERTZ, NEAL N. STANLEY*

1. What is tax parity
   a. Between mutual companies and stock companies?
      1) Should tax allowances be made for stockholders' equity?
      2) How does the present non-participating allowance compare with the tax treatment of dividends on participating products?

   b. Between participating policies and adjustable price non-participating policies?
      1) What is the difference between price adjustment and a dividend?
      2) Should the tax code recognize this difference?

2. What are the consequences of failure to achieve tax parity
   a. For new sales?
   b. For equity among companies?
   c. For replacements?
   d. For equity among different generations of insureds?

3. How can tax parity be achieved between
   a. Universal life and traditional products?
   b. Life insurance and annuity products?
   c. Life insurance companies and other institutions that compete for savings (including tax qualified savings)?

MR. PETER F. CHAPMAN: This morning we are going to be shooting at an elusive target - tax parity. My own feeling is that tax parity can only be defined in the negative as the avoidance of material violations of parity. It took me the better part of a quarter century to learn that policyowner equity consists of not treating any clearly defined group with more than a minimum of inequity. Similarly, the matching of assets and liabilities, and we have all become born again matchers, requires only the elimination of egregious mismatches.

Unlike these two examples, however, tax parity has emotional overtones that sometime preclude the professional consideration that they deserve. Percy Forman was a Texas lawyer who in the 1960's defended a number of notorious people, all of whom had two things in common. They were all accused of heinous crimes, and, they were all extremely affluent. A national publication tried to inveigle Mr. Forman into a philosophical discussion of justice. Not being one for abstractions, Mr. Forman merely said "Damn it, my clients don't want justice; my clients want freedom."

* Mr. Dox, not a member of the Society, is a CPA and a partner of Ernst and Whinney.

There is a strong counterpart in the subject that our panel will be analyzing. While claiming tax parity, many advocates of a particular position really want something more important - survival. In both cases, justice and tax parity, there is a reality that transcends the concept. In both cases, there are legalisms that attempt to separate words from their original intent in the interest of winning an argument rather than establishing a standard of fair treatment for all parties.

The panel will endeavor, to the fullest extent possible, to avoid both emotionalism and legalism, and to address the issues as professionals. When is a dividend not a dividend? Is there a real distinction between retrospective and prospective evaluation of experience? What is a proprietary interest and how do mutual company policyowners differ from stockholders? Finally, how can the life insurance industry pay its fair share of the nation's tax burden and compete on equal terms for the savings dollar against other institutions with significantly different tax structures?

If these issues are too important to actuaries to be discussed with partisanship, they are equally too important to discuss in a vacuum. A career spent with stock companies will obviously develop a different perspective from a similar career with mutual companies. Our lead off speaker is Neal Stanley. Neal was, until very recently, Senior Vice President and Chief Actuary of Republic National Life. Although he is now engaged in employee benefit plan consulting, he has neither renounced nor forgotten his past. Neal will discuss tax parity and the implications of failure to achieve it, from the point of view of the stock company actuary.

MR. NEAL N. STANLEY: In the Convention Statement of a stock life insurance company, line 25, "Dividends to Policyholders," is blank, and line 29, "Net Gain from Operations after Dividends to Policyholders," is the same as line 27. Dividends to stockholders are shown in the Surplus Account on line 47. Before any distribution can be made to stockholders, the full corporate tax must be paid on the amount shown on line 27. When a dividend is paid to the stockholder, the stockholder is taxed again on the dividend.

There are of course certain special deductions available to reduce the immediate tax on the net gain from operations. There is also the 818(c) election which can further reduce the immediate tax on the net gain from operations; however the special deductions are placed in "Policyholders Surplus" and that surplus is "walled-off" from the stockholders by the Phase III tax. Even the surplus that existed on December 31, 1958 is "walled-off" from distribution to the stockholders because that surplus cannot be distributed to stockholders until a Phase III tax has been paid on the Policyholder Surplus Account which has been built up from special deductions taken after December 31, 1958. The 818(c) election is of course merely a timing difference which does not change the ultimate profit to be derived from a block of business.

So, as far as stockholders are concerned, the full corporate tax must be paid on the net gain from operations before it can be distributed to them. This Phase III tax may not be fully understood and is often

ignored; however, that tax stands as a formidable barrier to the distribution of earnings to the stockholders. Even the sale or merger of the company may trigger the tax. As previously stated, the distribution in the form of dividends is taxed again to the stockholder on his individual tax return.

The owners of a stock life insurance company are therefore ultimately taxed on the same basis as are the owners of any other corporation. The full corporate tax rate is ultimately paid by the company on the net gain from operations, and the stockholder dividend is taxed again on the individual's return. It is hard to make an argument that such treatment is inappropriate or different from the taxation of the profits of any other business.

Now consider the Convention Statement of a mutual life insurance company. Line 27 is also labeled "Net Gain from Operations before Dividends to Policyholders". Line 29 is of course line 27 minus line 28. There are no dividends to stockholders shown on line 47. In the tax return of a mutual company there are no special deductions. To the extent that dividends are permitted as a deduction from the net gain from operations, such dividends are never taxed in the corporate return of a mutual company. Furthermore, no part of the dividend is taxed in the individual tax return of the policyholder.

To summarize, a stock company ultimately pays the full corporate tax rate on its net gain from operations and the gain is taxed again upon distribution to the stockholders. In a mutual company, the full corporate tax rate is never paid on the net gain from operations because such gain is reduced by some portion of the dividends credited to policyholders. Furthermore such policyholders dividends are received with no current tax to the policyholder. In many cases, no income tax is ever paid on such dividends.

The question naturally arises as to why the owners of a stock company are treated so differently from the owners of a mutual company. To the extent that their ownership interest is similar, should the two not be taxed similarly?

