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U.S. FEDERAL INCOME TAXES

Moderator: JOHN H. ELKEN. Panelists: STEPHEN D. BICKEL, JAMES W. DEDERER, DOUGLAS N. HERTZ*

1. Status of the American Council of Life Insurance proposal.

2. Congressional action.

3. IRS/Treasury pronouncements.

4. Impact on products.

MR. JOHN ELKEN: We are here to address principally the Tax Equity and Fiscal Responsibility Act (TEFRA), specifically those parts of it that refer to Life Company taxes and policyowner aspects that are involved. My CEO has been serving on the American Council of Life Insurance (ACLI) tax steering committee for the last couple of years, and I have been serving as his principal deputy. Clearly, the issue of taxation of the life insurance industry is a very important issue. It at least has the opportunity to deal, evenly or unevenly, with the competitive balance within the industry and, perhaps more importantly, has the opportunity, if mishandled, to deal very adversely with the competitive balance between the life insurance industry and other financial intermediaries.

I am going to proceed this afternoon by first giving a brief background on how the provisions went through the ACLI and Congress. Then, our panelists will spend some time addressing the specific provisions of the act. We hope to treat the impact on pricing, tax planning and the bottom line that these provisions entail. We look largely to members of the audience for the focus of that part of the program. We would like to be responsive to your interest and your questions and comments following the panel's presentation for what will be the majority of the program. The problems that are present in TEFRA will also be dealt with to some degree. This has the potential of leading us to a discussion of possible changes in the stop-gap legislation, TEFRA, or possibly the long range tax bill, although that is not the primary focus of this open forum.

During 1978 and 1979, as the life companies' federal income taxes rose rapidly and competition heated up, many companies became much more aggressive in tax planning to minimize the adverse impact of this rising cost in the competitive world. Not all companies were comfortable in this climate. The tax planning measures seemed to provide less than certain relief under a clearly outdated law. So in early 1980, a task force of CEO's was appointed by the ACLI board to address a possible revision of the 1959 Act which would be more stable and develop a responsible and not overly burdensome level of revenue. This group's efforts were not completely acceptable to the ACLI membership, so the tax steering committee was formed,

*Mr. Dederer not a member of the Society of Actuaries, is Vice-President and General Counsel with Transamerica Occidental Life Insurance Company, Los Angeles, California.

with additional members added to give broader representation. This committee labored for about a year. It modified the original proposal in a wide variety of ways to achieve agreement on a package within the industry. As the package was unfolded to Congress and Treasury, it was met with little enthusiasm. In their view, it added complications to an already very complex and little understood tax law. In the words of the chairman of the steering committee, "We had hooked so many feathers on the old bird she wouldn't fly." At the same time, Treasury was proposing a simpler modification to the tax law, merely repealing Section 820. This encouraged the steering committee to attempt to develop a simpler and less complex stop-gap proposal to counter the simple mod-co repeal. On the third try, the steering committee achieved a significant degree of industry agreement on a stop-gap proposal. This was introduced in both houses, and while it underwent a few meaningful changes, it survived in essentially its original form. The details of that legislative development were extremely interesting. However, it is much more practical for us to address the specifics of the law and for that I'll turn to our panel and Mr. Dederer.

MR. JAMES W. DEDERER: Thank you, John. My formal presentation is designed to address two broad areas of the stop-gap life company tax legislation of 1982 as well as offer planning comments and background observations along the way. The general areas to be taken up here are stop-gap's reinsurance provisions and stop-gap's various effective dates and grandfather provisions.

In the area of reinsurance, Section 820 is repealed and existing contracts are terminated effective January 1, 1982. On the other hand, we have a grandfather of mod-co Section 820 for years prior to 1982. To the extent that mod-co transactions did not involve fraud, any considerations other than the terms of the contract as it existed under the regulations as of December 31, 1981 will control with respect to that transaction. Such things as business purpose and transfer of risk will not have any effect with respect to the validity of mod-co transactions. The one possible problem would be that if a mod-co transaction has absolutely no risk transfer under it, the contract may not have originally qualified for Section 820, in which case you would not qualify for the grandfather.

The question of what constitutes fraud under the tax law is a very sensitive legal question. It's not defined in the tax law. Essentially, fraud is going to require some willful deliberate act to evade taxes coupled with some overt act or activity that connotes deceit or dishonesty. Fraud has been very narrowly construed, particularly in the criminal context, and I think you would find that is the same situation here. In passing, I just might add that the mod-co grandfather really is a trade-off for the complete repeal of Section 820, and it is a very significant trade-off in that the industry has appreciatively less leverage going into the next round of negotiating the tax framework than it had the first time around.

Stop-gap also provides specific rules for unraveling mod-cos both for Phase I and for Phase II purposes. The rules are of some significance to companies which would be taxed in Phase I for 1982. The rules essentially provide that contracts are deemed terminated on January 1, 1982. Ceding companies for 1982 will have half a year's reserves and assets. Assuming companies will have the other half of reserves and assets. All the investment income will be with the ceding company. In Phase I, the effect will be to increase income artificially for ceding companies deemed to recapture

mod-co business in 1982. The obvious solution is to get out of Phase I for 1982, and most mod-co ceding companies do that automatically under stop-gap. The rationale for the negative tax effect is that it is the mirror image of the initial transaction when ceding companies entered into it in the beginning of a particular tax year, when they had half a year's reserves and assets in Phase I for tax purposes, but no investment income at all.

The Phase II mod-co termination rules under stop-gap are designed to unravel mod-cos without any major inequities or inconsistencies while eliminating any windfalls attributable to reinsurance of Section 818(c) business, either for reinsurers or for ceding companies. The manner in which this is done is through a so-called "deemed termination payment". The contract is deemed to have been terminated and the amounts are deemed to have been paid back from the reinsurer to the ceding company as though the contract had been terminated according to its terms. In effect, the reinsurer will have Phase II income resulting from recaptured Section 818(c) reserves, assuming the reinsurer had made the election. The reinsurer will not get a deduction for the 818(c) element in those reserves. Prudent reinsurers should have planned for this eventuality, and, presumably, they had a deduction for this 818(c) element in the year of acquisition which should carry over to 1982 to offset any income in 1982 attributable to the deemed recapture. In addition, there is a three year installment payment provision for the payment of any taxes that would be due to this recapture.

