RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 2

FEDERAL INCOME TAX

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This session will review the status of Federal Income Taxation with respect to:

- Life Insurance Companies
- Policyholder Taxation
- Current Legislative Outlook

MR. STEPHEN D. BICKEL: Our panel will be talking about the new federal income tax bill for life insurance companies and life insurance policyholders.

The tax system for life insurance companies since 1959 has been a very complicated three phase system. The system broke down a few years ago when some of the brighter members of the actuarial and legal professions found major loopholes in it. The replacement, a stopgap law which applied in 1982 and in 1983, has expired. We are now under a law that is similar to the 1959 Act, but without some beneficial provisions.

The proposed legislation in Congress would be effective in January, 1984. The original version of the Bill, called the Stark/Moore Bill, was developed last fall. It was negotiated by Congressmen Stark and Moore with both sides of the life insurance industry. Many changes have been made by the Senate and these differences will be worked out in a Conference Committee.

I will try to describe the general structure of the Bill. The tax is based on the gain from operations. The reserves used to determine the gain are generally based on the minimum state law standards as defined by twenty-six states. These reserves will typically be quite a bit lower than the reserves which were being used under the 1959 Act. The difference between the reserves on the old basis and the reserves on the new basis at the beginning of this year will not be taken into income.

The gain from operations is reduced by the special life insurance company deduction. Under the House version, 25% of the gain from operations will be available as a deduction, which reduces the corporate tax rate from 46% to an effective 34.5%. The Senate version reduces the "haircut" to a 20% deduction, which equates to an effective corporate tax rate of 36.8%. The rationale for this deduction is that it offsets adverse features of life insurance taxation which are not found in the treatment of other corporations, particularly other financial institutions. Other financial institutions do not have limits on the deduction for tax-exempt

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interest and corporate dividends received, for example. Banks can set up bad debt reserves, while life insurance companies may not.

Another deduction is the small life insurance company deduction. This deduction is 60% of the first three million dollars of gain from operations, and it is phased out for larger companies. The definition of a small company is expressed in terms of the entire controlled group of which it may be a member. This deduction is a tradeoff for certain features of the prior law which benefited small companies.

The remaining significant feature of the Bill is that the mutual companies are treated differently than stocks. Those on the stock side refer to this difference as the ownership differential and those on the mutual side call it an add-on tax. Each mutual company must add to the gain from operations portion of taxable income a percentage of its equity.

There are some key issues that need to be resolved in Conference. One of them is the difference between the 20% and the 25%. A second issue is that the Senate version contains an alternative deduction to the special life insurance company deduction and the small life insurance company deduction. The alternative is the "Allowance for Risk Capacity, (ARC)". The deduction was intended to be 20% of first year premiums for individual life insurance contracts - direct premiums minus reinsurance ceded but without consideration of reinsurance assumed. This deduction was proposed as an optional alternative to the other two deductions. That proposal did not survive intact and now we have ARC with a sunset. The ARC deduction is phased out over five years as the other two deductions are phased in. In 1984 you would have 80% of the ARC deduction plus 20% of the "haircut" and the small company deduction. In 1985 you would get 60% of the ARC and so on, until it phases out in five years.

Another issue is the capital gains tax on variable annuities and variable life insurance. In the Senate Bill there is a provision which would eliminate the tax on capital gains in separate accounts. This provision is of particular importance to variable life insurance contracts, universal variable life insurance and variable annuities. Under the 1959 Act there is double and sometimes triple taxation on these capital gains because the policyholder has to pay a tax as well.

Now that we all understand this nice simple bill, our panel will discuss it in more detail. We'll start with a discussion of the mutual company add-on tax by Walt Juncker.

MR. WALTER JUNCKER: Congress has had much difficulty in developing a basis to tax the life insurance industry and even more difficulty in modifying the basis to accommodate the two predominate corporate forms in the industry, stocks and mutuals.

The 1959 Act was not satisfactory in allocating the industry tax burden. Inflation and the resulting high interest rates increased the minimum tax base of companies with large participating blocks to higher and higher levels. As a result, fewer and fewer policyholder dividends were deductible in the computation of taxable income.

A new approach was needed which was somewhat acceptable to all segments of the industry: large mutuals, small mutuals, large stocks and small stocks.

After a long summer of negotiations a theoretical basis for taxation emerged.

The new basis relies primarily upon several key assumptions. First, the life insurance business is a commercial industry with a profit orientation. Second, policyholder dividends paid by mutual companies, to some extent, are a distribution of company earnings to the policyholders as owners. Third, the portion of a policyholder's dividend that is a distribution of earnings can be measured as a percentage of the mutual company's equity. Lastly, the appropriate percentage can be obtained by comparing the after-dividend rate of return on equity for both stock and mutual companies. The difference is deemed to be profits paid out by the mutual companies in the form of dividends.

The product of the differential earnings rate multiplied by each mutual company's equity is equal to the add-on taxable income. In the proposed law, it is expressed as a reduction of the policyholder's dividend deduction that otherwise would have been available.

With the above assumptions and the political decision that the industry tax bill would be split 55% for mutuals and 45% for stocks, a method of alculating an add-on tax was developed. In order to calculate the add-on axable income, a numerator component and a denominator component must be leveloped for each stock or mutual company involved in the process for each axable year. The numerator component is the statutory gain from perations (adjusted to the tax reserve basis and for realized capital gains), while the denominator component is the average equity base. The last item is defined to be equal to the mean of the beginning and ending statutory capital and surplus balances adjusted for the excess of statutory reserves (including deficiency reserves and any voluntary reserves) over tax reserves, the mandatory security valuation reserve, nonadmitted financial assets, one-half the provision for policyholder dividends to be paid in the following year, and for deferred premiums.

The stock companies' rate of return for any tax year is the average of the rates of return of the fifty largest (gross assets) stock life insurance companies. Stock life insurance companies which are members of a controlled group are considered to be a single company. The average is obtained by adding the fifty rates of return together and dividing the sum by fifty. Thus, the largest and smallest stock companies have equal weight in the average rate of return.

The mutual companies' rate of return for any year is a weighted average. The sum of the numerator components of all mutual companies is divided by the sum of the denominator components. The large mutual companies have more impact on the rate.

For the tax year 1984, the stock companies' rate will be set at 16.5% in order to achieve the proper segment balance. This number will be adjusted up or down as the three-year moving average of the stock companies' rate of return changes from a base period average rate. The base period includes 1981 through 1983. The difference between the imputed stock company rate and the mutual company rate will be multiplied by each mutual company's equity to obtain the add-on taxable income.

