RECORD OF SOCIETY OF ACTUARIES
1983 VOL. 9 NO. 3

U. S. FEDERAL INCOME TAX

Moderator: PETER W. PLUMLEY. Panelists: RICHARD S. ROBERTSON, VIRGIL D. WAGNER, LOUIS M. WEISZ. Recorder: RICHARD K. M. LAU

1. Product design - Universal Life, Annuities, Modified Premium Whole Life

2. Reinsurance - will Section 820 Modco be replaced?

3. Future tax planning.

4. Policyholder taxation.

MR. LOUIS M. WEISZ: The passage of TEFRA clarified and changed some elements of product and policyholder taxation, in spite of the fact that many of the changes were temporary. In some cases, all that was provided was to clear up past matters through grandfathering, but these changes leave some doubt about present and future taxation.

For many mutual companies, the impact of TEFRA was to change them from "Phase 1" companies, (where they were taxed on taxable investment income less $250,000), to "Phase 2 negative" companies, (where they are taxed on operating gain less a credit for dividends to policyholders). Ignoring the effects of modco, TEFRA allowed significant product price reductions for mutual companies' new and existing permanent insurance products because of the significantly larger pass-through on policyholder dividends, and because of the significantly larger pass-through on policyholder dividends, and because of the 818(C) (2) adjustment.

The IRS in mid-June, last year, issued the Massachusetts Mutual private letter ruling on Universal Life. Private letter rulings, you will recall, only apply to the companies to which they are issued. They are not generally applicable to the industry unless the Revenue Service issues a Revenue Ruling. The ruling only applies to Massachusetts Mutual and its stock subsidiary MML Life. Under the contract, in the ruling, the policy form for the Massachusetts Mutual policy was par, that of its subsidiary was non-par. There were two holdings in that ruling. The first one was on the indeterminate premium portion of the term insurance in the contract. It says that the phantom premium, i.e., the excess of the permanently guaranteed maximum premium over the rate actually charged is a policyholder dividend which is immediately paid back to the company as a premium - whether in the mutual or the stock company.

Then TEFRA came along in the summer, and grandfathered 1981 and prior years by stating that it is not premium income. But TEFRA did not draw any conclusions for treatment in 1982 and later.

The second holding under the Massachusetts Mutual ruling was that for both companies, MML Life and Massachusetts Mutual, the excess interest was a dividend. Within a week after that ruling was issued, the Revenue Service issued Revenue Ruling 82-133 on excess interest. That ruling was written for a single premium deferred annuity contract and described both the treatment for a par contract and non-par contract. The Internal Revenue Code provides that dividends to policyholders include not only dividends, but also similar distributions. The legislative history behind the 1959 Act states that "dividends" includes distributions made to the policyholders out of the company's shares of investment yield. IRS regulations define a participating contract as containing the right to participate in divisible surplus and states that amounts paid pursuant to such contracts shall be treated as dividends to policyholders. Under the annuity contracts in the ruling, the excess amount credited over the guaranteed rate is subject to the discretion of management. It is not fixed in the contract, and is dependent upon the experience, (whether past or future) of the companies. The ruling holds that the excess is similar to dividends of the policyholders.

However, the ruling then goes on to the grandfather interest on reserves up to the date of the ruling and certain interest up to 1987.

TEFRA gives permanent relief here on some contracts. It provides on non-par, non-pension contracts a deduction of 100% of interest credited on "qualified" annuities if interest is guaranteed in advance (at a fixed rate or with a formula) for a period of not less than 12 months. If a formula is used, the rate may vary over a 12-month period, but the formula must be independent of the experience of the taxpayer. A "qualified" contract does not refer to a qualified pension plan, but it is one that involves life contingencies and provides for the payment of excess interest. Participating contracts are included if they meet all the other requirements (i.e., except non-par) but the deduction for them is 92½% instead of 100%. TEFRA grandfathered existing contracts as of last August 13 with interest guarantees for 12 months for money held at that date and any interest earned thereafter. Contracts issued after August 13 and before January 1, 1983 must conform to the new provisions by the first anniversary after January 1, 1983.