The ceding company also has some special 818(c) treatment. The deemed termination payment comes back in as other income to the ceding company. The ceding company is not going to be allowed a deduction for the 818(c) portion of the reserves that he receives. Moreover, for January 1, 1983, the ceding company will not get a reserve increase amount in Phase II in the amount of the 818(c) item. The probable rationale is that the ceding company should not get a Section 818(c) windfall on the recapture of its own business when, in all likelihood, it was not in a position to be taxed on the Section 818(c) element when it was originally reinsured. There is a special ameliatory provision to prevent inequities for middle companies in multiple mod-cos where one company can be both a ceding company and an assuming company.

Ceding companies have the option to terminate retroactively their mod-co elections within a six month period from the enactment of stop-gap (September 3rd), if they were a phase II negative company when they ceded the business. It is not clear when they must have been in Phase II negative, i.e. whether based on a final return on the Revenue Agent Report, or following final settlement. The other important point to realize here is that this has no effect whatsoever on reinsurers. The option exists only for ceding companies.

Stop-gap goes beyond mod-co in dealing with reinsurance transactions. Stop-gap addresses the taxation of dividends reimbursed under reinsurance contracts. It provides essentially that the reinsurer who reimburses the dividends is going to have a deduction for dividend reimbursements and also for the reserves. The ceding company will take that dividend reimbursement into income and then get a deduction for dividends paid out to policy-holders. The obvious implication of this is that 100% of the dividend reimbursement comes into Phase II income while the deductions for policy-holder dividends is subject to the limitation of either the 85 or 77½% safety net or the normal limitation under the 1959 Act. There is some ambiguity

under the law as to whether this applies only to co-insurance or to all reinsurance. As a practical matter, one should assume that it applies to all reinsurance as that is probably the way it will be applied by the government.

Reinsurance with a note has also been affected by stop-gap. This is a technique that became popular in the late 1970's simultaneously with mod-co. Stop-gap provides that an interest paid deduction in Phase I is not going to be allowed to ceding companies on amounts owing under reinsurance contracts except with respect to periodic settlement items. There are two significant aspects of this. There is no disallowance of an interest paid deduction in Phase II, and this applies only to ceding companies. In transactions where reinsurers may have amounts owing back to ceding companies (which is not completely uncommon and may become more prevalent), the interest paid deduction in Phase I is still available to those reinsurers.

Effective September 3, 1982, stop-gap provides a special Section 482 type reallocation rule for related party reinsurance. The Secretary's new reallocation authority in Section 818(g) is simply an attempt to provide for specific application of 482 type principles within the Subchapter L phase system. Related parties are those with an 80% affiliation. The provision is also designed to accomplish in one sentence what the proposed co-insurance regulations accomplished in several pages. It would permit recharacterization of Phase II income to Phase I income, and vice versa. Although Section 482 has been construed very narrowly and delicately by the courts, great caution is suggested for all new related party reinsurance arrangements. An interesting question arises as to whether a new block under an in-force treaty constitutes a new reinsurance arrangement.

Companies must make determinations as to the handling of their existing mod-co transactions. To the extent that there are mod-co transactions in force, notwithstanding that they are automatically terminated for tax purposes, they remain in effect unless some action is taken by the parties to change them. Any action by the parties should be undertaken with the consideration that something that might be done now may indicate whether there was fraud in the making of the contract originally. Another consideration, remote as it might be, is the possibility that TEFRA might be ruled by a court to be unconstitutional. In that case, Section 820 is back in the law and we're back in the mod-co business.

Co-insurance with a trust appears to be a valid and viable technique that accomplishes some similar objectives as mod-co with 820 elections and has been popular for the last few years. It is not at all impaired by stop-gap, except to the extent that stop-gap changes the tax position situation. With co-insurance with a trust, the reserves and assets belong to the reinsurer for tax purposes. That sort of technique has many problems associated with it in terms of GAAP and statutory accounting, and also under state insurance law. The commissioners have difficulty determining who owns those assets. For the technique to be valid for tax purposes, of course, the assets must belong to the reinsurer. One strong caution I would make is to be really careful about your tax positions, both on entering transactions and on potential recapture of business. Companies' tax positions are much more critical and delicate than people are inclined to recognize at this time under stop-gap.

Accident and Health (A&H) business plays a different role than it used to because the 2% A&H deduction is of no value with respect to the safety net limitation, but it's still of some value if you are using the old 809(f) 1959 Act limitation. This raises the possibility of reinsuring A&H business between and among companies, depending upon the utility of that A&H deduction. Reinsurance of the 818(c) business is still a valid technique, but tax positions for both companies at both cession and recapture is critical.

One of the specific tax objectives of reinsurance has been to take advantage of different phases and phase shifting. This perhaps was an appropriate target of stop-gap, and to a large extent, stop-gap has eliminated many of the tax benefits of phase shifting.

There are a variety of effective dates and grandfather provisions throughout TEFRA. They are designed to accomplish one or more of three things. They are designed really to sanctify some of the agressive tax planning of the past. They are also designed to protect the taxpayers with respect to positions that they took under the 1959 Act and prior to 1982 which may have some long term implications. They are also designed to provide taxpayers some time to comply with respect to the provisions of stop-gap. Many of the grandfather provisions were the result of specific bargaining and trade-offs between the industry, the Treasury and the Congress.

The provisions in stop-gap have effective dates which coincide with stop-gap, and therefore expire at the end of 1983. These items would include the disallowance of the excess interest reserve on essentially deferred annuity contracts and universal life contracts where a reserve is held over at the end of a calendar year. The so-called Hartford life company tax status provision with respect to deferred annuity contracts and whether they qualify as life insurance contracts for purposes of the qualification ratio applies only for the stop-gap period. The "geometric Menge" and bottom line consolidation apply only for the stop-gap period. Also, the safety net provisions, the new pension rules and the new guidelines with respect to flexible premium contracts apply only for the stop-gap period.

Section 820 is repealed as of January 1, 1982 and mod-co is grandfathered for pre-1982 years. The new dividend and interest paid rules apply after 1981 but they apply forever. The new Section 818(g) relative party reinsurance provision applies after the date of enactment of stop-gap. Again it applies forever.

