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FEDERAL TAXATION—AN UPDATE

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A current update on the status of recent or pending federal tax legislation. This will include topics of interest in all areas - pension, life insurance and health, from both the policyholder and company standpoint.

MR. SIDNEY A. LEBLANC: The topic this afternoon is income taxes. Our session will cover two somewhat distinct topics. We are going to start with the impact of recent and proposed tax legislation on employee benefits and on pensions in particular. We will talk about the impacts of the Tax Equity and Fiscal Responsibility Act (TEFRA), Economic Recovery Tax Act (ERTA), Internal Revenue Service (IRS) rulings, IRS regulations, and tax proposals as it affects pensions.

Our pension expert is Mike Mahoney of Milliman & Robertson. He will cover these topics.

The second, longer discussion will cover insurance company taxes. We are going to go over the Stark-Moore Bill which passed the House Ways and Means Committee last Thursday. We are going to start with a brief review of what led up to the Stark-Moore Bill.

I think this historical perspective is pertinent for the permanent record, and it sheds some light on the provisions of the Bill. This will be followed by a rather extensive review of the actual provisions of the Bill. During their presentations, our stock actuaries and our mutual actuary will express their opinions as to the mutual and stock viewpoint.

As you are aware, there was a split within the industry. The steering committee could not resolve it. The ACLI Board felt this was something of a disaster and stepped in and tried to resolve the issue. After a few attempts, they decided this was a fairly difficult task and gave up as well. It was ultimately resolved by Congress.

As a mutual representative who spent much of the last two weeks in Washington learning the hard way how to count votes in a subcommittee, I was pleased to note that the mutuals had responded to some of their problems. They felt they had a public relations image problem, and they have gone out and hired a public relations person to help solve this problem. They went inside government ranks to get someone who is familiar with government as well as public relations, and I am sure you will be pleased to hear that they have hired as public relations man, the former Secretary of the Interior, James Watt.

In any case, we do need to give some recognition in our presentation to the fight that has gone on within the industry. We have two men covering insurance taxes that I have worked with for the last couple of years and come to have a lot of respect for: John Elken of Bankers of Iowa and John Palmer of Life of Virginia. It is a good thing we have this caliber of people in our presentation because they have had to write their presentation within the last week in between trips to Washington. After the presentations, we have about half an hour planned for questions and answers.

Now I would like to start with the pension side of the house and Mike Mahoney.

MR. MIKE MAHONEY: Thanks, Sid. There is no intention here to make anybody an expert in any of the laws and all the things that have happened in the last couple of years. I intend to take a brief review of some of the recent legislation and regulations and also highlight some of the changes that are related to new plans like 401(k) plans and cafeteria plans. So let us start with the most recent and the most major, at least in my mind, Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

This bill was one of the most significant pieces of pension legislation since ERISA. It had far reaching effects on existing contributions and benefit limitations and the cost of living adjustments in these amounts. In addition, it established a new concept of a top heavy plan which necessitated further restrictions if further requirements were not met. The primary purpose of TEFRA was the raising of tax revenue. In fact, it was the largest revenue act in the nation's history. Let us review some of the major provisions.

The maximum annual benefit under a defined benefit plan has been reduced to $90,000. Under ERISA the maximum was the lesser of 100% of the average compensation over the three consecutive years yielding the highest compensation, or $75,000 with adjustments to that amount for cost of living increases. In 1982 the maximum was $136,425, hence the reduction is very substantial. The maximum annual addition to a defined contribution plan is $30,000. Under ERISA, the maximum rates were the lesser of 25% of compensation or $25,000, also adjusted for cost of living increases. In 1982 the maximum was $45,475.

Before TEFRA there was no reduction in the benefits which commenced after age 55 but prior to age 65. Under TEFRA, an actuarial reduction is required for benefits which begin prior to age 62. The new limit for benefits payable between ages 55 and 62 is equal to the greater of the actuarial equivalent of the $90,000 benefit at age 62, and $75,000. The interest rate used in the making of this determination is equal to the greater of 5% or the rate specified in the plan for determining actuarial equivalence. If the benefit commences prior to age 65, it can be as much as the actuarial equivalent to the $75,000 benefit which is payable at age 55. Benefits payable after age 65 can be adjusted upward. The maximum amount again is based on an actuarial equivalent. In this case it is the $90,000 benefit at age 65, and the interest rate is slightly different.

The interest rate used in making this calculation is the lesser of 5% and the specified plan rate for determining the actuarial equivalence. The $90,000 and $30,000 limits will remain in effect through 1985. Future increases will be based on the index used to adjust social security benefits and will only recognize increases since December 31, 1984. Prior to TEFRA, increases were tied to the increases in the primary insurance amount, thus, a floor benefit of $75,000 payable before age 62 will gradually be eroded as some of the increases start taking effect in 1986.