There are a few adjustments in computing the equity base for certain mutuals. The principal one is for mutual companies with an equity base that is large relative to that of all mutual companies. There is a five year transition rule for large surplus mutuals in which they can ignore a part of their equity base before they apply the differential earnings rate.

One of the big questions is how well the add-on tax will work. A small stock company with fluctuating rates can have a significant impact if its rate of return changes dramatically. A fluctuating rate of a large mutual will affect the other mutuals. Initially, I think they're assuming a differential earnings rate of 8-9%. The Bill provides for governmental studies to be done to see if the formula is accomplishing its goal.

The allocation of the add-on tax to product lines and policy groups within each line will probably vary widely, but I would like to describe two possible approaches.

The first is to allocate equity to the lines and/or policy groups to the extent the equity was generated in those policy groups. The company's investment allocation method would be the basis for such an allocation.

The second approach would be to allocate equity on a required or needs basis, i.e., how much surplus is required by a line or policy group. This approach is similar to methods currently used by stock companies in calculating internal rates of returns.

The process of internal allocation of the add-on tax could prove to be as difficult as the development of the concept in the first place.

MR. BICKEL: Walt, did you say that the tax would be about 8 or 9% of surplus?

Mr. DOUGLAS N. HERTZ: I think taxable income would be about 8-9% of equity. The tax would be about 3% on equity. The equity typically might be 1½ times surplus because of the other things.

MR. BICKEL: The add-on tax would be 34½% of the 8-9%?

MR. HERTZ: Yes.

MR. BICKEL: What does this do to the marginal tax rates? What is the marginal tax rate for a deduction of one dollar of dividends?

MR. HERTZ: Marginal tax rates are not going to be as useful to mutual companies as they have been in the past. My company will have a marginal tax rate with respect to the activities of other mutuals. If a mutual company raises its dividends, lowering its taxable income, the aggregate of mutual company tax is not reduced. The rest of us pick up the difference. We also have marginal rates with respect to the activities of the top fifty stock affiliated groups. That makes the concept of marginal tax rates less useful to mutual companies. We can't do our product pricing by running marginals through an asset share calculation.

MR. JUNCKER: I think the add-on tax, especially for the smaller mutual companies, will be more like a premium tax. The marginal tax is outside our control and will vary from year to year. We will try to anticipate where

it is going, but until some data develops, that is going to be a very difficult process.

MR. BICKEL: I hear a lot of talk about mutuals converting to stock companies because of this law. How do you quantify the desirability or the nondesirability of that sort of change? I assume you have to compare the add-on tax to the cost of acquiring capital?

MR. HERTZ: I think you had better evaluate such a decision very carefully. It's an extraordinary and radical step to change the basics of your form of corporate governings because of a tax law. It may become necessary. If the theory underlying this tax law is correct, if having changed to stock company form you find yourself after a few years being forced to retain more profits to give to your shareholders, you may not gain much by way of tax savings out of demutualization. If you think the theory underlying the law is incorrect because it imputes far too much income to mutuals, then maybe demutualization becomes the tax effective thing to do. I think any demutualization is an extremely radical step and would certainly not recommend that anybody contemplate doing it solely for tax-motivated purposes. It is a very complex and difficult process, if indeed it is possible, and it would require the greatest care.

MR. EARLON MILBRATH: I think Doug has hit on a very key point. If you go back to the concept that this add-on tax is intended to reflect the ownership differential, you see that it is intended to be equivalent to the taxes that are paid in the stock company on the earnings that are distributed to its shareholders. In theory the mutual company should still be able to distribute to its policyholders higher returns than a stock company policyholder would, equivalent to the after tax earnings that are being earned in a stock company and distributed to its shareholders.

MR. LYNN C. MILLER: I have a theoretical question for Walt or Doug. Aren't there quite a few conceptual similarities between the new bill and the 1959 Act? Under the 1959 Act most mutual companies were taxed on their taxable investment income minus $250,000. If you look at the method of calculating taxable investment income, it could be viewed as investment income on a modified GAAP surplus figure. This modified GAAP surplus is based on net level reserves assuming a current valuation interest rate. Don't we have a similar situation under the new Bill in that we were taxing some earnings on surplus?

MR. HERTZ: I don't agree with the concept that the 1959 Act was meant to tax investment earnings on a GAAP restatement of mutual company surplus. There was certainly an adjustment to an investment income base tax. It happened to produce tax revenues in the early years that were politically acceptable. I don't think you can say that the tax base under the 1959 Act really resembled mutual company's surplus.

As to other similarities between the old law and this one, the principal similarity that I see is that for stock companies, retaining status as a life insurance company for tax purposes is a beneficial thing to do. Under the 1959 Act, it got you the 818(c) deduction option, phase III deferral (if your economic circumstances put you in that situation), the various special deductions, nonpar, group, accident and health and so on. For a mutual company, technical status as a life insurance company under the 1959 Act was adverse, because it caused a disallowance of maybe 40% of

policyholder dividends. Had you qualified instead as an other than life insurance company, dividends would have been fully deductible. That same circumstance will remain under the new law. Under the new law stock companies will prefer life company status in order to qualify for the haircut. Mutual companies would prefer something other than life company status in order to have full dividend deductibility. To that extent I think there is some parallel between the old law and the new one.

MR. BICKEL: The non-life insurance companies look a lot better to both sides. They pay very little tax because they have unlimited tax exempt interest deductions. The parallel in my point of view is the difference between FIFO and LIFO. Under the 1959 Act, a company would deduct all of its policyholder dividends up to a certain amount, limited by the taxable investment income figure. Under the new bill, there is a certain described amount of dividends which are not deductible (the add-on amount), but beyond that additional dividends can be paid and deducted.

MR. HERTZ: It is true that the law expresses the add-on amount as a disallowance of policyholder dividends. I think conceptually that we should not view it as a tax on dividends. In fact, if your differential earnings amount exceeds the amount of dividends there is an adjustment in the amount of reserve deduction in order that the full add-on amount is taxed. This law is essentially dividend neutral. They came up with a definition of dividends at the same time that the definition of dividends became all but irrelevant. It is not completely irrelevant because of the proration rules but this law does not hinge on the definition of what is a policyholder dividend in anywhere near as dramatic a fashion as the 1959 Act did.

MR. BICKEL: Let's move on to the practical problems, particularly in the reserve computation.

MR. HERTZ: The reserve computation is perhaps the greatest change under the new law. There will no longer be an 818(c) election. This will have sweeping consequences in product design and pricing - particularly for companies selling graded premium products. If you are still pricing using the 818(c) deduction, a change is needed and soon.