The annuity excess interest provision (100% deduction or 92% deduction for non-qualified annuities) is effective after 1981 and applies forever. The twelve month interest guarantee provision does not apply with respect to monies held on August 13, 1982, nor to the interest on those monies. Contracts issued prior to January 1, 1983 have one year to be brought into compliance.

The universal life excess interest tax treatment for 1982 and thereafter has not been clarified. There is a revenue ruling out on the subject, but there continues to be some outstanding issues in that area. Pre-1982 grandfathering for excess interest on universal life has been provided by stop-gap.

There is an underpayment protection provision in stop-gap to cover companies who made their 1982 prepayments based upon the 1959 law and have an increase in tax attributable to stop-gap. They are covered with respect to any shortages in their preliminary payments through 1982. Indeterminate premium contracts are completely grandfathered. There is no phantom premium or phantom dividend prior to 1982. There are no rules after 1981, however, except that this specific no inference rule is provided in stop-gap.

With respect to deferred annuity policyholder taxation, the penalties and LIFO treatment provided under deferred annuities apply to investments and contracts after August 13, 1982 but the penalty does not activate until January, 1983.

The new guidelines affecting flexible premium contracts apply to contracts taken out through 1983. There is a one year compliance period for pre 1983 contracts.

Finally, with respect to the 818(c) approximation calculation, the reduction from $21 to $19 is permanent.

The one observation I would make with respect to all of these effective dates is that essentially the changes that are limited to the two year stop-gap period are the ones that might be perceived to be of benefit to the life insurance industry. The changes that are permanent are the ones that the Treasury wanted and got. Thank you.

MR. DOUGLAS N. HERTZ: My first topic is dividends and other special deductions, the items limited in their deductability by Section 809(f). These items include dividends and similar distributions to policyholders, the non-par special deductions and the special deduction for group term life and accident and health business. The 1959 Act "phase system" of taxation was retained in TEFRA but with important modifications in the level of deductability of these amounts subject to limitation. The traditional scheme still exists but the results that can be achieved are radically different. First, the statutory amount (the amount that used to be a quarter million dollars) has been raised to a million for small companies but now is graded off for large companies. This increase presumably reflects inflation since 1959. Secondly, there is an alternate limitation provided. We can elect between the use of taxable investment income as the limiting factor or the use of a new percentage deductability. In describing this percentage deductability, the law goes into a definition of the base amount. The base amount is all dividends incurred on non-pension business plus all non-par special deduction amounts available. The A&H and group term life special deduction is not part of the base amount. The alternative limitation is then the sum of all dividends on pension business plus the lesser of a million dollars or the base amount, plus either 77½% at a mutual company or 85% at a stock company of the base amount. These percentages were set to achieve a revenue target. There is no great wisdom or science involved in what was done there. ACLI originally went after 80% from mutuals and 87½% for stocks and there was a need for more revenue. The percentages were adjusted like a rheostat. They just turned the knob a little bit and more revenue flowed out. The 7½% difference between stocks and mutuals was an item negotiated in the ACLI steering committee. Presumably, the difference recognizes the mutual company policyholder's ownership interest in the company. The million dollar small company benefit is graded off so that it isn't a constant million dollars. If the total of the special deductions

exceeds four million dollars, it starts grading off, and it vanishes when the aggregate of special deductions reachs eight million dollars. Roughly, the formula is a million dollars less 25% of the excess over four million of the aggregate special deductions, and when you reach eight million the amount becomes zero and stays zero for amounts over eight million. Only one one million dollar amount is allowed per controlled group of corporations. This is then not an invitation for subsidiary proliferations. A question arises as to the mechanics of the provision. Do you allocate the million dollar amount among the members of the controlled group first and then grade it off separately within each of the separate companies? In that case, to illustrate the difference, a small subsidiary of Prudential might still have some of the million dollar amount remaining when the grading off process was finished. The alternative would be to grade off using the aggregate of special deductions for the controlled group, come down to whatever amount remains and then allocate that among the members of the controlled group. We really don't know which approach is going to apply. Presumably, regulations will tell us something about this.

The order in which the amounts subject to limitation are recognized has been changed. In the past, you first deducted the dividends, then A&H and Group Life term special deduction, and then the non-par special deduction. The order in which they were recognized mattered because there's an accumulative limit on the A&H and Group Life term special deduction. Consistent now with the inclusion of the non-par special deduction in the base amount, but not the A&H special deduction, the order now mandated is: first dividends, then the non-par special deduction, and then the A&H and Group Life term special deduction.

There are grandfathering provisions which tell us about amounts that were not dividends in past years. First, excess interest guaranteed or fixed by index in advance in tax years before 1982 and treated as other than a dividend in tax returns that were filed will not be given dividend treatment. Premium or mortality charge reductions guaranteed reduced in advance of the premium paying period will be treated similarly. These grandfathering provisions are explicitly meant to create no inference with respect to the treatment of excess interest or premium reductions in tax years after 1981. TEFRA very deliberately did not define what is a dividend to a policyholder. It would seem inevitable under this safety net concept that you can play for 100%; if you fail, you'll get 85%. It seems inevitable that there will be litigation.

The alternate limit for dividend deductibility will change tax planning for many companies. Most mutuals are going to become a new kind of Phase II negative. That is, they will be taxed on gain before special deductions less the alternate limit. This makes the Prudential the largest Phase II negative company. Tax planning has shifted at all ex-Phase I mutual companies. For example, Clifford Trusts have recently been popular for charitable giving. Once they are established, they have to stay in place for at least ten years. If stop-gap remains they will simply be useless, unfortunately. Furthermore, allocation of expenses between investment and general expenses now becomes a far less important subject for many of us. On the other hand, expenses, dividends, and surplus strain now become major tax planning items. Perhaps the good news that I came here today to announce is that actuarial salary increases are now deductible at more companies than formerly. The marginal tax rates will shift, making tax-exempt investments and intercorporate dividends somewhat more attractive

than they used to be. Also, because our marginal rates on investment income become much more like 46%, tax planning devices that were attractive to other corporations but not to insurance companies in the past may now be more attractive. Depreciation, depletion, and to the extent that TEFRA didn't entirely do away with them, tax leasing deals may now become more attractive to insurance companies.