Now, what happens to the treatment of policyholders under deferred annuities? TEFRA made some changes here. Prior to TEFRA, policyholders were taxed on a FIFO basis so that a policyholder first takes out his principal, and then his interest once all the principal had been withdrawn. The policyholder was only taxed to the extent that he or she took out interest. TEFRA, however, changed the rules from FIFO to LIFO. The intent was to tax people who were investing in annuities as tax shelters. Some people were pulling their interest out every year, but because they treated this interest as a return of principal, they were really paying no current tax.

TEFRA distinguished between contracts made before and after August 13 of last year. The treatment of this is spelled out exactly in the explanation of TEFRA that was published last December 31. On any partial withdrawals, you first take out the pre-August 14 money, - the principal, then the interest earned on principal contributed after 8/13/82, and finally the principal contributed after 8/13/82. There is a 5% penalty on interest withdrawn from post August 14, 1982 contributions, when withdrawn in 1983 or later, unless certain conditions are met. There is no penalty if the money has been there at least 10 years, or if a policyholder has reached age 59½, or has died or become disabled, or has received payments either in life annuity or substantially equal payments over at least 60 months. For purposes of the penalty, a policy loan is considered to be a withdrawal - as well as pledging the contract for a loan. Also, dividends paid out in cash to the policyholder (but no dividends left with the company) are classified and included in income according to the pre and post August 13, 1982 rules.

Next, I will talk about Modified Premium Contracts. Modified Premium Contracts are really graded-premium life type of contracts and include, for the most part, 818(C)(2) adjustments. When the 818(C)(2) adjustment was brought into the 1959 Act, it was mainly an aid to small stock companies. Now almost all mutual and stock companies use CRVM reserves. In particular, it is being abused under certain types of policies. Many policies which are at best renewal term are being called increasing premium whole life policies in order to get the $19 benefit under 818(C)(2). Some policies might, in fact, have trouble qualifying for the $5 deduction, e.g., the premiums may be very similar to yearly renewable term contracts, as the policies may not have a cash surrender value until the contract has been in force for many many years; or the premiums may be like an ordinary life policy only when the insured has reached a ripe old age.

The General Explanation of TEFRA prepared by the Joint Committee on Taxation discusses this and suggests that the policy should have a substantial cash value within several years after issue, or level premiums should be charged within several years after issue. It mentions that the Treasury is expected to issue regulations on this. Many people feel that 818(C)(2) has only very limited life left.

Next, I will talk about Flexible Premium Contracts. The intent in TEFRA is to define what a life insurance contract is. For example, to define whether a contract with a very large cash value but a very small net amount at risk is life insurance. This definition will determine the taxability of policy proceeds to the policyholder's beneficiary. Congress felt the flexible premium life contracts should have the same tax treatment as traditional level premium whole life contracts if they were substantially comparable to traditional contracts.

Under permanent provisions of TEFRA, a flexible premium contract is defined as a life contract which provides for the payment of one or more premiums that are not fixed by the company as to both timing and amount. Indeterminate premium policies do not really fit here since they have both guaranteed maximum premiums and fixed billing dates. But certain additional benefits, such as waiver and accidental death benefit, are allowed under the contract.

In order to be treated as a life insurance contract, there are certain mandatory guidelines that a policy must meet. If the contract doesn't meet the guidelines at any time over the life of a contract, the contract will not be treated as providing life insurance for beneficiary tax purposes. There are two tests. The first test has both premium and death benefit components. The second test is the alternative cash value test. Under the first test, both components must be met. The premium component states that the sum of premiums paid cannot exceed the single premium at issue or the sum of level premiums necessary to fund the death benefit of the contract and any permitted additional benefits. The premium limitation guideline means the greater of: (a) the single premium necessary to fund additional benefits under the contract based on the mortality and other charges in the contract and interest at the greater of 6% and the rate guaranteed in the contract and (b) the sum of the guideline level premiums (payable over the life of the contract but not less than 20 years) which are computed on the same basis as the single premium, except that the interest rate cannot be less than 4%. However, a premium exceeding the guideline premium is permitted if it is necessary to prevent the termination of the contract before the end of the contract year. If this test is violated, the insurer has 60 days after the end of the contract year to return the excess premiums, and any interest on them, and still meet the guideline test. Under the death benefit component, the death benefit (ignoring any additional benefits) must never be less than a specified percentage of the contract's cash value, namely 140% of the cash value for ages 40 and under, reduced by 1% a year for each age above 40, but not less than 105%.