Generally, three reserve standards will be needed under the new law. First, and most importantly, reserves on federally mandated bases must be used for purposes of income measurement. Second, statutory reserves are relevant in that they are used as a limitation on the amount of reserves that can be claimed for measuring income for tax purposes. Third, 1959 Act reserves, without section 818(c), are used for testing qualification as a life insurance company (with the TEFRA exclusion of amounts held at interest on contracts lacking permanent guarantees in regard to life and accident and health contingencies) and they are also used for purposes of limiting amounts retained in the policyholder surplus account.

The categories of reserves that life insurance companies are allowed to hold are essentially the same as under the 1959 Act. These are the technical life insurance reserves, unearned premiums and unpaid losses for casualty type business, amounts needed under insurance and annuity contracts not involving life or health contingencies, dividend accumulation and other amounts held at interest under insurance or annuity contracts, advance premium and premium deposit funds, and "reasonable" contingency

reserves under group term life or group accident and health for retired lives, premium stabilization or both. The only real change is the word "reasonable", and that may cause some concern to companies active in the group retired lives reserves market.

The biggest change comes in the measurement of reserves for income purposes in the first category I named - life insurance reserves. That's where most of our companies have most of their reserves. The new standards are set out in proposed Code section 807. The amount of life insurance reserves for a contract is the greater of the net surrender value of the contract or the tax basis reserve for the contract. This amount, however, is limited to being no more than the statutory reserves held. This is revolutionary. In the past statutory reserves have been the foundation of tax life insurance reserves; now, statutory reserves become all but irrelevant. Cash values, which used to be irrelevant, now are central in determining the amount of your reserve deduction.

For purposes of reserves, the net surrender value is net of any surrender charge that would be applied. The market value adjustments on cashout (in group pension business for instance) are not applied. For pension contracts the net surrender value is the balance in the policyholder's fund. This is a rather vague concept that the Committee Reports attempted to explain by making reference to any experience fund, experience accumulation, or asset share allocable to the contract. Presumably, this amount is not reduced by surrender charges.

Tax basis reserves must be computed using mandated reserve methods, the "prevailing" state interest rate and tables appropriate to the risk at the time of issue of the contract. The methods to be used in computing reserves are CRVM for life insurance; CARVM for annuity contracts covered by CARVM; two year preliminary term for non-can A&H business; the method prescribed by the NAIC, if any, for contracts not covered by any of the above; and finally, a method consistent with the above if nothing has been prescribed by the NAIC. For instance, it is my understanding that there is no NAIC prescribed method for valuing universal life contracts. Deficiency reserve amounts which show up in CRVM through the back door method of minimum reserve standards are not to be taken into account in these computations.

Another change in method is the legislative reversal of the Standard Life case. No reserve is permitted for any item unless the gross premium for that item is includable in income. This comes about in proposed section 811(c)(1). In rough concept, the government is trying to make us look more like other accrual basis taxpayers. Our premiums and dividends have been put on an accrual basis in this new law and that portion of reserve due to deferred and uncollected premium is not allowed. The effect of all this is a little unclear but it would seem that it's going to create an administrative mess.

As a final comment on method, the ban enacted in TEFRA to income recognition of reserves for future interest guarantees has been extended and is part of the new law. Future interest guaranteed at rates above the "prevailing State assumed interest rate" is taken into account and reserves as if guaranteed only to the end of the taxable year.

The basis of computation for life insurance reserves is set by the prevailing view of the states (not of the NAIC) at the time of issue of the contract. The prevailing State assumed interest rate is defined as the highest rate allowed by at least 26 states for the contract at the start of the year of issue. (Nonforfeiture laws are not to be taken into account in determining this rate.) For contracts other than annuities, the company can make an election to use the rate prevailing at the start of the year preceding issue. So, if you wish, for other than annuity contracts, you get a one-year transition when rates change. (Under the new Standard Valuation Law, rates could automatically change every year.)

The prevailing Commissioner's standard table for a contract means the most recent table prescribed by the NAIC and permitted by at least 26 states for the type of contract at the time of issue. These tables must be used, but may be adjusted as appropriate to reflect the risk (for example, substandard) under the contract, not otherwise taken into account.

When the prevailing standard tables change there is a three-year transition rule. The old table can be used for three years after the start of a "year of change". The definition of "year of change" is a little unclear due to a comment made in the Senate Finance Committee Report on the Bill. The Committee Reports say that the 1958 CSO should be good through 1986 after which the 1980 CSO will be mandated.

If no Commissioner's table prevails at issue of the contract, the Secretary will prescribe tables by regulation. This may be necessary in the area of health insurance where it appears that we've never had 26 states announce any standard at all. So, there are no prevailing Commissioner's tables for such business.

For pre-1948 contracts, Commissioner's tables were not required and the law specifically provides that statutory tables may be used. Finally, where there are multiple tables (for instance, projection scales associated with annuity contracts) the one producing generally the lowest reserve must be used. This provision shows up in proposed section 807(d)(5)(E). Interaction of this with the ability to adjust tables to reflect risks appropriately under the contract as discussed in 807(d)(2)(C) is not completely clear. Is it also not clear just how you determine which table gives generally the lowest reserve.

Comparison of tax reserve to net surrender value is made at the contract level including riders on the contract. This can result in a loss of reserves for which some partial relief is given.

For example, suppose we had a 1968 issue that was sold on a 1958 CSO basis at 2½% with cash value equal to the reserves on a net level basis after ten years. The 15th year mean statutory reserve (which equals the cash value) is $258.71. The 3½% CRVM mean 15th year reserve for the contract is $217.72. If this contract has a rider with a reserve of $35.00, absent any relief, the additional reserve for the rider is going to be lost.

Without the rider, the reserve calculation takes the maximum of $258.71, the surrender value, or $217.72, the tax basis reserve, and produces a result of $258.71. With the rider on the contract, the reserve is the maximum of $258.71 or the tax basis reserve, which now may be $252.72 adding in the $35.00. The maximum remains at $258.71. The problem is that

the rider is not treated as a separate contract but is aggregated with the basic contract for purposes of computing the tax basis reserve.

That leads us into the subject of supplemental benefits and the areas in which relief is offered for this problem. Certain supplemental benefits are specifically approved and statutory reserves may be applied as tax basis reserves for them unless regulations prescribed by the Secretary later say otherwise. The specifically blessed types of supplemental benefits are guaranteed insurability, accidental death and disability, convertibility, waiver, and any other form of supplemental benefit later prescribed by regulation. Importantly, income benefits are not included. The idea of things on this list is that the reserves for them should be de minimis in nature and they did not feel disability income was a de minimis type thing.

A supplemental benefit that's approved is called "qualified" if there is a separately identified premium for it and if any net surrender value for any other benefit is not available to fund this supplemental benefit. For universal life contracts, presumably the cash value is available to fund both the contract and the riders, while under a traditional contract the cash value adheres to the basic contract and is not available to riders. Qualified supplemental benefits may be treated as separate contracts in the reserve computation and because they are treated as separate contracts the "lost" reserve problem vanishes.