There are obvious differences between the interest of a stockholder in a stock company and the interest of a policyholder in a mutual company. A stockholder owns his interest in the company until he sells it to another party. He does not have to pay additional amounts to maintain his interest. He maintains his interest even at death. He makes one fixed investment in his stock. Any dividend that he receives is an easily measured return on that investment. In a mutual company, a policyholder's investment is made in the form of paying a higher premium than would be required on a non-participating contract. He loses his ownership interest in the mutual company on death or surrender of his policy.

It is difficult to segregate the investment of a mutual policyholder from the premium that he pays for his insurance. It is also difficult to segregate the dividend received by such a policyholder into the component representing a return <u>of</u> his investment from that representing

a return on his investment. Yet such a segregation is essential to tax fairly the mutual company and its policyholders. Only the portion of the dividend that represents a return of his investment is a proper deduction from the net gain from operations of a mutual company. Furthermore, a policyholder should be taxed on the portion of the dividend that represents a return on his investments in the same manner as a stockholder is taxed.

It is precisely this distinction between the return of investment and the return on investment that the phase I tax is supposed to measure. The surplus of a mutual company clearly represents the ownership equity of all of the policyholders. There is no reason that the return on that surplus should be taxed any differently, either to the company or the owners, from the corresponding return on the surplus of a stock life insurance company.

The difficulty is that the surplus of a mutual company, and a stock company for that matter, depends on the reserve basis chosen by the company, Since the reserve basis cannot ultimately change the return on the block of business, the choice of a different reserve basis should not make the tax on one company differ from the tax on another company. Therefore, the surplus for tax purpose is based on adjusted reserves, not the reserves actually held by the company. The adjusted reserves are intended to be what the reserves would be if they were recomputed on the basis of the investment return earned by the company. These adjusted reserves are calculated using an approximation formula that now appears to be unsuitable. Who could fairly object to a revision of a formula which makes it works better. Unfortunately, there is another approximation formula that is also out of date, the approximation used in the 818(c) election. Again, no one can fairly object to a revision of the formula. After all, the purpose of an approximation is to reproduce the same result that an exact calculation would produce. When an approximation method does not produce the intended result, that method should be changed to one that does. Tax consequences should not be considered.

The fact that the present approximation method does a faulty job of allocating dividends to policyholders of a mutual company into the two components, return on investment and return of investment, does not make the concept invalid. The method needs changing, not the basic concept. A revised formula could properly determine the corporate tax base for a mutual company, but the treatment of dividends to policyholders would remain a problem. The same dividend is treated as a return of investment to the policyholder with none of it taxed currently.

Suppose I went to my grocery store and gave the manager $1000 to invest on the condition that at the end of the month when I buy groceries he will give me a credit on my grocery bill for the interest. For tax purposes the grocer has the same total revenue as before. I have no taxable investment income, but I have paid less for my groceries. The grocer is happy, I am happy. Only the Internal Revenue Service is unhappy because it is clear that some taxable investment income is not being taxed. Yet such an arrangement is very comparable to the current

treatment of dividends to policyholders paid on the surplus earnings of a mutual insurance company.

It would seem that nearly all of the questions concerning parity between products can be resolved if return on investment can be separated from the return of investment. For example, a policyholder does not make any investment in an indeterminate premium policy and owns no portion of the surplus derived from the profits on such a policy; therefore, the policyholder does not receive any return on investment. The difference between the guaranteed premium and the premium payable is a discount, not a dividend. Likewise the mere deposit of money in a stock or mutual company does not constitute an investment in that company; therefore, the payment of interest on that deposit, either guaranteed or excess, should be fully deductible by either a stock or a mutual company provided such interest is the only portion of the investment income of the company which will ever be credited to the deposit. However, to the extent that excess interest represents a return on previous investment income withheld in surplus, such a return is a dividend.

Tax parity between stock and mutual life insurance companies will be achieved when the mutual policyholder and the stock policyholder are treated the same with respect to the portion of the mutual policyholder's premium that represents an investment in the company.

MR. CHAPMAN: Saving the summation for the end, I would like to present our second speaker, Doug Hertz of the Massachusetts Mutual. Doug is their actuarial income tax specialist. While his views are obviously conditioned by his employment, his presentation should stimulate thoughtful reflection by partisans on both sides of the principal issues.

MR. DOUGLAS N. HERTZ: First I would like to emphasize that I am not here as a representative of the mutual half of our industry or even of Mass Mutual. Generally, I will just follow the order shown in the program guide under Numbers 1 and 2.

I believe any definition that we give parity will likely produce only a rough sort of check. It is easier to identify situations where parity is absent than to say in the abstract what it should be. One possible measure of parity that I will use is a marketplace check for a lack of parity. That is, if taxes alone allows substantial price differences to exist, parity does not exist. Parity as seen here is impossible under the 1959 Tax Act. Some examples may highlight this statement.

First, pension business enjoys a tax advantage over non-pension business in a phase I company, a company taxed on taxable investment income. This advantage is absent in a phase II negative company, which is taxed on its gains from operations. Clearly, one situation or the other lacks parity.

Second, participating products are at a severe disadvantage in a phase II negative compared say to a phase II positive company.

Finally, products with high taxable investment income, for instance deferred non-qualified annuities, are disadvantaged in a phase I company. Probably every company these days, to some extent, markets its tax situation. That is, it sells products whose marginal tax to the company is small or, more likely, negative. There is nothing terribly wrong with doing this, but it does indicate a lack of parity.