The contract will meet the second test if the cash value at any time will not exceed the net single premium, ignoring any additional benefits. The net single premium must be computed using the most recent valuation mortality table an assumed rate of interest which is the greater of 4% and the minimum in the contract, and a maturity date of not earlier than age 95. For contracts issued before July 1 of this year, the assumed interest rate, could be 3% instead of 4%.

These provisions are applicable to contracts issued before 1984. Contracts issued before 1983 may qualify if they conform within 1 year after the enactment of TERFA, and they can qualify by computing the level premium in the contract at an assumed rate of 3%.

Now what might the future bring? John Chapoton, Assistant Treasury Secretary for Tax Policy, spoke on March 1 of this year to an industry group and discussed restricting favorable tax treatment for short-term investment vehicles by not treating them as life insurance.

He discussed splitting investment weighted policies into the traditional life feature and the investment feature - and then limiting the favorable tax treatment to the insurance side. Let's hope that the "insurance side" does not end up to be just term. He then questions whether the tax on the saving portion should be done by a supplemental tax on certain portions of investment income that would serve as a "proxy" for tax that might otherwise be imposed at the policyholder level. He questions whether tax benefits should be continued for certain non-term plans which result in little net savings - e.g., plans emphasizing tax benefits from systematic policy loans.

I wonder, has his position been affected by the new form of policies which split the protection and saving elements? Recall that for many years actuaries claimed that the ordinary life contract was a single contract and could not be split between protection and savings. And how has his effort been affected by lobbying of the banking and mutual fund industries? As an integral part of this, there is an asset accumulation function. Thanks to modern day computers, the traditional ordinary life product is appearing in other forms. If the tax situation has changed so that there are heavy taxes on the asset accumulation function there will be very little of non-tax-qualified permanent life insurance sold. The life insurance industry, both the stocks and the mutuals, have a vested interest in seeing that the favorable taxation of non-tax-qualified products is continued.

MR. RICHARD S. ROBERTSON: I want to thank Mr. Weisz and his associates on behalf of all of us, for their involvement in the design and writing of universal life insurance premium products, and for their valued efforts towards clarifying the tax law with respect to those products. Your efforts have not gone unrecognized. However, I think there is some room for criticism on the part of everyone involved in the development of the tax law. As we get on, I want to try to talk a little bit about how I perceive all the various players are motivated in this. That is necessary to understand where we are going and where we are likely to wind-up.

At this stage of the program, I'm prepared to talk about tax planning. I am not going to say a great deal because it is my perception that there is not a high level of tax planning going on at the present time. This is not unreasonable when one considers that in order to do effective tax planning, one must know what the current tax law is, and what it is going to be in the future. Clearly, we don't know what it will be in the future, but even the present law has no regulations, no judicial test. A great deal that might be done on the tax planning can't be done because of uncertainty as to how the tax actually can be applied. There are a number of areas that represent things that the planning people, (actuaries, attorneys, and accountants), will look at as opportunities to reduce tax liability.

Perhaps, the most significant involves, what is for most companies, a basic change from a tax based on investment income to one based on operating income. It means that particularly all elements of expense, acquisitions cost, commissions, and various development costs, are tax deductible and in a sense the cost of spending money is considerably reduced. The fact is that if one were to presume that this is a very temporary law and that we would only be taxed on operating gain for a short period of time, proper tax strategy would call for a very rapid acceleration of expenditures during this window so we could get the government to finance part of our growth.

Another area that the companies will always look at with respect to tax laws involves investments. The 1982 law for most companies does make tax exempt investments more attractive than they have been in the past, along with investment markets also making tax exempt investments attractive. If one assumes that the current law will continue in its present form for any length of time, one would try to commit substantially increased amounts of money to state municipal bonds, common preferred stocks, and other tax favored forms of investment. Some of this is being done, but it is very difficult to make a commitment of long term investment money under a law that will, on this matter, expire in a few months. And many of us don't have a great deal of money that we are looking for an investment opportunity to use. We are putting a high priority on building up our liquidity. Hence, I don't see the type of shift in investment emphasis one might expect if we had a permanent law.