There are, of course, problems that arise in this shift to Phase II. The most significant problem is that the shift is temporary. Stop-gap will end on December 31, 1983. Clearly, it is a major problem for actuaries trying to do the planning in a fundamentally long range industry to be living with a two year tax law. Broadly speaking, in companies that are undergoing the change from Phase I to this new style of Phase II negative, it would seem that ordinary lines will reap a tax benefit. Group lines may be hurt by this shift. Again it depends on the circumstances of the individual company. Older blocks of business will tend to suffer if mutuals reflect this shift in their dividend scales. The problem is that dividends tend to be very high on older blocks of business, and, of course, the dividend is only fractionally deductible. Further, we don't know what to do about tax changes on such products as universal life and variable life insurance. TEFRA gives no guidelines as to whether these products contain dividends to policyholders.

My next subject is life insurance reserves. Recall that reserves are restated by the Menge formula in computing taxable investment income in order to approximate the amount of reserve which would have been held had the assumed interest rate used in computing reserves been the adjusted reserves rate. For tax years beginning in 1982 and in 1983 TEFRA changes this revaluation formula, the 10 for 1 rule, from the familiar arithmetic formula to what is called the "geometric Menge" formula. Where before we simply reduced our reserves by 10% for each 1% of increase in assumed rate that we wanted to reflect, we now have a revaluation factor given as .9 raised to the power of 100 times the difference between the adjusted reserves rate and the average interest rate actually assumed in reserves. This change affects only taxable investment income. For the great many taxpayers that are now Phase II negative, it will have no effect whatever. For those companies which are affected, for which taxable investment income still does count, the new formula gives a higher deduction whenever the adjusted reserves rate is more than 1% higher than the actual rate assumed in computing reserves. The formula tends to be more accurate in today's circumstances when the interval over which we are attempting to revalue can be as wide as 5 to 7%. The ACLI had initially proposed putting a maximum on the adjusted reserves rate to limit it to going no higher than 9½%. The 9½% was chosen principally because this new geometric formula achieves an absolute maximum regardless of the assumed interest rate in reserves at 9.49%. This maximum provision is not in the final law, and, as with the limits on special deductions, the tax planning problem here is that this provision is temporary in nature.

The approximate revaluation formula given by 818(c)(2) to restate preliminary term reserves to a net level premium basis has been revised. It is permanently shifted for issues after March 31, 1982 to $19 per thousand of the amount at risk for other than term business. The formula for term insurance is still $5 per thousand. Companies are allowed to switch from the approximate to an exact method of revaluation [818(c)(1)] for tax years starting after 1981 without seeking permission from the commissioner to do

so. Presumably, this applies only for policies issued after March 31, 1982. The Senate Finance Committee report discussed the application of 818(c) to graded premium policies, specifically on page 341 of the finance committee report. It referred to some such contracts as disguised term policies and the committee wrote into the report its expectation that Treasury would issue regulations dealing with this matter. They apparently want to see substantial cash values or level premiums appearing after a few years.

New Code Section 818(h) provides that if interest is payable under a contract at a rate in excess of the lowest rate assumed in calculating reserves, and is guaranteed beyond the end of the taxable year, reserve computations should be done as if the interest were guaranteed only to the end of the taxable year. Roughly speaking, they want us to stop accelerating deductions. This rule applies only to guarantees made after July 1, 1982 and applies for reserves at the ends of taxable years which began in 1982 and 1983. There is a grandfathering provision that was put into the law principally at the behest of one major company which had an awful lot of such reserves at the beginning of this year. If such excess interest reserves were held under code section 810(c)4 and had produced no benefit whatever for the taxpayer in prior years, then the company is allowed to recompute its beginning-of-year reserve for 1982. The company is allowed, in effect, to lower the beginning reserve in going into a period in which it anticipates being taxed on gain from operations.

It is not clear just what contracts are affected by this provision. Group guaranteed investment contracts, deferred annuities, and pension contracts all seem reasonably clearly to have been targets of this provision. Other contracts such as universal life with separately stated interest guarantees also seem to be hit. There's a colloquy between Senators Benson and Dole in the Congressional Record for July 22 of 1982 which seems to make it clear that the provision is not applicable to policies which do not guarantee a separately identifiable excess interest, such as single premium immediate annuities. New York specifically requires reserves for future interest guarantees on group contracts now. So we have here a specific disallowance of a reserve specifically mandated by the states. I personally see this as the start of a very adverse trend in taxation. I think we are going to see in years to come much more of this sort of specific disallowance of reserves that are otherwise required by law.

MR. STEPHEN D. BICKEL: In the area of flexible premium life insurance contracts (universal life), the Treasury was concerned with the possibility that the contracts might have too great a savings element. The classic example was that of a policyholder paying a million dollar premium in a policy and only having a million and ten thousand of death benefit. The Treasury didn't feel such a contract should have the benefit of the exclusion from income tax at death. We now have two alternative tests, one of which a contract must meet in order to obtain the benefit of the exclusion. The death benefits under the flexible premium contracts will be excluded from gross income if 1) the sum of premiums paid does not exceed the "guideline premium limitation", and 2) the death benefit does not exceed a certain percentage of the cash value (140% up to age 40 grading down to 105% for ages 75 and above). As an alternative test, the death benefits will be excluded from gross income if the cash value at anytime does not exceed the net single premium for the death benefit based on 4% minimum interest and maturity at age 95. This is a paid-up insurance test.

The "guideline premium limitation" which is the maximum amount of premiums that can be paid up until the date of death, is defined as the greater of a guideline single premium or the sum of guideline level premiums. The guideline single premiums are based on the guaranteed mortality and expense charges in the contract and an interest rate not less than 6%. The guideline level premiums are based on guaranteed mortality and expenses and a minimum of 4% interest. The guideline premiums can include premiums for qualified riders. Premiums for accidental death, premium waiver, guaranteed insurability and family insurance benefit can be included in the guideline premium calculation. The minimum premium paying period and the earliest maturity date that can be used in these calculations is 20 years or age 95 if earlier. The guideline premiums are to be adjusted for changes in benefits which are made after issue. If there are increases or decreases in death benefits, there is an adjustment of the guideline premium. Excess premiums which are paid by the policyholder in excess of the maximum but returned to the policyholder within sixty days after the end of the contract year will not disqualify the contract.