Even in the rough marketplace check that I propose, parity vis-a-vis banks or mutual funds is a hard concept to define because policyholders are taxed differently from depositors or investors. This is an extremely important problem for our industry. We tend to feel that we are over taxed. Yet, most outside commentators feel that favorable tax treatment of our policyholders more than makes up for any tax that we pay.

With regard to stock/mutual parity, tax allowances for policyholder equity are hard for mutual company people to accept. We have long heard the argument that our policyholders are legally our owners and our dividends are thus partly equity returned to those owners. In a purely legal sense, the policyholder may have some ownership rights. In some ways, however, the owner analogy fails, particularly when we view the economic,not the purely legal, consequences of ownership.

For instance, the policyholder cannot reap a capital gain on his ownings by selling out in the marketplace. More importantly, supporters of the owner theory have never given a method or a theoretical basis for identifying the equity portion of a policyholder dividend. This casts some doubt, on the economic substance of the entire legal ownership argument. Most mutual company people that I know simply do not buy the ownership argument. In their view, their duty to their policyholders is to provide low cost insurance, not to produce capital gains or equity returns. Our policyholders purchase insurance to minimize risk, not to advance venture capital. The transaction should be seen as an installment purchase, not as an equity investment.

Finally, to the extent that companies pass insuring risks on to their customers through the lack of permanent guarantees, they deprive the role of capital in the company of its meaning. In this sense,the mutuals, and to an increasing extent, the stocks have true equity risks or rewards. I should note that agreement in theory on these matters does not necessarily mean a hopeless impasse in practice. A negotiated compromise may well have been made. I refer here to the ACLI Stop Gap Tax Bill. Both sides in that negotiation feel that they have given up a lot. I think many mutual company people feel that the differential in dividend tax credits is simply a federally mandated transfer payment, from our policyholders to stock company shareholders. Nevertheless, they will agree in the interest of industry unity, if the cost is not too high. The arbitrary nature of this differential to any theoretical concept of equity ownership, leads many to fear, however, that it will grow in response to political, as opposed to economic, realities. This is a matter of major concern to many people at mutual companies that they may be giving up too much.

Parity between par and adjustable non-par contracts is an extremely controversial area, one in which I have strong, controversial opinions. Bluntly put, price adjustments on nominally non-par contracts are dividends in all but name. Their tax treatment should be guided by the economic substance and not by the cosmetic form of the adjustment. To elaborate, distinctions based on the characterization of dividends as payments of purely retrospective earnings, in contrast to price adjustments based on limited future guarantees, are a sham; or, to put it more politely, an attempt to play on the obsolescence of the 1959 Tax Act. To elaborate on this point, I would note that dividends can and often do have a limited degree of futurity. The Academy of Actuaries' Report on dividends shows clearly that prospective elements may properly enter into the calculation of traditional dividends.

Further, I would like to note that a discretion of management exercised a year or so in advance is still a discretion of management. State laws and definitions are not and should not control for tax purposes. Calling such a contract non-participating is not consistent economic realities on which taxes should be based.

The economic reality is that price adjustments are, in the language of Section 811 of the Code, "similar distribution to policyholders" and should be taxed as dividends.

It is my personal view that products whose investment return to the policyholder are tied to an outside index are not life insurance. Ultimately, they will be taxed as investment deposit funds and term insurance. On a common sense level a product with guarantees of market interest returns looks an awful lot like a variable rate debt instrument and will likely wind up being taxed as such. Surely, the savings and loans will view such a result as leaning toward parity. In these indexed products, the lack of any meaningful prospective legal valuation reserve is more than a minor technical defect. It may triple totally the reserves from the tax viewpoint. I suggest a review of Ruling 77-451. The E.F. Hutton Life Ruling on policyholder taxation was based on the premises that the contract had life insurance reserves. The fact that indexed products may well not have technical life insurance reserves may mean the Hutton Ruling will not apply to products of that nature.

Further, as actuaries we should be concerned that investment speculation under these indexed products is going to lead to trouble. I wonder how state regulators can approve a product which cannot comply with the standard valuation laws.

The consequences of a failure to achieve tax parity. For Sales: We all face an intensely priced competitive world. Business will go where the lower cost or higher returns are found. Our own agents will sell elsewhere while chanting the CLU pledge if lack of parity favors other companies or other products. Parity here must be measured among intermediaries in general. It does no good if insurance companies achieve tax parity among themselves and the banks get all the business.

Parity among product categories is also desirable. Favoring one product form, say annuities, distorts our markets.

For The Companies Involved: Today's lack of parity precludes certain companies from entering certain markets and favors others in those markets. To give just one spectacular example -- mutuals will be frozen out of the Universal Life market entirely if excess interest is not deemed to be a policyholder dividend. Part of the problem is that we are not all new little companies with a choice of what we are going to be. Our in-force determines our tax situation though use of subsidiaries can ease the problem. But licensing, costs capitalization and so on limit the usefulness of subsidiaries. So, tax parity can be a matter of marketing survival. Replacements are clearly a major concern for mutual and stock companies alike. Some people see Universal Life as a major replacement vehicle. This rather extreme view is not entirely without cause. We have seen replacement ads and campaigns to recruit our agents by the Universal Life Companies. A worrisome scenario arises when we think about replacements. Suppose that Universal Life, with its combination of tax deferred annuities and term, is formally granted a tax favored status over par products. Massive replacements with their associated costs and capital losses, are a foreseeable consequence.

Mutual company business would go elsewhere, forcing mutuals to replace themselves by transferring their business to their stock subsidiaries with large attending capital losses. Government revenues from our industry would then drop sharply. All of the business will be tax favored. Since the government will not sit still indefinitely collecting nothing, the law will be changed to restore the lost revenues. The net result of all of this is simply a costly restructuring. This many established companies fear.