The talk is about reinsurance, of course. Are there opportunities under the 1982 law to significantly reduce taxes through reinsurance? Here again, because of the very temporary nature of the law, companies are reluctant to invest substantial resources and make long term commitments that may not turn out to be desirable strategies in retrospect. The 1982 law does tax different companies differently depending on their tax position. That is, it is not a one phase law. Companies that are in a position where they can defer part of their operating income, or defer a percentage of group insurance premiums, or, some of other deferral benefits, have a very substantial marketing advantage where other companies that don't and, unless one is willing to assume that this is a temporary situation, a company that does not have the advantage of these benefits is going to have to structure its affairs until it gets them. Otherwise, it will not be able to compete in the market place. If the current law were to become permanent, there would be a substantial movement, not just involving reinsurance, but other activities to try to get those favored categories of business into the companies that can get the benefits of these deferrals. Therefore, in the long run, it is my belief that the question of whether reinsurance or other ways of moving business among companies will be used extensively, will depend to a great extent on whether or not different companies are in different tax positions. There are also other areas where one might consider the use of reinsurance. For example, companies that are not in the tax paying position may seek forms of reinsurance to place business with companies that are, and therefore, shift the acquisition costs to a company who can use it. This kind of tax planning goes on in different forms in many other businesses as well. These are some of the kinds of things that we can look forward to in the future.

We must keep in mind of course, the Government, Congress, Treasury, and Internal Revenue Service. These are all the comments I have on tax planning. I think that those of us that have tax planning responsibilities really believe that given the high level of uncertainty, our primary efforts should not go toward minimumizing one year tax liabilities but trying to help focus the attention of what kind of tax law will be appropriate in the future years, and to try to analyze what that might be and what the implications might be for the strategic planning for our organizations.

MR. VIRGIL D. WAGNER: When Mr. Plumley first asked me to participate in this panel, I wondered what, if anything new, there was going to be to say about Federal income taxes of life insurance companies. I knew that you had already had many occasions to hear about the provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, and it wasn't apparent that any progress would be made toward the replacement of the stopgap legislation. While I am not sure that what has happened can be called progress, there has been quite a bit of activity on which to report.

First, I will begin with where we stand right now, and then back up to fill in the intervening period.

Immediately following the passage of TEFRA, the American Council of Life Insurance (ACLI) Board of Directors appointed a new, expanded Steering Committee for company tax legislation. The Steering Committee is made up of Chief Executive Officers of ACLI. Its purpose was to develop an industry position on permanent legislation for the taxation of life insurance companies. As of this date that Committee has been unable to reach a consensus. Therefore, there is no unified industry position at this time.

At its regular meeting, the Board of Directors of the ACLI decided to become more aggressive and, in effect take over where the Steering Committee left off in attempting to develop a compromise which could be acceptable to all segments of the industry. The Board has scheduled a special meeting for June 10, and if sufficient progress is made, will schedule a general membership meeting some time after that. So, although we have no unified industry position at this time, the effort continues.

Since TEFRA, considerable interest in permanent tax legislation for life insurance companies has been shown by various government officials. First, on October 8, 1982 Senator Robert J. Dole, Chairman of the Senate Finance Committee, announced that he had directed his staff and the staff of the Joint Committee on Taxation to prepare reports on various options for comprehensive revision of life insurance company taxation.

In his press release, Senator Dole said it was his hope to get a basis for real reform, and he expressed the opinion that for too long the legislation relative to taxation of life insurance companies has not been sufficiently flexible to adapt to changing needs.

On November 10, Representative Daniel Rostenkowski, Chairman of the House Ways & Means Committee, in a speech to the ACLI Annual Meeting, called for industry and government cooperation in developing tax changes. He promised active participation and noted that life insurance company taxation would be considered within the context of other financial institutions.

Just after the convening of the 98th Congress, it was announced that Representative Fortney H. Stark (Pete Stark) had been assigned the issue of life insurance company taxation for study by his House Select Revenue Measures Subcommittee. Soon after that, Senator Dole sent a letter containing eight specific questions to the ACLI. The questions were to help him determine a proper theoretical basis for taxation of life insurance companies. These questions ranged from matters of proper accounting, to the role of life insurance companies as capital providers.

On March 1, we got some insight into Treasury thinking when Assistant Secretary John Chapoton spoke to the annual meeting of the National Association of Life Underwriters. He stressed the need to review the investment aspects of life insurance contracts within the context of all financial intermediaries. For taxation at the company level he suggested a focus on the correct measurement of economic income with results fair to both mutual and stock companies.