One of the first product decisions that must be made by companies is choosing between the two alternative tests. The idea behind the guideline premium test was that the policyholder could be told at the time of issue exactly how much premium he can pay without having to worry about what the actual interest and investment results turn out to be. In many cases, the guideline premium tests will permit a greater savings element than the alternative test, but not always. Guideline premiums on the other hand are much more complex for the company to administer. There are many calculation questions which are not clear. It's possible when adjusting a policy for a decrease in death benefit after issue, for example, that the premium for the decrease is bigger than the premium for the original policy, resulting in a negative guideline premium. The statute can be read as saying the premiums of riders must be spread over the whole life of the contract in the calculation, even though they are payable only to age 60 or 65. There is a number of little complications like this. The 5% corridor at the late ages is a nuisance in the calculation process. Another factor to consider is that, with the guideline premium approach, it is not necessary to have that limitation in the contract. You can simply notify the policyholder what the premiums are without making it contractual. The alternative paid up insurance method must be contractual. There is some thought that these corridors of 140% and so forth might be changed after stop-gap, which is a consideration. With single premium contracts there is the inconsistency of 6% in the guideline test and 4% in the alternative tests. These are all things to consider in choosing between those two methods.

In the area of non-qualified annuities, the Treasury has disliked non-qualified annuity contracts for a long time. They have felt that they are treated too favorably compared to direct investments and taxable savings such as bank accounts, money market mutual funds, and so forth. Their solution to the problem was first to make the interest on these contracts fully deductible at the company level and, as an offset to that, to have a penalty tax on the policyholder to represent the value of the deferral of tax and then also to change the rules on partial surrenders. There is qualified guaranteed interest which applies to non-qualified pension contracts. This interest is 100% deductible in the case of non-par contracts and 92½% deductible for par contracts. The interest must be guaranteed prospectively, either by formula or a stated rate, for at least twelve months. In the case of par contracts, the 92½% applies to the excess

over the assumed rate for reserve purposes. These amounts of qualified guaranteed interest are deducted as interest paid, so there is a deduction in computing both taxable investment income and gain from operations. The one year requirement does not apply to funds held on August 13, 1982, and contracts sold between August 13, 1982 and January 1, 1983 must meet the one year requirement by the first contract anniversary.

The next step was to change the rules on the taxation of partial surrenders. Prior to this time, the partial surrender was treated first as a return of principal without any taxation and then as return of interest which would be taxable at ordinary income rates. This was reversed, so we went from FIFO to LIFO. Amounts received under an annuity contract prior to the annuity starting date will be treated first as a return of income subject to ordinary income tax and secondly as a result of principal. Policy loans will be treated as partial surrenders. Premiums paid before August 14, 1982, however, are grandfathered and may be withdrawn first. A withdrawal first would come out of premiums paid up to August 13, 1982, then would come out of interest, and then finally out of premiums paid after August 13, 1982. There is a 5% penalty tax on the income allocable to premiums paid within the past ten years. The 5% is supposed to represent the value of deferring tax on the interest. A theoretical tax would have been something like 1% a year, so 5% is an average over the ten years. There is no penalty tax, however, for an amount that is received after age 59½ on death, disability or on annuitization in substantially equal payments for at least five years. Here it is necessary to allocate the interest to the premiums in order to determine the amounts to which the penalty tax applies. There will be a priority of about five different buckets. Thinking again of a partial surrender, first you can withdraw the premiums paid before August 14th and have no penalty tax and no ordinary income tax. Secondly, you can withdraw the interest on the premiums paid before August 14th. There is no penalty tax and apparently no income tax on that amount although that can be interpreted differently. The third category is interest on premiums paid after August 13, 1982 and more than ten years before surrender. This would not be subject to a penalty tax, but would be subject to income tax. The interest on premiums paid after August 13th but less than ten years before surrender will be subject to both the penalty tax and the income tax. Finally, the premiums paid after August 13th will be tax free.

Another item addressed in the Act is "double dipping". The "double dipping" problem relates to the qualified pension contracts. A Phase I company receives a deduction of the current earnings rate times reserves and the law now states that this deduction cannot exceed the actual amount credited to the policyholders. Prior to this time, it was possible for the deduction to be more than the amount paid out, which created the effect that, on interest paid contracts, as you would sell an interest paid contract with a new money rate it would raise the overall portfolio of investment income in the company. Therefore, the company would not only get a deduction for the interest paid, but would also get a greater deduction on the old pension contracts. The Act eliminates that double dip.

The elimination of the double dip was the cost of postponing another problem that had to do with interest paid contracts. The problem is how interest paid contracts are to be used in determining the qualification test of whether a company is a life company or a casualty company. Interest paid contracts are not life reserves, but if they are counted in the denominator

of the qualifying fraction, a company might, by virtue of having a large block of these contracts, shift from a life company status to a casualty company status. For a mutual company, this would be pretty good because casualty company taxation is more favorable than life company taxation. Casualty companies have no limit on taxes and interest deductions, and are allowed to deduct all dividends. It would be a good thing for a mutual company to be treated as a casualty company. For a stock company, on the other hand, it is a pretty terrible situation, because a switch in status would trigger a Phase III tax. The Act says that the status of a company will not be changed as a result of interest paid contracts during the stop-gap period. This only postpones the question of how to treat these contracts after the stop-gap period.

The last item in the stop-gap bill was the bottom line consolidation, which simply means that the tax can be determined by consolidating the bottom line of all the different companies. The alternative to this would have been regulations that have been proposed which involved a phase by phase system. Such a system would have eliminated much of the benefit of consolidation, had it taken effect. Therefore, during the stop-gap period, we have the bottom line approach.

MR. ELKEN: Thank you, Steve, Doug and Jim for leading us through the provisions of the stop-gap legislation. As I indicated, we really feel it would be most valuable at this point if we concentrate on questions or comments from the floor. At this time, we would be very pleased to entertain your questions and comments. There are microphones in the aisles for you to use. Please use them and state your name clearly so that the recorder can identify you properly.

As you are composing your questions, I have a couple for our panel. One of the things that intrigued me is the point that Jim made about the possibility of TEFRA being declared unconstitutional. I wondered if there was any consortium of reinsurers that was working on that point, Jim?

MR. DEDERER: Not that I'm aware of.

MR. ELKEN: Maybe there would be a consortium of potential mod-co'ers that ought to get together on that. We have a question here.