The Senate Bill has a similar provision for term and annuity benefit riders on contracts issued prior to January 1, 1989, on existing plans of insurance. Under the House version of the Bill, term rider reserves can be lost in the comparison to cash surrender values.

Substandard reserves are another category that can be "lost" in this comparison with cash values. Again, some relief is offered. Reserves for what are called "qualified substandard risks" may be computed separately. In this area, qualified means that you hold separate reserves for the substandard risk; that there is a separately identified premium for the substandard risk; that the surrender value of the contract is neither increased nor decreased by the fact that it is substandard; and that the cash surrender value is not regularly used to pay charges for the extra risk.

Two final points on the new reserve rules in general. First, there was a ten-year spread in the old law with regard to the income effect of changes in valuation basis. This provision has been retained in the new law for changes made after January 1, 1984.

Second, on variable contracts (these are now specifically defined in section 817) reserves are computed as outlined above, but the change in reserve caused by capital appreciation or depreciation is not recognized for income purposes. You can, to the extent that there are capital gains in a separate account, end the year holding higher reserves for which no deduction may be claimed.

Steve mentioned the fresh start. Generally, we'll restate our reserves on the new law as of January 1, 1984, and the change in reserve from December 31, 1983 is forgiven. It does not come into income, not even spread over ten years.

It's further provided that the ten-year spread will result in no further income if related to weakening of reserves in pre-1984 years. Those amounts are forgiven. There will be further deductions if you had pre-1984 reserve strengthening only to the extent that post-1983 deductions would have exceeded the benefit you get from the fresh start. There is also a provision that premiums related to deductions thus denied are excluded from income.

For reinsurance and reserve strengthening after September 27, 1983, the House and Senate versions of the Bill differ. The House Bill denies the fresh start to reserves transferred by reinsurance entered into, modified or terminated between September 27, 1983 and January 1, 1984 or to reserve strengthening done after September 27, 1983. The amounts not forgiven this way are to be taxed at 46%. They don't qualify for the haircut.

The Senate Bill simply provides that reinsurance agreements or modifications or reserve strengthening reported between September 27, 1983 and January 1, 1984 are not taken into account until 1984. The Senate provision seems to me as the more likely to prevail. Under it, the fresh start remains but cannot be shifted by reinsurance or augmented by strengthening undertaken with knowledge of provisions that would be in the new law. Also, nonpar deductions and so on cannot be created or moved by reinsurance agreements after September 27, 1983. I'll note further the Senate provision relates only to income measurement. Reserves do move under reinsurance agreements for life insurance company qualification.

A small company whose assets were less than or equal to $500 million on a controlled group basis as of 12-31-83 can irrevocably elect to forgo the fresh start and to hold statutory reserves for its 12-31-83 in force as it runs off the books. The price for not getting involved in that restatement is loss of the fresh start.

Further, if an electing small company has 1984 tentative LICTI less than $3 million, it may elect to hold "adjusted" statutory reserves for contracts issued in the period between January, 1984 and year end 1988. The adjusted reserves use the geometric Menge formula of TEFRA to restate the reserve to approximate what it would be on the prevailing state interest rate.

Aside from the sheer administrative burden of coping with these changes, there are many problems and questions which have arisen. First and importantly, the ACLI is attempting to answer the need for someone to research prevailing rates and tables. It would be nice to have one central organization settle that question. They have had some success with individual life and annuity lines and also with group annuity lines of business. As I said before there may be no prevailing standards for health insurance. Many actuaries feel that the folks in Washington really can't mean that we have to use unprojected annuity tables such as the 1971 group annuity table or tables without age setbacks. Categories of risk classification under the new law are somewhat unclear. Must we use male/female separate tables? Must we use select and ultimate tables? Must we recognize smoker/nonsmoker distinctions? It is a little uncertain.

The Committee Reports allow grouping of contracts in performing the cash value to tax reserve comparison for contracts identical with respect to "issue age, issue year, plan, etc". A number of large companies do their valuations on a group basis and have no capacity to deal with contracts on

a seriatim basis. One question that comes up is whether broader groupings than the ones indicated in the reports are acceptable. How are the amounts computed? Are we allowed to use mean reserves any more? When we compute reserves will we have to pay attention to the contract's paid-to date? How can that be done if contracts are grouped? Can we do grouping for the statutory to tax reserve limitation? The law provides that groupings may be used for the comparison of tax basis reserves to cash values but they did not provide that same relief for the comparison to statutory reserves. If we don't get that relief, grouping becomes useless.

There is a question as to just how exact things must be. We often use estimates and simplifying assumptions in computing reserves. The old law blessed this, using words like "computed or estimated on the basis of." Do the old standards still apply? Frankly, we don't know.

MR. BICKEL: There is a handout in the back of the room which shows the progress of the ACLI's research so far. They've attempted to determine when a particular mortality table or interest rate became available in 26 states. One problem that the handout points out is the 1980 CSO problem. The Senate Finance Committee Report states that the 1980 CSO would be required at the latest after 1986. Based on the research of the ACLI it should have been after 1985.

MR. HERTZ: We may not want to bring that up.

MR. BICKEL: The second question regarding 1980 CSO is which 1980 CSO table is to be used? We have the male/female, smoker/nonsmoker, and select/ultimate tables.

MR. HERTZ: Nobody knows.

MR. BICKEL: Can you go to the 1980 CSO plan by plan for tax reserve purposes? If you are starting to introduce some plans on a 1980 CSO basis now, should you be using that for tax purposes?

MR. HERTZ: It is my understanding that you can go to the 1980 CSO plan by plan and, if we believe what's in the Committee Reports, you have until issues of 1987 before all of your new business has to be on the new standards.

MR. BICKEL: Another thing that is confusing is the cash value comparison. The easy way to do it is on a policy anniversary basis - the terminal reserve compared to the cash value. Is that correct or do you have to actually look at the calendar year end values?

MR. HERTZ: There is a great deal of concern that you are actually supposed to look at the calendar year end. I'm not sure that the authors of the Bill fully comprehend the difficulties involved in doing so. It's not clear that you are allowed to compute reserves using a mean reserve. That's one of the convenient approximations that we in the industry have always used. With this legislative reversal of Standard Life, you might have to respect a little more carefully the actual paid-to date of your various contracts. Again, we don't know how that provision relates to the provision that you may group contracts for purposes of these computations and comparisons. If you are going to group contracts by issue year, it is difficult to respect issue date.