Meanwhile, the ACLI Steering Committee group was exploring the elimination of the phase system of taxation. It was soon recognized that the various complex proposals were too tough to deal with in detail in such a large group. Therefore, a negotiating team of 8 members--4 mutuals and 4 stocks--was designated to hammer out a proposal which the Steering Committee could then consider and, hopefully, adopt. After a number of meetings, the negotiating team had failed to achieve its objective. The task was then assigned to just two members--Mr. Robert Beck, of Prudential, and Mr. Ian Rolland, of Lincoln National Life. They did result in a proposal which was considered by the Steering Committee, but as I have already said, without a consensus being reached.

The Beck-Rolland proposal was a single-phase system of taxation, oriented to "Gain from Operations." The proposal first identified classes of individual life insurance other than traditional non-par, i.e., par, universal life, indeterminate premium, variable life, indexed products, etc. For these plans the tax reserves were the CRVM reserves with a cash value floor. Dividends to policyholders were broadly defined to include excess interest and phantom premiums and were 100% deductible for stock companies and 92½% deductible for mutual companies. No special non-par deduction was available for these plans.

For individual traditional non-par insurance, a company could elect a net-level reserve on an exact basis, or use the CRVM reserve with the cash value floor. Both new and old business were valued in the same manner under both elections. For traditional non-par insurance, a non-par deduction of 4% of premium was allowed for business issued prior to 1984 and 3% for business after 1984.

The Beck-Rolland proposal phased out the 50% deferral of excess gain from operations with protection of policyholder's share account overhand. The accident, health and group life deferral of 2% was changed to a ½% deduction available to all stock companies. Dividends on accident and health and group life were 100% deductible. Other provisions included: life, non-life consolidation at 100%, elimination of proration of dividends to a stockholder parent, taxation of subsidiaries based on their own legal form, deductibility of credits to qualified pension business at 100%, and the TEFRA treatment of non-qualified annuities. A small company deduction and a definition of "life insurance company" were to be developed and included.

While this was going on, Representative Stark, who has a background in insurance, both as a student and as an agent, was enthusiastically doing his homework. He had held numerous meetings with staffers to prepare himself on the subject, as well as special meetings with various industry representatives to discuss the subject. Those on the scene were impressed by his diligence and expanded knowledge of the subject in preparation for the hearings of the Select Revenue Measures Subcommittee which were held on May 10-11.

Two full days of testimony at the hearings ranged from the academic and theoretical, to the very pragmatic. I will give you some detail on the testimony of three witnesses of particular interest to you. That is the testimony of Assistant Treasury Secretary Chapoton, the testimony of a group of stock companies, and a group of mutual companies. Before I do that, however, let me discuss one of the specific subjects which was common to the testimony of all three and for which there is some agreement at least in general principle. That is the subject of a definition of life insurance.

Assistant Treasury Secretary Chapoton and Treasury staff have suggested at various times the need for a definition of life insurance to control the use of life insurance products as investment vehicles which benefit from special rules of life insurance taxation. Mr. Chapoton testified that the more narrow the definition of life insurance, the less need to reconsider the treatment of life insurance taxation under various sections of the code. The mutual group suggested a definition of life insurance which would relate the cash value under the policy to a net single premium for the current benefits provided by the policy. The stock company group testified that a definition of life insurance along the lines of the IRC Section 101(f) definition which was included in TERFA should be included in any permanent tax legislation.

Since the need for a definition of life insurance of some kind is generally agreed to by all segments of the industry, a task force at the ACLI continues to work on development of such a definition. While there is general agreement for the need, let me emphasize that there is room for considerable compromise in determining where the line which separates life insurance from investment should be drawn. A major concern is that if too liberal a definition is proposed, there may be additional incentive to restrict deductibility of loan interest or the exclusion of interest credited to reserves (the inside build up).

Treasury testimony was based on the premise that all permanent life insurance can be split into two components; an insurance component and an investment component. Tax treatment of life insurance in pension products has made this split in the past, and this thinking is not new to Treasury. They provide considerable background information on various life insurance products showing the two components and the current tax treatment of them.

Mr. Chapoton expressed four areas of concern relative to taxation of the policyholder. The first is the need to define life insurance. I have already discussed his comments relative to this subject.