Accrued benefits, as of the close of the plan year, after November 1983, will not be affected by the new dollar limits. Additional accruals or additions may not be permitted to the extent they would exceed the limitations. Changes in the terms and conditions of a plan after July 1, 1982 cannot be recognized in determining accrued benefits for these purposes. There could be a reduction, however, in a situation where the participant is covered by both a defined benefit and a defined contribution plan and where the participant's benefit under the defined benefit plan is determined by

subtracting the participant's defined contribution fraction from the total allowable fraction since any increase in the defined contribution fraction would serve to reduce the defined benefit portion.

Under ERISA, if an employer maintained both a defined benefit and a defined contribution plan, a fraction was computed for each plan separately. Based on a comparison of the plan's benefit to the existing maximum limitation, the total allowable fraction before TEFRA was 1.4; now it is one. TEFRA also changed the method for computing the fraction. Depending upon whether it is a defined contribution plan or a defined benefit plan, the numerator is either the sum of the annual additions or the projected annual benefit, whereas the denominator for each year of service is the lesser of 1.2 times the maximum dollar limit or 1.4 times the percentage compensation limit. The effective date of the maximum benefit provisions of plans in existence on July 1, 1982 is plan years beginning after December 31, 1982, with amendments required by the beginning of the first plan year after December 31, 1983. Collectively bargained plans must comply by the earlier of the expiry of the agreement or January 1, 1986.

TEFRA also established a rule for top heavy plans. For such plans there are limitations on plan compensation, requirements for accelerated vesting, a required minimum non-integrated benefit for other than key employees, and penalties for distributions to key employees prior to age 59½. A top heavy plan is defined as one in which more than 60% of the present value of accrued benefits in defined benefit plans or 60% of account balances in defined contribution plans belongs to key employees. Key employees are defined as officers, one percent owners earning more than $150,000, 5% owners regardless of compensation, or the ten employees owning the largest interest in the employer. Special rules apply to organizations with 50 or fewer employees. Maximum compensation for top heavy plan purposes is $200,000, adjusted for the cost of living. The required accellerated vesting schedule is either 20% after two years of service, increasing by 20% each year such that 100% is attained after six years, or 100% after three years of service. The minimum non-integrated benefit required for non-key employees is: for a defined benefit plan, two percent of final average earnings, no more than a five-year average, per year of service up to 20%, or for a defined contribution plan, a minimum contribution of three percent.

TEFRA also provided that group term insurance for key employees was not excludable if the plan was discriminatory in its eligibility requirements or in benefit amounts. Eligibility standards are not discriminatory if 70% or more of all employees benefit, 85% or more of all planned participants are non-key employees, the Secretary of Treasury determines that the plan is nondiscriminatory, and in the case of cafeteria plan, the standards established for these plans are satisfied.

Effective in 1984, the special rules for HR-10 and Keogh plans were also eliminated, and those plans are in essence subject to the same corporate rules including the top heavy rules.

Now we have had a quick run through TEFRA, let us look at another new benefit structure that, while it was there a while ago, is only recently becoming very popular, 401(k) plans, or as they are sometimes called, cash or deferred compensation arrangements.

These types of plans have stirred an extensive interest on the part of plan sponsors. Their origin stems from a 1978 amendment to the Internal Revenue Code which

permitted a profit sharing company to set up a qualified deferred compensation plan. Three years after that, the IRS issued regulations affecting these types of plans and the interest increased. Under these plans, an employee can elect to defer a portion of his compensation under a salary reduction arrangement on a pre-tax basis. That is, the contribution would be made before federal income tax, and in some states and cities, like New York, before city and state taxes. There are certain restrictions to insure that the plan is nondiscriminatory related to the average salary reduction of the lower two-thirds of those in the eligible group compared to the top one-third.

There are two specific rules which I will not try to go through now.

Section 401(k) plans have been set up in conjunction with savings and thrift plans with the employer matching contribution going through the savings thrift plan. Part of the reason for this is that the savings thrift plan might have already been established and it was easy to tack on the 401(k) plan. Also, it was thought in many instances, that with the tie-in to the savings thrift plan, the participation on the lower two-thirds group might be more likely to contribute to part of the package, so this was meant as an encouragement. In some instances as a variation, the plan might have called for a flat contribution by the employer whether or not the employee participated in a savings thrift plan. In that case, the employer contribution was to the 401(k) plan, and it had to vest 100% immediately if it was used as part of the test for nondiscrimination.