MR. MILLER: You mentioned that 818(c) on graded premium whole life is a thing of the past now. Would anybody on the panel care to comment on the status of the graded premium whole life 818(c) adjustments for contracts that have been issued in the past?

MR. HERTZ: I don't know the status of things right now. There were proposed regulations which came out last year. The ACLI submitted comments on the proposed regulations. It was my understanding that some time in the spring there were supposed to be hearings on the subject. I have not heard that any such hearings have been scheduled.

MR. MILBRATH: There is a significant issue for stock companies in terms of the deferred tax provision as it relates to the "fresh start" forgiveness of 818(c) reserves. You've all established deferred tax liabilities over the years for those 818(c) reserves and there are three potential treatments in your financial statements for those reserves.

One would be to snap them back out of liabilities and into surplus immediately as an extraordinary item in the income statement. That's sort of a liability type approach. The concept is that the law is changed and the liability is no longer there, so it ought to come back immediately.

The second alternative is to dribble back those liabilities over time as the 818(c) reserves would have turned around on the theory that a deferred tax was set up and whenever it reverses you reduce the deferred tax liability and pay whatever tax would be payable at that time. This seems to be consistent with the rationale of the new law. We didn't get a check from the government for the fresh start but instead will not be paying the tax in the future when those reserves would otherwise have turned around.

Finally, the third alternative is to let those deferred tax liabilities remain on your balance sheet forever. The Insurance Companies Committee of the American Institute of Certified Public Accountants (AICPA) has been struggling with this issue for some time. They had reached a tentative recommendation two weeks ago to follow that latter approach, based on the concept that we have a mere rate change subject to application of APB 11. That recommendation is getting an unfavorable reaction from the life insurance industry. The Accounting Standards Executive Committee within the AICPA met with the Insurance Companies Committee representatives yesterday and reviewed the issue. The issue was sent back to the Insurance Companies Committee. You will want to track this issue closely.

MR. JUNCKER: With all the unanswered questions I am wondering if it will take as long to get things resolved as it did the last time a major revision in the tax law (the 1959 Act) was passed. Is there any organized effort to answer these questions other than what the ACLI is doing on rates and tables, or is every company on their own at this point?

MR. HERTZ: I don't know of any broad organized effort either to answer the questions based on what now exists or to attempt to get resolutions of these issues from government. Of course, if you go to the government you may get the wrong answer and that's one of the problems. We have in the industry a mutual company group, a stock company group and the ACLI. It's possible that among these groups a substantial effort will be made later this year to produce some kind of group viewpoint on what the answers either are or should be.

MR. BICKEL: We want to talk now about the implications of the law on investment policy, and Earl will give us the benefit of his thoughts.

MR. MILBRATH: I am going to cover the implications for stock life insurance companies and then Doug Hertz will cover the implications for mutual companies, in particular as it relates to the add-on tax.

Surely, as you have seen by now this new law is extremely simple. Listening to Walt and Doug talk about it, there should be no problem at all in determining the impact on investment policy! But seriously, most of the complexities they have discussed do not affect investments, and the new law is much simpler in its application to investments than the old law.

There are three areas of change that impact investment policy. They are going to impact your companies differently. For stock companies in particular it depends upon whether you were a phase II negative, phase I, or a phase II positive company previously. I will try to give you some generalizations today that you may carry back and discuss with your investment officers.

The three areas within the law that will affect the investment policy are the elimination of the three phase system; two changes within the proration formula in determining policyholder share of investment income; and finally, the effect of the taxable income adjustment that reduces the marginal tax rate from 46% to 34.5% or 36.8%.

Under the three phase system, for companies taxed on taxable investment income, investment policy could affect the average and current earnings rates and it could affect the deductions for policyholder dividends and policyholder interest requirements in Phase I. That goes away.

You need not be concerned with phase switching. In the past, particularly if you were on the edge of one phase or the other, you could actually tax plan with your investment policy to some degree to take advantage of that three phase system. You also will lose another advantage that existed in the 1959 Act, namely the double dipping that was available with the group investment contracts. There you received the interest paid deduction and a favorable impact on the pension interest requirements in phase I.

The new proration formula has been simplified but still does essentially the same thing in concept. I will refer to the Senate version of the Bill which has been more refined and seems to be more likely to prevail. The denominator of the formula is intended to be investment yield but it has been simplified. Rather than taking gross investment income and deducting investment expenses, the Congress decided to simply include 90% of gross investment income in the denominator. The gross investment income will continue to include tax exempt interest and non-affiliated dividends. However, dividends qualifying for the 100% exclusion as dividends from affiliates will no longer be included within the definition of gross investment income.

The numerator has been changed much more significantly. Interest on non-customer debt is no longer included in the policyholder share. Like the 1959 Act gain from operations computation, you will continue to compute required interest on the reserves, but it will now be calculated using the new tax basis reserves that Doug has described and the maximum interest

rates that are specified for those reserves. The stop-gap legislation interest included an element of excess interest within the policyholder share. Specifically, when excess interest on nonqualified annuities was given an interest paid deduction, that was specifically included within the policyholder share. The question of excess interest on pension plan products was still somewhat up in the air. In the future, all excess interest is includable as a policyholder interest requirement as are all amounts credited to pension plan contracts and deferred annuities in general.

Finally, there is a whole new element included in policyholder's share and that is an amount intended to reflect the excess interest inherent in dividends to policyholders on a participating policy. There is a very complicated formula within the proposed law which defines how this element is calculated, but I am not going to cover it here.

The intent of the proposed law is to simplify the law and to make the treatment more comparable to other corporations. For example, within the calculation of gain from operations, tax exempt interest is no longer included in gross income, but the increase in reserve deduction is disallowed to the extent that it is deemed to be related to tax exempt interest. This is accomplished by subtracting the policyholder share of tax exempt interest from year end reserves in computing the increase or decrease in reserves. The practical result is the same thing, but conceptually it is more comparable to what other corporations do. Finally, the dividends received deduction will continue to be limited to the company's share of the dividends received.

What are the implications of all that? It's going to vary somewhat from company to company but we can generalize by saying that the required interest on the new tax basis minimum reserves will tend to be lower. However, the policyholder interest is going to be increased significantly by including all excess interest and by including the excess interest element deemed to be within policyholder dividends. As a generalization, for most companies, the policyholder share will be higher, the company share will be lower and therefore tax exempt interest and dividend producing investments will be relatively less favorable to you than in the past. There was a very significant shift in the tax effect of such investments for many Phase I companies as they went from the 1959 Act to stopgap and now there will be a shift again.