The second area of concern is the tax treatment of life insurance, and its consistency with policy objectives. The full death benefit under a life insurance policy is excluded from income on death, including the investment income portion. Mr. Chapoton stated he did not think it appropriate to reconsider this long-standing feature of tax laws at this time. However, it may be appropriate to consider whether all investment income should continue to be exempt from current tax. Some of this income is used to pay future mortality costs, but the remainder is added to the policyholder's savings, and Treasury questions why all such earnings should be given more favorable treatment than a savings account. A sufficiently restrictive definition of life insurance would alleviate this problem.

The third area which Mr. Chapoton would give consideration is that of rules relative to surrender, withdrawal, and loans under life insurance policies. In the case of surrender, Mr. Chapoton indicated it may be desirable to deduct the cost of insurance from the investment in the contract when determining the taxable gain. With respect to withdrawals, he indicated that the ordering rules which were applied to annuities in the TEFRA legislation should be considered for life insurance. These rules would state that the amounts withdrawn are first gains, if any, which are taxable and secondly, the investment in the contract which is not taxable. Finally, he suggested some limitation on life insurance policy loans patterned after the new TEFRA Section 72 rules on qualified pensions as a guide.

The fourth area of concern is relative to group term life insurance. For group term life insurance it was suggested that the use of a uniform table for Section 79 be reconsidered, that the unlimited exclusion for retired persons be eliminated, and that the anti-discrimination rules of Section 79 (d) be extended to all Section 79 coverage, not just the $50,000 exclusion amount.

Mr. Chapoton's testimony included an additional four areas of concern with respect to life insurance company taxation, which he said should be examined closely. First, he indicated that the effective exemption of one half of underwriting income should be reviewed. This is of benefit to only a few stock companies and encourages creativity in reclassification of income.

The second area which deserves review is the deduction of policyholder dividends. Policyholder dividends represent both a return of premium or investment income and a return on equity in the company. To the extent that the policyholder's dividends represent a return on equity, they should not be deductible. He suggested the possibility of inputing earnings on yet to be determined capital contributions for mutual companies.

A third area of concern, relative to company taxation, is the deferral for non-par and accident and health and group life insurance. These, too, provide incentive to enter into non-economic agreements in order to benefit from the deductions. It is questionable whether or not the deductions themselves are justified.

The fourth and final concern expressed relative to life insurance company taxation is the treatment of policy reserves. Assistant Secretary Chapoton suggested that the reserving process allows acceleration of deductions through pessimistic mortality assumptions, low interest rates, and unrealistic assumptions relative to loading charges, i.e., use of net level reserves. This is further aggrevated by use of the formula to approximate reserves.

The basic thrust of a statement supported by 53 mutual companies is that the 1959 Act is flawed and must be replaced. Any replacement should tax the true economic income of the company and should proceed from rational principles, rather than pre-selected revenue objectives. Four basic criteria were given which any new tax formula should meet:

1. A full deduction should be given for all business costs and created older credits. No artificial deductions should be created by the law.

2. A deduction for reserves reasonably computed should be allowed.

3. A tax law should not cause a distortion in competition.

4. The result should be consistent with taxation of other financial institutions.

Following the general format and stated criteria, some specific issues were addressed with certain recommendations. In the product area, it was suggested that all features of flexible pricing must be treated the same. For example, policyholder dividends, excess interest, or non-guaranteed premium features are all forms of flexible pricing and should be treated similarly. It was further stated that the same treatment must apply to similar products, regardless of the type of company. On the subject of ownership differential. it was pointed out that the policyholder's interest in a mutual company is not like that of a shareholder's interest in a stock company.

This interest is not marketable and cannot be exchanged for value. It was pointed out that even if an ownership differential exists, it is small, and that any capital contribution which was made by policyholders was included in the company's income and was taxed. Hence, any dividends relative to these contributions should be deductible. The mutual companies suggested that a minimum tax on positive economic income from operations would be reasonable and could be patterned after rules already existing for general corporations. Arguments were presented in favor of tax-free inside buildup, elimination of proration of exempt interest, full deductibility of credits to pension plans, and elimination of tax on the investment income earned on group welfare plans.