MR. RALPH H. GOEBEL: I attended a meeting this morning on segmentation, and one question came to my mind. Let's say that you have three or four segments. One might be your group annuity segment, another one might be your individual insurance segment and each one of these segments would have a different composition of assets and liabilities. I wonder if anybody has anything to say about allocation. One possibility might be to make out different returns for the different segments, each one having a different company's share. Then of course you won't add up to 100%. Does anyone have any comment on that?

MR. ELKEN: I know I've thought about that issue. It is my understanding that clearly you are not able to deal with a tax return that focuses on segments in your company tax return, and while that process you refer to may help you in an allocation sense it doesn't do anything to your total tax bill, at least as I understand it. Do you gentlemen want to add anything?

MR. BICKEL: Senator Dole has announced a project where he asked the GAO and his staff to consider the possibility of eliminating the differences between life insurance taxation and casualty company taxation in order to solve the problem precipitated by GIC business. One possible way of resolving that, I suppose, would be to tax our health business like a casualty company, which would involve a walling off of the health business.

MR. DAVID B. ATKINSON: I wonder if anyone on the panel would care to take a guess at what would happen in 1984 when stop-gap runs out.

MR. BICKEL: It will be extended to 1985!

MR. DEDERER: I don't know that I'm any more expert than anybody else, but from my two or three years involved in the process of the big package, and then the development of stop-gap, and what I saw directly and indirectly as the aversion of members of Congress (not necessarily their staffs) to take up the subject of life company taxation, it's going to be awfully easy for them to extend stop-gap if it is perceived to be producing enough revenue for the government, and if it is perceived to be not completely unpalatable to the industry. It will be awfully easy to perpetuate it, I think, maybe with some fine tuning.

MR. ELKEN: There have been some indications that there is ready acceptance of the concept of extension in Congressional circles. There also is some pretty direct evidence that, at the Treasury at least, extension of stop gap is a very unattractive last resort and only to be accommodated as a very bad deal. I just noticed that Dick Minck walked into the room. Perhaps you might have something to say on this point, Dick.

MR. RICHARD V. MINCK: John, thank you. I think there are two things to keep in mind in assessing what happens if permanent legislation is not enacted during 1983. First, the direct result would be a loss in budget terms of slightly in excess of a billion dollars. If you look at the way stop gap went through, they had projected revenues for 1983, 1984, and 1985, and did it on the basis of stop gap terminating at the end of 1983. That's not a real loss in a sense in that I don't believe that members of Congress were anticipating that stop gap would end and nothing would take its place but you do have that to cope with. Secondly, Congress is going to be busy with an awful lot of problems next year, and it is the least conceivable to me that they might not do anything. I believe in order to insure the best chance that something is done, we had better be in with a bill fairly early in the year making specific proposals and, John, thank you for the chance.

MR. ELKEN: Thank you. Yes, you have a question?

MR. CHARLES G. BENTZIN: I have three questions, one of which deals with the question of under what circumstances is a Phase III tax triggered in regard to either the sale or merger of companies? The other two deal with annuities, one of which is that in the annuity law, there is some language that says something in regard to August 13th, and the question is whether or not any investment income that is triggered on an annuity after August 13th is somehow treated differently than investment income which was earned on the annuity prior to August 13th, in each case assuming the annuity was originally issued prior to August 13th? Also, are there any rules on the aggregation of annuities within the same company; i.e. if someone already has an annuity, does the sale of an annuity somehow trigger any aggregation

for the purposes of the tax on distribution, whether it is interest first, premium first, and so on?

MR. BICKEL: On the annuities, there is a lot of vagueness in the statute about how to handle the interest on the old premiums or how to allocate the interest generally between what's taxable and what's not taxable. There are meetings going on with the joint staff by the ACLI and others to try to resolve these, hopefully in the "blue book", which the staff is writing up to explain the bill. All I can say now is I don't know the answer either. One idea they are talking about, though, is an idea of aggregating premiums by, say, calendar year or contract year in hope that this would somehow simplify the process. The application of the law to multiple premium deferred annuity contracts is a real mess. Back on the other question, the Phase III tax question, there is a little bit of vagueness now since Section 334(b)(2) has been replaced by the new Section 338, whether the 338 election triggers a Phase III tax. I think it's pretty clear to us that it does, but it's not clear in the code.

MR. ELKEN: I'm not sure I understood the question on the annuities, and I perhaps didn't, so let me just state it: If there were investment increments prior to August 13th which generated an investment income credit to the contract after August 13th, was that an investment increment after August 13th and therefore subject to the new rules? It seems to me that the income earned in the future off of investment increments prior to August 13th would always get an old treatment. I'll look for some nods from some people. I'm getting a few nods.

MR. BICKEL: That's the most favorable.

MR. ELKEN: I think that's what's intended, but as Steve has pointed out there are several questions which need clarification in the handling, particularly in the area of a contract which has both old and new money in it, as to what the sequence is. In the aggregation issue, again my understanding is that there are no provisions for aggregating a series of, let's say, single premium or other contracts within the same company, although you wonder about that because of the way a flexible premium annuity will be dealt with then is somewhat different from a similar series of single premium contracts. But, it is my understanding that there are no specific provisions for aggregating a number of annuity contracts in a given company. Again I'm seeing one or more heads nodding yes. Any other questions?

MR. ALLAN D. GREENBERG: A question to Jim Dederer or anyone else that wants to comment on it: With respect to Section 818(g) (reinsurance between related parties), does the fact that the code section referenced in 818(g) applies to individuals tend to invalidate the effect of this section? It seems that the only people who would be affected by this code are people who own individual or credit insurance companies, and that doesn't seem to be what the Treasury would really work hard to put into the law. But does the fact that there are different code sections referenced with respect to the million dollar limitation and to Section 818(g) have any substantial significance?

MR. DEDERER: I'm not sure whether it has significance or not. It's certainly not the intent behind 818(g) as you indicated. To the extent that

we have an ambiguity attributable to the terminology in 818(g), I think you can expect to have attempts to have it clarified by the government.

MR. BICKEL: I think the significance of 818(g) is that it specifically mentions that allocation of not only net income, but investment income, premiums, deductions, assets, reserves, credits, and 818(c). I think they have a lot of freedom to think of things to do with that they couldn't have done with just 482.