The third area, which is probably the simplest in concept and easiest to explain, is simply the effect of the Taxable Income Adjustment which reduces your effective corporate tax rate to 34.5% or 36.8%. That simple change is likely to have the greatest impact on your investment policy. All of the investments that were designed to reduce ordinary income taxable at 46% and either defer it or to convert it to 28% taxable income are of less advantage if you are converting 34.5% income, let's say, into capital gains rates.

Further, the marketplace is likely to continue pricing municipal bonds, preferred stocks, etc. on the basis of corporations which normally pay a 46% taxable rate on ordinary income. Consequently the yields that will be available in the marketplace are not likely to be as attractive to you. Discount bonds which many companies have used very significantly the last few years are going to face that same situation. The tax deferral is not

at 46% on the market discount but at 34.5%. You still will pay a 28% capital gains tax upon sale or maturity.

For example, if we had purchased at 60 a 6% coupon bond maturing in 15 years, the pretax yield to maturity would be 12.1%. A fully taxable equivalent yield rate based upon a 46% ordinary rate and a 28% capital gains rate (which we have been using under the 1959 Act) would be, for Phase II negative companies, 13.6%. If our new marginal tax rate is going to 34.5% on ordinary income, that tax equivalent yield rate is going to drop to only 12.8%.

Incidentally, the Senate Bill contains a provision that would tax market discount at ordinary income rates at sale and maturity rather than at 28% rates. That would apply only to bonds issued after the date of enactment but clearly those bonds in the future would be of limited or no value to the life insurance industry. This provision may be of some value to companies which own a large block of discount bonds today, as there may be a higher value for them.

Investments (such as real estate or equity investments) designed to produce currently taxable losses and save 46% tax dollars which later convert to 28% capital gains will be relatively less attractive to you. You need to look at those very carefully.

Even those simple tax shelter programs that are simply timing differences, such as a leasing program that would give you a 46% deduction today and turnaround as 46% income in the future, will be less attractive because you are getting only 34.5% savings today, cash available to be invested. It's really the investment income earned during the temporary period of tax savings that is helpful to you. Again I suspect that the marketplace is going to tend to price those investments generally on the full 46% temporary tax savings for other purchasers of those investments.

I hope I have given you some food for thought today. It may not seem too bad, as if each of us in our individual tax situations were in a 50% tax bracket and suddenly the rate changed to 30%. We can't take advantage of tax shelters as much anymore, but on the other hand we are not paying as high a tax burden. However, the unfortunate part of this Bill is that if you look beyond the investment implications you will see we are paying more tax, but we have had our options to reduce taxes through tax sheltered investments reduced significantly.

MR. HERTZ: Regarding proration, the company share - that is, the part which is tax beneficial to companies in dealing with exempt or deductible yield - generally speaking is going to be reduced under the new law. This is especially true for mutuals because of the impact of policyholder dividends in the new proration formula. The House and Senate Bills differ on this point, but both of them are bad. At my company, for instance, which is a large mutual company, company share would be about 5% if the House version were to prevail and would be about 25% if the Senate version were to prevail. Under the 1959 Act, our company share was about 50% and we weren't buying any exempts then. In either event, there will be very little incentive for us to hold exempts and investments in stocks will be discouraged.

Under the new law, our effective corporate tax rate is either 34.5% in the House Bill or 36.8% in the Senate Bill. This tends to make us different than other institutional investors and skews us away from the choices that others would make. As Earl commented, the market will probably continue to price securities based on the tax situations of others and so we are going to be odd-man out. For example, the capital gains versus ordinary income trade-off will be different for us. This will affect our desire for market discounts, stocks and real estate, all of which can be used to turn what otherwise would be ordinary income into capital gain. As Earl noted, market discount on securities issued after passage of this law would not be a capital gain item due to a general change as in section 25 of the Senate Bill or proposed section 1276 of the Code. These would have the accrual of discounts, the part that used to be capital gain at maturity, taxed as ordinary income at maturity. There is still a deferral of taxation but when the tax is paid it will be at the ordinary rate.

As a side note on this effective rate discussion, companies electing the alternative life company deduction, as proposed in section 806(e) of the Senate Bill - Steve referred to it as the ARC amendment - would have varying marginal tax rates for the first four years. Roughly speaking, they would start at a rate near 46% and would gradually move to a position where they have the same marginal tax rates that the rest of us have.

Mutual companies are going to have special investment problems because of the impact of the add-on tax. Any asset adds to our surplus in the sense that, marginally, if the asset is taken away surplus goes down. Since assets add to the equity base, assets which are not productive become a negative item because they generate taxes.

Low yield assets then are a problem under the new law. Any asset owned by a mutual company earning less than about 4½% should be disposed of because the after tax earnings on the asset are negative. In broad concept there is about a 1½% tax on a 4½% earning asset and it's taxable - you pay about 1½% because there is a mid-30's tax rate - and about 3% tax as an add-on. The government just took it all away. It's not pleasant, incidentally, to contemplate how this new law is going to work if we ever get a 4% new money rate.

We must expect mutuals to attempt to reduce surplus to the extent safely possible under the format of this new law. One clear strategy is to sell low yielding investments and purchase investments with high yields. In effect, this gets as yet unrealized capital losses out of our nominal surplus. Much of the surplus reported in our annual statements today is created by the rules that we have in the life insurance industry for valuing assets. Mutual companies will be able to afford to hold real surplus but we will no longer be able to afford to hold nominal surplus created by the rules for valuing assets. In general, I think it's fair to say that the new law is going to push mutuals very strongly in the direction of more efficient and effective use of their surplus.

As to specific categories of investments, investment in stock is hard hit by the new law. The proration problem that Earl and I have discussed makes shareholder dividends less attractive to us. The reduced spread between ordinary income and capital gains rates further reduces the attractiveness of stocks, especially growth stocks. Finally, to add insult to injury, for mutuals, unrealized capital gains on stocks that we are holding - the

excess of market value over purchase price - appears in our equity and consequently is taxed annually. We have an annual recurring tax on unrealized capital gains. It would appear from this that convertible bonds may be a more attractive investment for mutuals than stocks. I mean that in both senses of the phrase. Mutual companies will prefer convertible evidences of indebtedness to common stock and they may prefer convertible securities more than a stock company.

Real estate investment has some pluses as well as some minuses for a mutual company. The traditional tax benefits, investment tax credit and depreciation, are still there although the accelerated depreciation doesn't give us the same benefit that it would give to others due to the change in effective tax rate. Real estate is depreciated in value in our annual statement, however, even if it is rising in value so that unrealized depreciation in real estate is not taxed as it is for common stocks at a mutual company. This may cause a resurgence of interest at mutuals in buying and holding real estate.