The last item I want to talk about is equity among different generations of insureds. Equity is going to be very difficult to define, much less achieve, if new business is sold for tax purposes through specially created subsidiaries. I cannot see equity arising in such a scenario.

More generally, any change in the law disturbs the existing balance of equity among different classes of policyholders. For example, under the proposed ACLI Stop Gap, older blocks of business priced at the time they were issued with more conservative assumptions will generate more tax than newer blocks, simply because they have more by way of dividends. Should this be recognized in policy pricing? In dividend pay-out? How should it be recognized? Products such as yearly renewable term generate little or no taxable investment income, but their substantial dividends will be a problem for the mutuals under the Stop Gap formula. I have no doubt that different actuaries at different companies will solve these problems in their different ways, hopefully, this year. It does not appear to me that there will be any one best approach.

MR. CHAPMAN: Thank you, Doug. I do not think that anyone has any doubt where Neal and Doug stand on this subject. Our third panelist, Jim Dox, has nothing but friendship for both stocks and mutuals. Jim is a CPA, a partner of Ernst & Whinney. He is a tax specialist in their Dallas office, from which he deals with both types of company. Those of you

who have been fortunate enough to read Ernst & Whinney's comprehensive and, in my opinion, definitive treatment of the Universal Life tax issues may be aware that Jim was the principal author of that statement. Jim will address tax parity among products and tax parity with competing institutions.

MR. JAMES B. DOX: Initially, let me say how delighted I am to be here today,to discuss and review with you, an area which quite frankly begs for answers. To suggest that solutions somehow exist which will produce even a consensus among a qualified but diverse a group as this may be a bit too optimistic. However, the size of the task at hand should not keep us from a lively discussion.

What is becoming rather commonplace and a bit frightening is that folks who deal in life insurance taxes no longer can anticipate answers to major tax questions. Key issues seem to go unresolved for extended periods. Attempts to deal with these key issues in terms of tax parity, or lack of it has crept into many philosophical tax discussions. As we can witness today; it has become the topic at seminars and other gatherings of insurance people. The fact that one chooses to talk about it might suggest that "tax parity" can be achieved among the variety of life insurance products presently being marketed. After listening to Neal's and Doug's presentations, from the stock company versus mutual company perspectives, one quickly surmises that achieving this objective will be difficult. My position with this panel is not like that of an umpire, able quickly to give a "safe" or "out" sign to the parity problem. Nothing could be further from reality!

Before preparing my discussion, I felt that it would be necessary to define and isolate this item called "parity" so that we all know what we are looking for. As it appears in the Webster's New Collegiate Dictionary, the term "parity" is defined as

> "the quality or state of being equal or equivalent; equality of purchasing power established by law between different kinds of money at a given ratio."

As we shall see in later examples, one method of analyzing tax "parity" is to measure certain predetermined goals among insurance products. Generally, three objectives surface rather quickly in this exercise: (i) pre-tax product profitability, (ii) overall tax cost, and (iii) policyholder effect.

The initial goal, pre-tax product profitability, is something that both stock and mutual interests seem to agree upon. Product pricing, the key to this element, is an extremely complicated process. Errors in this phase, whether favorable or unfavorable, can remain undetected for many, many years. I sincerely doubt that any insurance company approaches its product pricing with a tax "parity" concept in mind. One must assume that having the ability to establish a niche in the marketplace informs the company that its "parity" objectives have been achieved.

In focusing on the second objective, we must all remember that tax cost is an important and particularly critical part of product pricing. In

the past, the tax cost element, while important, was more predictable. Because of the number of recent tax problems associated with the life insurance industry, tax cost has achieved high visibility in attempts to achieve "parity".

We are presently faced with a 1959 Tax Act that quite frankly did not envision double digit inflation and 18 to 20% prime interest rates. While one can continue to complain and suggest the malfeasance of those who drafted this Act, until it is changed it must be dealt with in an acceptable manner. Self-correcting methods and assumptions can be used in attempts to price products properly. All of the 1959 Act deficiencies, however, seem to collide when trying to calculate taxes under its provisions. Various dissimilar methods of providing insurance and in some cases investment opportunities, must all mesh into a Form 1120L and produce a reasonable and rational result. Items which are treated as policyholder dividends by one company may become transformed into policy benefits by another company. Investment earnings may be added to policy benefits and be completely deductible by one insurer while other companies face an uncompromising Internal Revenue Service attempting to remove any tax benefit from similar add-ons. In short, achieving tax "parity" in terms of the tax cost of a given insurance product may be less than possible.

A third concern must take into account "parity" as it applies to the individual policy or contract holders. In the past this has caused the least amount of concern. By and large, most of the products, whether participating or nonparticipating, whole life or annuity, increasing or decreasing term have all been able to approach the policyholder with the same net result: the nonrecognition of the inside interest buildup. While it should be remembered that annuity products and whole life products do share a somewhat dissimilar treatment upon distribution, I have not heard of any unfavorable discord on this subject.

There now surfaces, however, a notion that many of the new products entering the market are being threatened with the disassociation of this achieved "parity" which all products shared in the past. This new movement, which would remove the tax-free policyholder build-up from certain forms of products in today's market, promises to be one of the most volatile in the future. If your affiliation is with a company that is not involved in these new areas, you tend to view many of the new products as being principally investment contracts, rather than insurance products. You suggest that they should be taxed as such. If your allegiance lies with the other side, you are very quick to make the point that while the product does differ, it is still a derivative of what has been accepted for many, many years. As such, you suggest that should the new product be given different policyholder tax treatment (i.e. withdrawal of "parity"), then all product taxability should follow suit.