Stock company testimony was given for the stock information group -- a group of 120 stock companies. The position of the stock group is predicated on the fact that the 1959 Act furnishes the soundest foundation for a workable ongoing system of taxation for life insurance companies. Therefore, a new structure for the permanent law is not necessary. The stocks also posed three basic principles which should guide the movement to a permanent solution:

1. There should be full deductibility for amounts credited to policyholders as customers.

2. Any residual profit should be taxed at the corporate rate.

3. There should be a recognition of the special problems of measuring net income over time because of risk assumptions inherent in this insurance business.

In addressing the deductibility of full amounts credited to policyholders, it was pointed out that excess interest and indeterminate premium plans simply are methods of adjustment to the amounts credited to policyholders. These credits transfer value from the company to the customer just as guaranteed interest does and should be treated in the same manner.

On the issue of mutual company dividends to policyholders, it was stated that a substantial portion represents a return in the nature of equity dividend to the owners. Theoretical computations had been prepared which showed the non-deductible portion of dividends to policyholders for mutual companies which represent return on equity. One approach set this proportion at 39% and another approach set it at 45%. Calculations based on the 1959 Act without the TEFRA changes would have disallowed 43% for the same year of calculation -- a figure which falls in the middle of the range of the stock companies' theoretical calculations.

Comments relative to the need for deferrals reiterate the profit measurement problem inherent in long-range contract guarantees and the need to hold contingency funds out of shareholders earnings. It was pointed out that a lower diversification in group insurance frequently exists than in the general portfolio. It was proposed by the stock company group that these deferrals in the 1959 Act be removed by election from the limitation under 809(f) so that they would be available to all stock companies.

Permanent legislation proposed by the stocks would retain TEFRA provisions relating to bottom line consolidation, geometric Menge, Section 101(f) guidelines, the limitation on group pension deductions, and the life company qualification rules. They would also continue the increased statutory deduction of $1 million with special deductions for small companies. A stock company, owned over 50% by a mutual company would be treated as a mutual for tax purposes.

As you can see, Representative Stark and his Subcommittee did not get a single answer as a solution to the problem. I am sure they did not expect one. The concluding comments which Representative Stark left were a hope and a promise. His hope is that the industry will get together on a proposal, which would make his job much easier. His promise, however, was that he will have a bill this year, and he will have it whether or not the industry unifies. He considers the extension of stopgap to be a very last resort and indicated that if it comes to that, stopgap would be extended only with a "toll charge".

As to what may or may not happen, your crystal ball is as good as mine. A lot will depend on whether there is a budget bill and/or a tax bill. If there is a movement to raise taxes, the life insurance industry is in the front row, with an author of a bill ready, willing, and able to help solve the problem.

MR. ROBERTSON: What I am going to do in this section is to give you my perception of where things seem to be going, and particular interests various groups have in the process. Also, I'm going to warn you from the start that it is going to be a very subjective discussion. Everyone involved has his own perception as to what's going on. And I don't know whether my perception is better than anybody elses, probably not, but I think it might be useful to many of you to at least talk about this for a little bit. Let me first talk about where the stock companies are.

To begin with, the stock group is a very heterogeneous group. It is not a unified block, there are many companies with many different competing interests involved. There is a group of stock companies that finds the 1959 law very attractive. It gives those companies competitive advantages and produces an attractive level of taxation. These are among the companies that are most actively supporting the restoration of the 1959 law and these companies are, of course, acting out of their own self interest. The problem is that what is in their self-interest is not in the interest of the rest of the industry and while they're certainly entitled to argue for their position, they should not expect the rest of us to support them, and ultimately we won't. There is also a group of companies that is not in this position but, because of the way deferred taxes are calculated, their earning statements tend to make them look as if they are in that position.

These companies, I have a harder time understanding. Basically, what they are doing is a very poor accounting rule; a method of calculating deferred taxes that is not consistent with economic reality. And they are letting bad accounting drive business judgements that are adverse to the interest of the company and stockholder.

I'm hopeful that some of these companies will realize before the process gets too far that this is not really where they ought to be. Then, there are the companies that are predominately writing universal life and other non-guaranteed products. Some companies believe that they have a strong case that excess interest is not dividends. Others are not willing to gamble the large amount of dollars that would be involved in trying to get a judicial determination of that fact. In order to recognize the interest of these companies, the ctock company bill specifically characterizes these non-guaranteed elements as expenditures and not as dividends. If we could presume that this would hold up in legislation, these companies would want to continue to support the stock company bill. Companies that are predominately term-writers also have an interest. Many of these companies have a strong interest in maintenance of section 818(C)(2). The stock group is working hard to accommodate their interests as well. The bill proposed by the stock group has something in it for everyone of these groups. If it is passed in its present form, all will be happy. The problem is, by doing this, it produces a bill with the mutual companies paying something like 75% to 80% of the total for the life insurance industry.