MR. GREENBERG: Yes, but Steve, doesn't the section reference really not refer to most insurance corporations the way they define them? Am I wrong in this Jim? Doesn't it seem that they referenced the wrong section, and that the 818(g) does not refer to corporations but rather to individuals. Why I don't know, but I thought it seems to imply that.

MR. DEDERER: Yes, but that was not the intent of the thing and I think they will get it clarified. Clearly they are trying to apply it to all life insurance companies with the 80% affiliation, not limited to credit life, and the concept of affiliation with respect to individuals doesn't make much sense anyway.

MR. ARDIAN GILL: A comment and question, maybe two questions for Jim Dederer. Jim mentioned that it wasn't clear under the law where the dividends were on a traditional mod-co contract (no 820), since the amendment speaks of traditional co-insurance contracts, but I think the conforming amendments of 809 do clear that up by putting dividends reimbursed back into the income of the ceding company, so you really need the dividend deduction to go along with that.

MR. DEDERER: Ardian, I guess the ambiguity I was talking about is in the language of stop-gap. The heading of the provision talks about reinsurance contracts and inside the body of it it talks about conventional co-insurance contracts.

MR. GILL: Yes, it's not entirely clear but I think the ambiguity is at least reduced. Would you confirm my understanding, Jim, that the termination accounting of the 820's, where the reserves going back to the ceding company cannot exceed the assets for Phase II, in no way effects the policyholder and company share calculation? In other words, you use the tax reserves for those in both Phase I and Phase II?

MR. DEDERER: I could try to confirm it for you. I'm not sure it's right, though. I think that's right.

MR. GILL: On funds-withheld co-insurance, there is no interest deduction for the ceding company in Phase I. Does the assuming company get an income? Who has the reserves? If you don't get an interest paid deduction, who has the reserve deduction?

MR. DEDERER: Those little follow up issues are not made clear at all under stop-gap. It seems to me that, as is elsewhere in the tax law, for instance with respect to Section 482 as a matter of fact, correlative adjustments generally are going to be made automatically to mirror one side of a transaction as it impacts on other taxpayers. While it's not clear there, I think that principle is going to apply.

MR. HAROLD CHERRY: For the purpose of this question I would like the panel to assume that stop-gap continues after 1983, or at least something substantially similar to it does. What impact do you see on the pricing of new business (permanent and term) in terms of levels of premiums, cash values, reserves, reserve basis, that kind of thing, related to the design of the pricing of new products. Secondly, what impact do you see on inforce business, particularly par business, with respect to dividends and such business, or enhancement programs on account of stop-gap that try to take advantage of the law to the utmost?

MR. HERTZ: As a first comment, given the fact that dividends are only partially deductible and other items are more likely fully deductible, there will be a tendency to move away from dividends toward benefits, perhaps charging lower gross premiums and having thinner dividend scales. That might be a motivation toward some sort of product enhancement program for inforce business to reduce the level of dividends on older blocks. You've got to be a little careful in how you do that so you avoid having a large up front dividend, or maybe you want it and partially deduct it. A lot of these areas are still rather unclear because we don't know the interpretation that the Internal Revenue Service is going to take toward updating projects in the future. Steve, I don't know much about non-par.

MR. BICKEL: I think the critical questions that the stock companies are facing right now is also what a dividend is and decide whether something qualifies for an 85% deduction or 100%. We have the problem with the revenue ruling which was issued last summer which said, literally, that even on a fully indexed policy or a variable life policy, there would be an imputed dividend which would only be 85% deductible now. Companies are having to decide whether or not to gamble on 100% or try some sort of indexing. The actuaries are asking their lawyers what the tax really is. I would like to ask Jim to comment on the indexing question in particular.

MR. DEDERER: Are you sure you don't want Massachusetts Mutual to talk about the index? We have had an index contract as some of you may know for almost two years fully permanently indexed. We have requested a company tax revenue ruling with respect to it. That ruling has not been dealt with as of yet. It's been in there probably as long as any universal life ruling has been in there. They are currently, they tell us, studying the subject. They are obviously having a very difficult time with it, because when you index your contract to an external indicator when it's permanently guaranteed, you don't have experience of the company, and you don't have discretion of management, then you haven't anything to do with the amount of interest that's being added to cash values under the contract. We get the sense that they don't want to issue a favorable ruling but that they find it extremely difficult not to. It's a dilemma that plagued them all through the last year or so while they analyzed the Massachusetts Mutual ruling and through the stop-gap undertaking, and they're still wrestling with it now. We don't know what they'll do, but we are, I think, going to try to get them to take some sort of specific position pretty soon. In the back of their minds of course, is that if they do issue a favorable ruling, it provides a safe harbor away from the safety net percentages. I don't think that should be of great concern because permanent indexing is a major commitment on the part of the insurance company. It represents a significant undertaking apart from being able to declare a new interest every twelve months. I can certainly justify on that basis separate tax treatment. I don't think a

favorable indexing ruling would presage many contracts similar to ours, so I don't think the revenue would be significant.

MR. ELKEN: The issue just being addressed is a very interesting one. This whole area is the subject of many other panels, at this meeting and others. The proliferation of new contracts and new methods of dealing with pricing certainly gets right at this issue. What things compare with the traditional dividend on a participating contract in some respects, and are different in other respects, and how much they are alike, and how much they are different is an extremely interesting subject and will be one that will be dealt with in the future, one way or another. Clearly, there are similarities between the various kinds of what have been dubbed "post-issue price adjustments", and there are also distinctions between several of them, so how do you deal with them?

MR. JEFFREY D. MILLER: To Mr. Bickel on the subject of flexible premium life insurance contracts: I may have misunderstood you. Did you say that the net single premium limitation required or did not require a contract provision in the life insurance contract? I guess I read it to say the guideline premium limitations do require a contract provision but the net single limitation did not. I may have misunderstood that.

MR. BICKEL: I think it is the other way around, Jeff. There are some different interpretations here. It says, by the terms of such contract, the cash value of the contract may not at any time exceed the net single premium, so the alternative limitation must be in the contract. But for the guideline premium corridor approach, such a phrase doesn't appear. I don't think you have to make the corridors and the guideline premiums a part of the contract. They may want to anyway.

MR. ELKEN: I think I would agree with Steve's interpretation that the alternative cash value test or net single premium whole life test doesn't have to be specified in the contract in that way but the terms of the contract have to provide that that is the limit. Any other questions or comments?