Summing up this introductory part of our discussion, we quickly see that the problem of "parity" is very difficult to isolate, much less to solve. I suspect that if some magic wand could be waved to enable each and every insurance company to achieve total success with all of its policies, lack of "parity" would still exist simply because some

companies were making more or were not satisfied with their share of the marketplace. Having attempted to suggest that parity may not be achievable, we would like to illustrate some of the inherent problems. Specific products are matched and identified so as to isolate the tax "parity" problems. The illustrations are designed to encourage discussions in the problem areas. The examples have been put together in a simplified form with some overall general assumptions which are applicable to the Universal Life, Whole Life, Annuity, and finally, Financial Institution Accounts.

SLIDE 1

	Product Description			
	U/L	W/L	ANNUITY	BANK A/C
Premium	10,000	10,000	10,000	10,000
Investment Income	1,050	600	1,250	1,300
Expenses	(2,850)	(5,500)	(1,500)	(100)
Premium Accumulations: Reserve + Benefits	(7,150)	(4,475)	(8,500)	
Investment	(250)	(150)	(300)	
Policy Dividend	(600)	(275)	(750)	
Time Deposit Liability				(11,000)
Pre-Tax Profit	200	200	200	200
Tax Cost	(400)	(225)	(475)	(100)
NET	(200)	(25)	(275)	100

Universal Life - Assumes

1. An initial premium payment of $10,000 which will also be used in all examples.
2. A fairly competitive rate of investment income credited to the cash value accumulation.
3. No "excess interest" tax problem.
4. The policy includes an unidentified amount of term insurance cost.

5. A pretax profit results; the tax cost is reflective of all items in the policy.

Whole Life - Assumes

1. The same initial premium payment of $10,000.

2. Significantly higher commissions and lower initial cash values resulting in lower investment income.
3. The participating policy pays a policyholder dividend.

4. Tax cost is measured by two elements in the entire makeup of the policy, the investment income and the guaranteed interest rate.

Annuity - Assumes

1. The same $10,000 of premium of income.

2. Smallest amount of commission expense and also the largest of the cash value accumulations.

3. No life insurance coverage.

4. No "excess interest" tax problem.

5. The tax cost is determined by all of the elements involved in the policy.

Bank Account - Assumes

1. The same $10,000 of premium. It should be noted, however, that this is not an item of income to the bank. For illustrative purposes only, the item has been included in that column as an item of income and deduction.

2. The tax cost is directly traceable to all of the elements entering into the liability accumulation.

SLIDE 2

	Product Description			
	U/L	W/L	ANNUITY	BANK A/C
Premium	10,000	10,000	10,000	10,000
Investment Income	1,050	600	1,250	1,300
Expenses	(2,850)	(5,500)	(1,500)	(100)
Premium Accumulations:				
Reserve + Benefits	(7,150)	(4,475)	(8,500)	
Investment	(850)	(150)	(1,050)	
Policy Dividend		(275)		
Time Deposit Liability				(11,000)
Pre-Tax Profit	200	200	200	200
Tax Cost	(100)	(225)	(100)	(100)
NET	100	(25)	100	100

Universal Life

1. This illustration shows the Universal Life product with its "excess interest" classified as a policyholder dividend. None of the policyholder dividend is assumed to be tax deductible.

2. Tax cost results from all items except the amount attributed to the policyholder dividend (excess interest) thereby resulting in a rather significant tax cost.

Whole Life

1. We note that the "excess interest" treatment does not affect this product. The tax cost in this case is the same as our previous example.

Annuity

Same substantial result as under Universal Life with the "excess interest" classified as a policyholder dividend. Because the

interest earned is greater, the "excess interest" becomes larger. This results in an increased tax cost.

Bank Account

Since the Financial Institution does not have the "excess interest" problem, its tax cost remains constant.

In summarizing the slide illustrations, it can readily be seen that while each of these products are insurance related, they all have dissimilar characteristics. Some emphasize insurance coverage while others emphasize cash value returns. Some have high expense loads while others do not. And, finally, the resulting Company tax treatment discloses the extremely tenuous "parity" problem.

At this point in the discussion, we now turn to the effect of "tax parity" on the policyholder.

In attempting to achieve parity for the various life insurance and annuity products at the policyholder level, the potential company tax problems must not be transferred to the policyholder. If the burden of taxation, or even the burden of uncertainty, is shifted in this direction, the insurance industry will most likely see a switch of funds to other financial institutions. While their rates of return may be lower many policyowners may choose certainty in their personal taxes.

At present, the first real policyholder problem is treatment of "excess interest". The insurance industry guarantees a conservative rate of interest accumulation, and promises, on a non-guaranteed basis, greater amounts if the situation warrants. These larger amounts represent the difference between the current and guaranteed interest rates. The "excess interest" uncertainty needs no introduction to this group since the issue looms on the horizon as large as it did approximately three years ago. It was then that a number of requests for private letter rulings surfaced. Initially the IRS national office was inclined to attribute some form of policyholder dividend treatment to these investment intensive products. Today, more and more people, including the Internal Revenue Service, are beginning to understand what "excess interest" is all about and how different treatment affects their objectives. It is not uncommon in today's insurance atmosphere to have agency people call and ask for the latest reading on "excess interest". We are faced with a probable IRS National Office position of treating "excess interest" in any form as a policyholder dividend. Some companies are at least marginally comfortable with actions which they have taken with respect to their own product. They are hopeful that these actions, which seek to disassociate the excess interest credit from management discretion, will minimize or eliminate a potential IRS challenge. Most commentators agree that their solutions are at best optimistic and that long and expensive litigation to support their position is possible. Such litigation could mirror the time frame taken to decide the deferred and uncollected premium question. However, the stakes this time will be much higher; the solvency of many companies will hang in the balance.