In closing, I'd say it's generally rather difficult to give investment advice under this new law because of uncertainties as to its long term effect. The politicians always did talk about the taxable income adjustment as a revenue rheostat and there has already been talk of looking at it again next year. We can grumble about having a different effective tax rate than other taxpayers. We may not have that as a problem much longer. The difficulty in terms of giving investment advice is you simply don't know.

MR. LYNN MILLER: Temporary guidelines were enacted under TEFRA in 1982 that determine under what conditions flexible premium life insurance contracts shall be afforded the same tax treatment to the policyholder and beneficiary as traditional life insurance contracts.

Although a favorable private letter ruling was released in early 1981 regarding E. F. Hutton Life's Universal Life contract, the IRS became concerned that a potential "investment abuse" situation existed. The passage of TEFRA was critical for Universal Life, since there were rumors in the summer of 1982 that the IRS would withdraw its original ruling. The new tax bill contains a revised provision regarding the "Definition of Life Insurance" that extends the temporary provisions of TEFRA to all life insurance products; strengthens these provisions; and makes the definition permanent.

I have been asked to discuss the new definition from a stock company point of view. A life insurance contract is defined as any contract which is a life insurance contract under applicable state or foreign law and conforms with either the "Cash Value Accumulation Test" or the "Guideline Premium Test." The reference to applicable state law is very important since the IRS could claim that universal life type products are a combination of term insurance and a side fund. This could result in application of the test to only the "net amount at risk" or pure term portion. Under the bill, if a product is considered as life insurance by the state regulators and meets the definitional requirements, the entire contract will qualify as life insurance.

The definition of "life insurance contract" does not include any portion that is treated under state law as providing annuity benefits. This

effectively excludes a combination of pure term insurance and a flexible premium deferred annuity from qualifying as life insurance.

The test requirements must be satisfied for the entire lifetime of the contract.

In most instances, stock companies will utilize the "Guideline Premium Test (GPT)", and mutual companies will choose the "Cash Value Accumulation Test (CVT)." I will confine my comments to the GPT.

In order to comply with the GPT, two separate subtests must be satisfied:

(1) At any point in time, the sum of "premiums paid" cannot exceed the "guideline premium limitation".
(2) At any point in time the death benefit must not be less than the applicable percentage of the cash surrender value. This is often referred to as the cash value corridor test.

"Premiums Paid" are defined as the actual gross premiums paid by the policyholder less any withdrawals of cash that are not included in the policyowner's taxable income and less any premium refunds.

The guideline premium limitation equals the greater of the "guideline single premium (GSP)", or the sum of the "guideline level premiums (GLP)". The GSP is the single premium at time of issue required to fund future benefits. The GLP is the level annual premium payable over a period not ending before age 95 required to fund future benefits.

The basis on which the calculations of the GSP and GLP are made are:

(1) The guaranteed mortality charges at time of issue. If none are specified, then mortality charges equal to the mortality rates used in calculating statutory reserves will be used.
(2) The guaranteed charges for qualified additional benefits and guaranteed expense charges.
(3) A rate of interest equal to the greater of the rates guaranteed at time of issue or 6% (for the GSP) and 4% (for the GLP).

Future benefits include only those benefits defined by the basic contract and do not include qualified additional benefits (however the charges for qualified additional benefits are considered). Future benefits are determined at time of issue and are subject to the following computational rules:

(1) In general, death benefits and qualified additional benefits may not increase, however, there is one exception to this rule. In the calculation of the GLP an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the "net amount at risk". This will allow the pre-funding on a level premium basis of the so-called Option 2 death benefit structure (return of cash value death benefit).
(2) The maturity date shall be no earlier than age 95 or later than age 100. This definition of maturity date includes any date on which endowment benefits are paid.

(3) The amount of any endowment benefit or sum of endowment benefits, including the cash surrender value on the maturity date, shall not exceed the smallest amount payable as a death benefit.

Qualified additional benefits are limited to the following:

(1) Guaranteed insurability
(2) Accidental Death or Disability Benefits
(3) Family term coverage
(4) Waiver of Premium
(5) Other benefits provided by regulation

The second subtest is the "cash value corridor test". Even if a policy complies with the guideline premium limitation, it is possible for cash values to approach the death benefit long before the maturity date due to excess interest and mortality charges less than the guaranteed maximum charges. The cash value corridor test addresses this problem by requiring the death benefit to equal or exceed the following percentages of the cash surrender value.

Attained Age	Percentage
40 and under	250%
45	215%
50	185%
55	150%
60	130%
65	120%
70	115%
75	105%
90	105%
95	100%

For ages between those listed above, the percentage will reduce on a linear pro-rata basis. For example, between ages 40 and 45, the percentage would reduce 7% per year from the age 40, 250% level.

The definition of death benefit does not include any qualified additional benefits.

The cash surrender value is defined as the cash value without regard to surrender charges, policy loans or any reasonable termination dividends. The above percentages will allow more cash value per unit of insurance than the CVT. For example:

Attained Age	GPT Corridor	58 CSO 4% CVT Corridor
40	250%	315%
50	185%	233%
60	130%	179%
70	115%	145%

The apparent liberalization for later durations under the GPT is offset by the fact that at time of issue, the GSP under the GPT must be based on an interest rate of at least 6%, while under the CVT, the rate can be as low as 4%. In other words, the GPT is more restrictive with regard to the

relationship of cash value to death benefit in the early durations when compared to the CVT and less restrictive at later durations.

There is one situation where the guideline premium test can be violated and not result in disqualification. The payment of a premium which would result in the sum of premiums paid exceeding the guideline premium limitation shall be disregarded in applying the test if the amount of such premium does not exceed the amount necessary to prevent termination of the contract on or before the end of the contract year, provided there is no cash surrender value at the end of the year.

In the event of a change in future benefits or any qualified additional benefits that were not reflected in any previous determination of the GSP or GLP, proper adjustments to the GSP and GLP will be made based on regulations prescribed by the Treasury Department.

There are provisions in the bill that allow reasonable errors that would result in disqualification to be corrected. The taxpayer must establish to the satisfaction of the Treasury that the errors were reasonable and steps are being taken to remedy the errors. In addition, any premium paid during a contract year and returned by the company, with interest, and within 60 days after the end of the year will reduce the "sum of premiums paid". The interest paid by the company on these return premiums shall be included in the taxable income of the taxpayer.

If, during any taxable year of the policyholder, a contract fails to meet the definitional rules, the contract shall be considered as a combination of annuity and term insurance as of the beginning of the taxable year and all future taxable years. The cash surrender value less any policy loans (or, if smaller, the investment in the contract) as of the beginning of the taxable year shall be treated as an accumulation fund under an annuity contract.

The excess of the amount paid by the reason of the death of the insured over the net surrender value shall be considered as an amount paid under a life insurance contract.