MR. ROBERT E. RICH: Steve raised the point of Section 338 replacing the old Section 334(b)(2) for purposes of undergoing tax liquidation after an acquisition. Steve, does the company have an option with respect to purchases prior to the enactment of TEFRA? Can a company still elect to go through the tax liquidation under Section 334(b)(2), or, effective with the passage of TEFRA, is Section 338 the only option currently available?

MR. BICKEL: There was a transition provision which applied to transactions which generally occurred, perhaps, in the second or third quarter of the year, something like that. They do have an option of the old law or the new law. For any acquisition made after August 13th there is no option. Your only option is the 338 election, and you have 75 days after the acquisition date to decide whether or not you want to make that election. You can try to get a ruling in that period of time if you want, but it's a pretty tight time period.

MR. RICH: I guess it's to November 15th, something like that, to elect if you want the 338. The original 334(b)(2) gave you a two year time period. Do you still have the two year period for acquisitions, say, mid 1981? Do we still have until mid 1983 to go 334(b)(2)?

MR. BICKEL: On that, I'm not up to date. I don't think we have that much time, though. You will need to check that yourself. I didn't have a transaction at that time, but I do know there are companies that are trying to decide now whether to change their minds on a particular effective date. But I think they have to decide pretty quickly.

MR. RICH: We were trying to decide which one and then we got to wondering if we even had a choice, whether it was 338 or nothing?

MR. ALAN W. SIBIGTROTH: We've had a good deal of discussion that relates to indeterminate or non-guaranteed premium contracts. Do the panelists have any strong views one way or the other as to whether there are phantom premiums, or whether there are any dividends in these products?

MR. HERTZ: Yes, very strong views. Differing, however. I tend to see dividends almost everywhere. Mr. Dederer tends to see policyholder benefits or whatever. I think there is a dividend in that product, and the so-called "phantom premium" (people who don't like it call it a phantom) is real, and will be accounted for as a bit of revenue which is particularly offset by a deduction which is limited in nature. I think that does create something of a problem. Yes.

MR. ELKEN: I think if we went seeking we could find a second opinion on that point.

MR. BICKEL: Calling a phantom premium a dividend is one of the silliest ideas I ever heard of, but I think that we certainly have to assume the IRS will assert that it is, and frankly as far as consistency among products of different types, there is good practical reason for it being called a dividend.

MR. SIBIGTROTH: Can you analogize it at all to, say, group insurance where you don't have any guarantees, and hence there's no limit as to how much you can have in the dividends or the contracts where you could arbitrarily set your premium guarantee to be $500, for example?

MR. BICKEL: Premiums are the things you collect and pay commissions and premium tax on.

MR. ELKEN: I think the two views that are expressed here pretty clearly give the divergence that's present here, and as a practical matter from some standpoints, you almost have to deal with it as a dividend.

MR. CARROLL R. HUTCHINSON: I understand that the part of the law dealing with universal life that refers to the comparing of the cash value with the net single premium was put in for the primary purpose of controlling adjustable life policies. Is there any evidence that companies using universal life are making wide use of this limitation to qualify?

MR. ELKEN: Let me respond to the first part of that because the company that I'm associated with is an adjustable life writer. Just to go briefly through the history of that, the original ACLI proposal involved a definition of flexible premium contracts which sought to exclude adjustable life type contracts, issued by Bankers Life and Minnesota Mutual and some others, from the flexible premium guideline considerations. This was rejected by the Senate Finance Committee largely because they were not sure as to what

other things that exclusion or that narrow a definition of flexible premiums might get involved with. Through the course of working with Treasury and others, they settled on this alternative cash value test as the way to deal with adjustable life. But it obviously is available for any other flexible premium type contract. I guess I would refer to Jim for commenting on whether or not companies are making use of that.

MR. DEDERER: I don't really know what you mean by wide use, but I think you can safely assume that specific companies will make use of it.

MR. BICKEL: Do you consider that adjustable life is under the flexible premium definition?

MR. ELKEN: Clearly we feel that our form of adjustable life is, and I think Minnesota Mutual does also. That's a good question because there was a question about that point. Largely, the non-scheduled premium or lump sum dump-in is the element of the contract that most clearly puts it under the flexible premium definition, we feel.

MR. BICKEL: As far as whether it is being used, someone told me they thought it would be something like 75% using the guideline premium limitation versus 25% using the alternative.

MR. GOEBEL: This is a nit picking question. For the purpose of either using the $21 or $19, what is an issue after March 31. At Northwestern National and, I suspect, at most companies, contracts are in the underwriting process. They are actually issued, say, in April, May or June, but policy is dated back to March 31, and that maybe all you have on the record, or March 1st or something like that.

MR. ELKEN: Anyone have a ready answer for that?

MR. BICKEL: Whatever the computer shows, I guess.

MR. ELKEN: I suppose we would hope the revenue agents aren't looking into too much detail on that, but I don't know what the answer is. Any other questions?

MR. ALBERT P. BURGESS: My question regards consolidation. In the past, with respect to consolidation or consolidated filings of life companies, there has been a lock-in principal. You elect to consolidate, and you don't get out. Now under the TEFRA, there are some of the obstacles to consolidating that have been removed, as for instance, clarifying how many specials the members of a controlled group get. The question I have is, some of the provisions that are favorable to consolidating are short term, two year provisions, but the consolidation provisions could still wind up locking you in. Two years down the road, the dividend aspect, for instance, could disappear. Does anyone have a good feeling for how easily companies that consolidate during this period could get out of consolidations at a later time if the rules change.

MR. BICKEL: People have told me that there's a good chance that if they changed the consolidation rules, you would have a chance to opt out, but that's as firm as I've ever heard it.

MR. DEDERER: I think you can reasonably assume that, but you can't be 100% sure.

MR. BICKEL: Apparently there is some precedent.

MR. HERTZ: I think there has been a general principal in the past that if a change in the law renders a consolidation election substantially adverse to a taxpayer, that the Secretary will, at that point, allow an election to get out of it.

MR. ELKEN: Any other questions? Many of you are probably looking forward to your workshop sessions tomorrow to hammer out some other points. Well if there are no further questions then we will thank our panel for their contributions. Thank you for your interest and input.