It is here that we have the greatest need for tax parity, or at least the competitiveness among these products. Some suggest a simple answer: either grant a complete policyholder dividend deduction for all companies on all products, or subject that dividend to the extent of the similarity It would seem from our examples that both alternatives are unworkable. We are all aware of the legislative proposals facing the industry today which would give otherwise unused policy dividends some deductibility status. Perhaps this is the answer. In any event, one can quickly conclude from the discussions today that solutions which work to the advantage of one segment of the industry and to the detriment of another, quickly provide other financial industries with the opportunity to appeal to your potential or existing policyholders. It behooves the industry to come to some rapid and acceptable conclusion about the "deductibility of this excess interest".

The second potential controversy, regarding policyholder taxation, has been surfacing for some time. It deals with the classification of certain Universal Life and annuity products as noninsurance products. In spite of the potential "excess interest" problem, Universal Life and its related offshoots have grown more saleable and attractive. From time to time, the question of whether the product's funds are life insurance reserves or merely a deposit account has surfaced. An ad hoc ACLI study group has recently put together a draft position paper proposing guidelines on whether an insurance product is to be treated for income tax purposes as life insurance, an annuity, or a liability deposit. While it is not our purpose today to discuss the particular guidelines we again find a significant effort being made to create tax parity which may end up achieving just the opposite. Overall solutions must be found by the insurance industry which will permit its three major products maintain their share of the marketplace.

In summary, we have tried to bring together some of the problems in developing tax parity for various life insurance products. Based upon my work in preparing for this particular session, it is my overall conclusion that given the variety of insurance products on the market today and with a tax law having numerous provisions and which have certainly outlived their time, the achievement of tax parity will be extremely difficult. As is the case with most items in the economic sector, the older, more established products seem to be suffering more. Newer products, able to respond to newfound consumer investment objectives, are attempting to take advantage of a tax law which was not designed to deal with them. This invites controversy. Will the tax law be rewritten to produce a new structure capable of dealing with the old and the new? Only time will tell; however, the task of developing such a workable solution is to some frightening and futile to others. A solution to tax parity in the insurance industry is a must; if it is not achieved, premium dollars will flow out of our industry and accepted into other financial institutions. While there is no widely definition of "parity," continued discussion will at least expose all the possible solutions.

MR. CHAPMAN: Thank you, Jim. To recruit this panel, I had to promise that after the presentation of papers they would get at least one crack at one another. If Jim was the umpire, I will have to be the traffic

cop. In order to keep us within our time limits. I am going to define one particular area of each speaker's presentation and each of us up here will get one question or comment within that area.

Neal, your whole argument hangs on the possibility of identifying and measuring a mutual company policyholder equity interest. You pointed out the number of significant factors (and I can suggest a few more) in which the nature of policyholder equity deviates from true ownership. The question is: can we identify such an interest; how many differences can be recognized before the methaphor becomes flawed? The second part of that question is: does the inability to quantify it up to now indicate that it cannot be done, and would additional research be futile?

Question within that area, Doug.

MR. HERTZ: I would like to go to Neal's grocery store analogy with his deposit of $1,000. The situation that he is describing is very akin to the situation that occurs when individuals make interest free or low interest loans in return for services. You brought that up purely in the context of a mutual company policyholder accumulating surplus in the company, but is not it true of all companies -- permanent cash value products have the effect of a low interest loan. A policyholder deposits money with us; that money earns interest and that interest partially funds the services and benefits that he receives from us. I certainly do not mean to suggest that there is anything wrong with that, just that the phenomenon you describe cuts much deeper than just the surplus element in a mutual company contract. I suggest that what is going on really is more related to the concept of free interest that was widely bandied about around when the 1959 Tax Act was being written. That is really what the '59 Act was attempting to tax, and not as you suggest the mutual company policyowner's equity interests in the contract.

MR. STANLEY: I think I did try to point out that there are differences between the stockholders' ownership interest in the stock company and the mutual policyholders interests in the mutual companies -- their inability to get capital gains -- their inability to trade in. And for that reason, I would be quite willing to have the mutual companies earnings only taxed once rather than twice, as the stockholders' earnings are taxed. The question of whether that equity can be measured had, I think, been solved by the 1959 Tax Act. The Phase I Tax was designed to split earnings into a company share and a policyholders' share. As far as I am concerned, it is already been done.

MR. HERTZ: I guess we differ I see the policyholder's share as identified in free interest versus required interest, not in identifying the mutual company equity interest. After all stock companies have taxable investment income too, and some of them are taxed on it.

MR. DOX: Two brief items. From my experience, the policyholder surplus account does not prevent stock insurance companies from paying dividends. I would not deny that this probably does exist for some companies, but typically it is not the item that holds monies in the

company. In fact, from an accounting standpoint, policyholder surplus has been designated as permanent, even though acknowledging that this will have to be paid. But, as the law stands now, policyholder surplus is there to stay and most companies guard it with their lives. So, I do not understand that comment. On the whole issue of equity ownership in a mutual company versus a stock company, I can only go back to a simplistic example. If I had a $5,000 participating policy in Doug's company and I owned a hundred shares in Neal's company, I would hardly view those two vehicles the same way. That is my personal feeling. I never thought of my insurance coverage as being an equity investment, or my stock investment as having anything to do with insurance. Maybe I am wrong. But I know the arguments that have surfaced about equity ownership in mutual companies; it is a tough one to push if for no other reason than that it is difficult to measure.

MR. CHAPMAN: Thank you, gentlemen. One final comment: the role of both the mutual companies' surplus and the stock companies net worth has been considerably diminished as more and more of the investment risk and some of the mortality risk has been shifted to the individual insured. That is the point that both speakers have made.