After disqualification for any taxable year, the excess of the cost of life insurance protection over the amount of premium paid (reduced by policyholder dividends received) shall be treated as a distribution from an annuity under Section 72(e). The cost of life insurance will be the lesser of the mortality charge, if any, stated in the contract or the cost of insurance based on 5-year term uniform premiums as prescribed by the Treasury.

In the event of disqualification, an excise tax will be imposed on the company equal to 10% of the net surrender value. If this excise tax is charged to the policyholder, the company must pay an additional tax equal to the amount charged. The company must notify the policyholder of disqualification within 30 days, or be subject to a nonreporting penalty. The provisions of the bill apply to all contracts issued after December 31, 1984, with special rules for certain contracts issued during 1984.

1. The new rules will apply to any contract issued in 1984 that was on a policy form that was not approved by at least one state prior to March 15, 1984.

2. The new rules will apply to any contract issued in 1984 that provides an increasing death benefit and has premium funding more rapid than 10-year level premiums.

The provisions of TEFRA relating to flexible premium life insurance contracts will continue to apply to issues of 1984.

Stock companies selling universal life type policies will generally choose the Guideline Premium Test for the following reasons:

1. At time of issue the policyholder knows for certain how much premium can be paid.
2. Due to the large corridor requirements under the CVT, the company may be forced to restrict acceptance or impose underwriting of future premiums during a period when the cash surrender value is at a maximum level, since payment of premium would result in an immediate increase in net amount at risk. The administrative expense of monitoring each premium payment would be costly. At time of issue it may be difficult for a company to quantify the rules regarding acceptance of future premiums. Thus, a great deal of uncertainty would be created in any illustration of future premium payments and values.
3. Increases in future death benefits can be substantially larger under the CVT as compared to the GPT. This could present a reinsurance problem that could be very troublesome for smaller companies.

The following is a brief summary of the significant changes the new tax bill introduces when compared with TEFRA:

1. The GLP minimum premium paying period has been extended from 20 years to age 95.
2. Under TEFRA, the maturity date could not be less than 20 years or age 95, if earlier. This has been extended to age 95, which eliminates limited duration endowment products.
3. The new computational rules will not allow death benefits to decrease and at a later date begin increasing.
4. The cash value corridor percentages have been increased from the TEFRA level of 140% at age 40, reducing by 1% per year to 105%.
5. Prefunding of a "return of cash value" death benefit on a single premium basis is not allowed.

In summary, the "definition of life insurance" rules in the proposed tax bill are more restrictive than TEFRA, however the new bill will finally introduce certainty with regard to how policyholders will be taxed on their life insurance purchases.

MR. BICKEL: We're running a little short on time. Let's take five minutes for questions from the audience.

MR. CHARLES H. PICARD, JR.: I have a question for Lynn Miller. With regard to substandards, a policy might have temporary substandard extras, or there could be a situation where after issue a policyholder requests a new rating. Would that imply a higher guideline level premium in the early years or would you have to post-fund the guideline substandard extra?

MR. MILLER: The calculation of guideline level premiums is based on the guaranteed maximum mortality charges. Therefore, if these maximum charges are not adjusted upward to cover substandard extras, there would be no adjustment to the guideline level premium. However, if the guaranteed maximum mortality charges are adjusted for substandard extras, the guideline level premium would be adjusted accordingly. This would result in a post funding of temporary flat extras. If the substandard extras are subsequently removed or reduced, there would be no change in the guideline level premiums.

MR. ERNEST REYNOLDS: I realize that many of the questions are unanswered in the way of reserves, but we are reporting quarterly earnings this year. I'm curious as to what the companies are doing. For reserves, are you planning to use interpolated terminals, means or mid-terminals? Also, for interim statements, what have you done in March and what are you planning to do in June?

MR. BICKEL: For the first quarter, we assumed a hybrid of the old law and the new law. Our theory was we were governed by the 1959 Act, but we did peek at what is coming with respect to the deductibility of excess interest, bottom line consolidation, and so on. I'm not sure what we'll do next quarter. We don't have any new tax reserve calculations, but we've made estimates. I suppose we will use them for a little while.

MR. MILBRATH: That's all you can do - estimate where you're going to be with the best information now available.

MR. JOHN H. BUCHANAN: In determining the present value of the mortality charges which are specifically stated in the contract, is the value discounted for interest only or for interest and survivorship?

MR. MILLER: With respect to a flexible premium, interest sensitive product such as universal life, you determine the appropriate guideline level or single premium that will fund the defined benefit structure of the contract based on mortality, interest and expense guarantees and based upon the technique defined in the contract for accumulating cash values. Does this answer your question?

MR. BUCHANAN: No.

MR. MILLER: Would you please restate your question?

MR. BUCHANAN: In calculating the present value for the guideline single premium to fund the future benefits, the law says that if the mortality charges are specified in the contract you use the mortality charges specified. If not, you use the mortality specified in the reserve calculation. Is this value based on an interest only discount, or is it based on an interest and survivorship function?

MR. MILLER: Interest and survivorship are generally involved in the calculations. Universal Life contracts utilize the retrospective version of the traditional prospective formula used in determining cash values and the endowment benefit at maturity. With our contract, the retrospective formula does involve an element of survivorship. An example might clarify my point. If a Universal Life contract has no expense charges and if the mortality charges are based on 1958 CSO mortality rates and the interest

rate is 4%, the resulting guideline premiums should conform to 1958 CSO 4% net level or single valuation premiums.

MR. BUCHANAN: But if you have a select and ultimate set of charges I don't think that will happen.

MR. MILLER: It depends on whether the guaranteed maximum charges are select and ultimate. The calculation of guideline premiums is not dependent on "experience" or "current" mortality charges.

MR. BUCHANAN: It is my understanding from reading both the House and Senate versions that all flexible premium contracts in force at 12-31-83 will be grandfathered, assuming that they met the TEFRA guidelines. Is that your understanding as well - that the new law only applies to those contracts issued after a certain point in time?

MR. MILLER: That is correct. All flexible premium contracts that conform with the TEFRA guidelines will not be required to satisfy the provisions of the new tax bill.

MR. BICKEL: Also, any plan you were selling on March 15 you can continue to sell for the balance of the year.

MS. GRACE V. DILLINGHAM: I call your attention to this memo from Larry Higgins, our chief counsel for federal taxes. If you have suggestions that might be taken to the Treasury for a proposed regulation, input would be welcome. Our people are up on the Hill all the time trying to get things clarified or something new put in (usually with not too much success but we're trying).

MR. BICKEL: Thank you. The more input the better. We've exceeded our time, so let's adjourn. I wish to thank the panel. It's been a very interesting and informative discussion.