Even the advocates of the stock group have a hard time justifying that with a straight face but the problem is that once you start trying to modify those percentages, you can't keep all these various sub-groups of the stock group happy with the result. That is probably the biggest problem the stock company group is going to have in pursuing its interest on Capitol Hill. I speak with even less authority as to what the mutual companies are striving for. They start with a very simple concept that says "let's just tax income." We have had many discussions over how easy it is to determine what income is. If you come right down to it, income is defined in such a way that it will produce substantially no tax for most mutual companies. Therefore, the mutual company bill produces about the desired level of tax with about 75% to 80% being paid by the stock companies. I can't tell you how sincere or how dedicated they are to that proposition, but I suspect that they realize that's not an appropriate approach either. I do believe that the most important consideration driving the mutual companies is - they cannot tolerate a tax law that would tax a product sold in a mutual company so heavy that it cannot effectively compete with a similar product sold to the stock company, and I guess that's a position that I have considerable sympathy for. The tax laws are supposed to be neutral with respect to a matter such as this. Unless, there is a strong social policy to favor one segment of the industry over the other, the law should not do so. That clearly is a big concern of the mutual companies. This is not to say that we are anywhere close to an agreement as to how you design a tax bill that is neutral.

Perhaps, the biggest issue dividing the stock and mutual companies is, "is there a so-called equity interest by the policyholder in a mutual company contract?" And if there is, how do you measure it?

How do you identify that portion of the return to a mutual company policyholder that represents profits, and therefore should be subject to income tax? How do you separate that from the part that represents refund of excess redundant premiums?

As to the 7½% that is in the 1982 law, I honestly believe it is a little on the low side. The Beck-Rolland proposal, which also had that 7½% differential did tend to favor the mutual companies. I don't expect Mr. Weisz or any of our mutual associates to agree with that, but I do think that in the long-run, one of the elements towards building something they can get wide support in the industry is going to be increasing that differential, perhaps something around 10%.

What's going on now is that the stock companies are going up to Capitol Hill and telling Congress and congressional staffs with incredible skills how they can get large amounts of tax revenue from mutual life insurance companies. Mutual companies are going up to Capitol Hill and telling Congress and congressional staffs how they can get large amounts of tax revenue from stock life insurance companies. Congress under severe pressure to reduce the amount of a deficit is taking very careful notes and undoubtedly will find ways to use suggestions that are coming from both sides. In the meantime, the longer this goes on, the more expensive it is going to be for all of us. Partly because no one really has a clear perception of what he is likely to get, I think we all have unreasonable expectations as to what's possible.

Until those expectations get dampened, it's going to be very difficult for anybody to give up something that, at this point, is perceived as being possible. But it is going to have to happen. At some point along the line, the range of options is going to narrow to the point that our primary interest is in getting a tax program that will allow the life insurance industry to effectively compete against other financial institutions, to effectively serve our customers to effectively provide the kind of protection that life insurance traditionally has provided and done very well. And we are going to realize that we have more important things to do than spend large amounts of time on Capitol Hill lobbying for taxation.

In the meantime, what is going to be the tax law for 1984? The people who seem to have the best track record in forecasting this sort of thing believe that it will not be possible to get any permanent solution this year. They also believe that a return of the 1959 Act will not be allowed to happen, and there will be some form of extension of the current law probably with some modifications. My own scenario modifies this a little bit. It says "Yes, that will probably happen, and it will probably happen with a bill that is passed as Congress rushes to adjourn for the political conventions next summer." Which, you realize that will mean we will spend the first half of 1984 not only not knowing what the future tax law is going to be, but not knowing what the current tax law is, and that will make it extremely difficult for us to price our products to set dividend scales, and do a lot of the other things we need to do to get our job done. Partly for that reason, I feel that it is absolutely important that we focus our resources in getting the tax thing fixed, rather than continuing the present battle.