Doug, You have put a lot of weight on the argument that a marketplace test is prima facie evidence of the existence of an absence of tax parity. Is that really valid? It may work out that way, but does not tax parity proceed from the fundamental concept that the operations themselves may be different? There is some inherent difference between a prospective premium reduction, and one that is theoretically retrospective but which probably contains some futuristic elements. And is not the market test the end product rather than the result? Do not you agree that tax parity should not be used to preserve endangered species?

MR. STANLEY: I wanted to expand on my phase III statement because I do not think that the public fully realizes its significance. We know at least three large companies that have paid their phase III tax this year. In merger situations, it is common sense that if you have something in your company that you cannot give to your stockholders without taxation, it will have some effect on your worth. So the stock companies get a tax deferral from these special deductions. While the mutual companies get a permanent tax forgiveness from their dividend deduction. I do not think those two are the same. To the extent that the premium is the same, the deductibility of the premium should be the same. I agree that if a mutual company sold a product that returned annually to the policyholder the full earnings on that product, a non-taxable dividend would never be created. You only get a taxable dividend if its paid out of return surplus.

MR. HERTZ: You seem to be suggesting that the real problem with mutual company products is the possibility that the policyholder will be able to make an investment by depositing an excessive premium. I am overwhelmed by the temptation to point out that the product in the marketplace today most associated with that abuse is Universal Life.

Peter, I would like to respond to your comments that the function of the tax law is not to preserve endangered species. I agree and would add that neither is its purpose to create them!

MR. CHAPMAN: I do not know how I can follow that one.

Let me just ask Doug two questions not covered in his presentation. Number 1. Whenever we talk to anyone from Mass Mutual we have to ask them where their private letter ruling stands. I can think of no better opportunity nor no better source than Doug. And, secondly, I would like him to comment on what we see as a movement by a number of mutual companies into the Universal Life area. How does he view that? Is that something that is ultimately bound to happen?

MR HERTZ: With regard to the ruling, I suppose that everyone in the room knows that Mass Mutual applied almost a year ago for a private letter ruling on Universal Life products. There were two products involved in the ruling. One would be a participating product marketed by the parent company; the other, a non-par product issued by a stock subsidiary. We requested that the reserves on these contracts be held to be life insurance reserves. In fact, we are asking for a confirmation of the Hutton ruling, that Universal Life is a life insurance product. It is really a parity argument. We have two products that are essentially the same -- would you kindly tell us, IRS, if you intend to tax them the same? The Hutton ruling seemed to indicate that a direct increase in reserve was flat out possible -- the alternatives posited in that ruling were dividend or reserve strengthening. I personally consider the reserve strengthening to be ridiculous; I cannot understand what it means. And so we asked that the amounts under the Universal Life contracts be deemed to be dividends. I have every confidence in what the ruling will say. We have not had an adverse conference. Others with the excess interest issue in various forms have. In my view, there is no question how the IRS intends to rule. As to when they will rule I cannot tell you. I suspect that it will be within a month, but we have no definite word on that.

As to the moves of a number of companies to introduce an Universal Life product -- I have got nothing against the product. Its product characteristics are in large measure very attractive and I think there is a market for it. Once we get the tax problems of our industry settled in an equitable fashion, some companies will market it, others will not. The situation that we see now, however, where it is an all or nothing situation excess interest and indeterminate premium reductions are not dividends. Hence, either the product is in effect tax free or these amounts are dividends and, for a phase II negative company, not fully deductible. It is rather extreme. What is needed is some amending of the law to relieve the uncertainty. Once the issue is resolved, once we have created tax parity for the industry, lots of companies will market Universal Life. We ourselves may choose to do so; I simply do not know.

MR. CHAPMAN: I wonder if I could ask all three speakers to comment very briefly on the Stop Gap Tax Bill. Is it a significant step toward the achievement of parity? Do you want to start that one Doug?

MR. HERTZ: Yes, I think the ACLI Stop Gap represents a major step in the direction of tax parity for our industry. I am certainly in support of the underlying concepts.

MR. STANLEY: I view Stop Gap very much the way Doug does. The dividend provisions do seem to provide some relief. The question immediately comes up about the excess interest provisions, which seem to affect a significant part of the industry. My own opinion is that it does not achieve what they are looking for. In fact, in my mind, its probably going to create more problems than it solves unless something is done. If it passes in its present form, unless something is done in two years, it will become an open invitation to controversy, simply because it does grandfather things through the end of 1981. But since it does not purport to address any issues after that date, I think the industry, principally the annuity companies, faces real uncertainty. It does not take five years to build up a problem; you generally have one in six months. So I am not sure that we achieve what that part of the industry is looking for. But in some of the other areas, I think that it does start to address some of the problems.

MR. DOX: For a two year period, the only hope is to get some type of compromise. For that reason I support it. It does have a lot of defects; the industry in the next two years should do something else. But I do not see how you can fail to support it.

MR. STANLEY: I did not suggest that we did not support it. I was asked to see if it achieved parity. I, personally, do not think it does.

MR. HERTZ: I do not think so either. And that is why the issue should be resolved in the next two years. I would hate to see it extended beyond that time.

MR. CHAPMAN: You did a good job of alerting us to the problem of parity and the danger of not achieving it. In particular, you focused on the excess interest. I was a little disappointed though, towards the end when you seemed to wring your hands and say that it is impossible to achieve parity. Now, I will have to go back to Justice Stewart, who said that he could not define pornography but that he recognizes it when he sees it. Could I ask you to do something analogous with parity and stick your neck out and say which treatment of excess interest you think achieves a higher degree of parity, or a greater degree of lack of parity.

MR. DOX: I did not intend to wring my hands, but I know that while I was not around for the 1959 Tax Act negotiations the insurance industry has been engaged in this controversy long before I entered the scene, and I see it continuing. I quite frankly do not think its possible to achieve parity, for no other reason than that I think we are in a corporate competitive environment that is going to introduce various different products. We have got a tax law that only the insurance industry really cares to understand. So we are going to be faced with this situation when looking at the problem. In terms of excess interest deductibility, I am really unequipped to say which perspective is right. I would say only that any form of partial deductibility will not be

satisfactory to the excess interest companies because the margins are extremely thin. They will not economically support any kind of a disallowance. I guess the other alternative is to suggest that it is priced wrong. I have heard that too. If you are not making money perhaps you have to do something else. Maybe that is the answer. I think that we can live within the insurance industry, but institutions outside the industry, such as money market funds, banks, etc. is another question.

MS. CAROL A. MARLER: I understand that in Canada the inside interest build up is now taxable. What are we doing in the U.S. to address this problem, which will become more severe than the problem of insurance company taxation?

MR. CHAPMAN: I am not aware of anything that is being done. I suspect that we are just closing our eyes and hoping that the issue does not arise.

MR. DOX: This touches upon an important point. Over the last two or three years there have been industry negotiations and discussions on tax law. The first thing the industry did was to throw their section 820 chip into the pot, so now they no longer have it. One marketing stronghold of our industry is the tax free build up of inside interest. It is something all companies in the industry enjoy. If you start surfacing that,you find yourself heading in the same direction, and you will find that chip being thrown in. The more inside interest is emphasized, the more people will think about it, especially the banking industry.

MR. CHAPMAN: The way some products are marketed makes the issue substantially more inflammatory. If policy loans are borrowed at 16% interest, it costs somebody in the 50% tax bracket eight percent. If the interest is then credited at a rate which is just below 16%, that creates leveraging of seven or eight percent. You have pointed up a very real problem.

MR. CLAUDE THAU: I am also concerned about pricing based on anticipated taxes. That is a situation we are all in because of the unpredictability of the future tax law. It is a problem that all of our policyholders also share because of the question of the non-taxable build up of cash values. Agents from mutual companies have come to me with illustrations showing how much money I would have at age 65, and that was the only thing they showed. I never did figure out why their arm was over the rest of the illustration. We also share another problem which relates to the replacement problem. I do not think that the replacement problems that exist today can be attributed to a lack of tax parity or to universal life; neither of those situations created the problem. The problem was created by improper investments, policy loan problems, and new mortality assumptions based on improved mortality.

I would like to ask Doug a question. He made a comment that non-guaranteed elements in non-participating contracts were a sham, that they are similar distributions. I take exception to that. Rather than engage in a debate, I will just offer a compromise position. I

maintain that there is a distinct difference between a non-participating element and a participating element. I thought Doug might agree with that and relate his point to the taxability of the non-participating verses participating element. I think there we have to differentiate between the world in which we live at this instant and an ideal world in which tax parity has been achieved. There is no way under the existing 1959 Tax Act to compromise the matter; either you have a dividend or you do not. There can be tax differences between stock companies and mutual companies. We have an industry negotiated compromise position which allows for such a differential. I am not wildly enthusiast about it, but I view the differential as a price we pay for industry unity, and I support it.

MR. JAMES F. REISKYTL: I was a little disappointed that Jim feels it is impossible to achieve tax parity because someone will inevitably be disappointed in the results. I am not sure that is a criteria for determining tax parity. I would like Jim to clarify his statement. Also, I would like the panel to explain what they consider an ideal tax law? As a society, we always look forward, and we look at the practical situation. At least we can have a dream or an ideal as to where we are going.

MR. DOX: If we define parity to be a condition where everyone thinks they are being treated equally, we could never hope to achieve it. The insurance industry is not unusual in their inability to get there. The oil industry went through a real brouhaha a couple a years ago. I just do not think that parity in even the majority of the companies' eyes can be achieved; you know one segment certainly will feel that they have got the answer, and I am sure another segment will disagree. But at least we are talking. Some companies have real operational dissimilarities, so it is a tough job.

MR. STANLEY: First I wanted to comment on that inside build-up question. Jim Anderson's original paper on Universal Life proposed that the company just consider it interest paid and 1099 the policy-holder. I do not think that is unreasonable. If excess interest was declared not fully deductible, there might well be a large market that you can forward 1099 information to regarding the interest paid over deposit.

MR. CHAPMAN: Just to supplement that, imagine a second generation Universal Life product that is in a money market fund. We then have a tax privileged money market fund competing with money market funds on which interest is taxable. Look at this from the stand point of the securities industry. By slapping the term insurance on it, which costs pennies in relationship to the amount that is going into the fund, suddenly you have an enormous competitive advantage over the fund that is being marketed in a parallel way. The securities industry has some very powerful friends in Washington. When that product hits the streets in large numbers, I think you will see a real challenge to the taxation of inside build up.

MR. STANLEY: I may be prejudiced because I worked on the 1959 Tax Act but I think that the 59 Tax Act, if run as intended, is good a law as one will find for the life insurance industry.

MR. CHRISTOPHER H. WAIN: I wanted to supplement the comment about the taxability of the policyholder. There have been substantial discussions going on about changing the taxation under Section 72, which could affect the taxability of annuity products. I wish to ask Doug Hertz if he would agree that if a guaranteed premium was higher than a payable premium solely or primarily to avoid deficiency reserves, the difference should not be taxed as a dividend.

MR. HERTZ: I am not sure how one would establish that the gap between the guaranteed premium and the payable premium was solely because of deficiency reserves. A company issues a contract, that contract has permanent guarantees, and the level of the premium is at the company's current rate.