Another point that should be realized is that the 401(k)s are filed under the profit sharing portions of the Code; therefore, if the company does not have a profit, the contribution, which is under the salary reduction, cannot be made because that contribution is deemed to be an employer contribution. Thus, care should be taken in defining what are profits for a particular year.

Originally, the reduction in compensation was not considered for social security benefits or for pension plan benefits. However, this has been changed. The employee, who is now earning less than the taxable wage base, will have to make a social security contribution on that portion of his compensation which is deferred. Also, the plan sponsor can choose to include the deferred compensation as part of eligible compensation for the employer defined benefit plan.

One of the major drawbacks to these plans was the very stringent definition of hardship. In order to meet a hardship distribution, it was considered it had to be a last resort, all of the financial resources had to be used, and furthermore, excluded from hardship was a college education for the children and purchase of a principal residence. The IRS expects to issue final regulations on these plans very soon. And there has been some indication that the withdrawals might be permitted for college, principal residence, and major medical. This will certainly be a very good advantage and will give further impetus to the establishment of these plans. These plans provide the employee with a terrific benefit, much better than an IRA. You can contribute more than $200,000. There is the advantage of 10-year forwarded tax averaging on distributions, and there are no tax penalties on early withdrawals if they meet the constraints.

Another type of benefit program which is gaining substantially in popularity, is cafeteria or flexible benefit plans. Under these types of plans, the employee can make up his own benefit package from an employer provided optional benefit program, or in

some instances, the employee must take an established minimum or core benefit and then add on.

The 1976 Tax Reduction Act amended ERISA to provide that employer contributions made before January 1, 1978 to a plan in existence on June 27, 1974 were excluded in the employee's taxable income to the extent that the employee actually elected taxable benefits. For plans not in existence on June 27, 1974 employer contributions were included in the employee's taxable income to the extent that the employee could have elected taxable benefits, thus the problem of constructive receipt.

The 1978 Revenue Tax Act added Section 125 of the Internal Revenue Code. This set up the rules applicable to all cafeteria type plans for tax years after December 31, 1978. Employer contributions were excludable from the taxable income as long as certain conditions were met. The coverage requirements were met if there was no discrimination in favor of the highly compensated. Eligibility requirements were met if the plan did not require more than three years of service for participation in the plan. Total benefits and nontaxable benefits for the highly compensated cannot be greater than such benefits to other employees. For this test, benefits were measured as a percentage of compensation.

If the cafeteria plan included health benefits, there were two additional tests which had to be met. Contributions under the plan, on behalf of each participant, must include an amount which equals 100% of the cost of the health benefit coverage under the plan of the majority of the highly compensated participants, or equals or exceeds 75% of the cost of the health benefit coverage of the participant similarly situated having the highest health benefit coverage, and contributions or benefits under the plan in excess of the above would bear a uniform relationship to compensation for both the highly compensated and lower compensated employees.

Finally, there is one other type of plan which I would like to cover, and that is PaySOPs. Essentially, these are viewed by some individuals as a government offer to establish a free employee plan. These plans were somewhat hidden in the Economic Recovery Tax Act of 1981. In reality, a PaySOP is a specialized form of employee stock ownership plan. Under this type of plan, the IRS requires employers to make contributions into a trust fund of either company securities or cash to buy these securities. The stock is then allocated each year to the employees, accumulated on their behalf, and then distributed at retirement or severance of employment. Although operating somewhat similarly in nature to a profit sharing or a defined contribution plan, employers can take a tax credit as compared to a tax deduction equal to one-half of one percent of payroll or contributions which are made to a PaySOP in 1983 and 1984, and three quarters of a percent for years 1985 through 1987. Tax credits are more advantageous than tax deductions since a tax credit reduces Federal Income Tax liability on a dollar for dollar basis. Under current law, these tax credits are scheduled to expire after 1987, but if legislative history repeats itself, we can expect extensions well beyond 1987. The evolution of the PaySOP can actually be traced back to 1975 when TRASOPs were established. And since then, after those were expired, you had the ESOPs, and now we are into the PaySOPs.

Finally, I would like to just briefly review some pending legislation as it is now before either the Senate or the House which will also have an effect on employee benefit plans.

HR 3930 Single Employer Pension Plan Amendments Act of 1983 - This would raise the Pension Benefit Guarantee Corporation (PBGC) premium from $2.60 to $6.00 for plan years after December 31, 1982. Plan terminations are divided into two categories - standard and distress. Standard is open to all plans. It does not require PBGC approval. Future accruals would stop. All service after the termination would be recognized for vesting and eligibility. Continued funding would be required. A distress termination is open to firms in financial difficulty. The PBGC would be required to pay guaranteed benefits for plans that meet any one of four specific tests:

1. The plan received funding waivers three out of the last five years preceding plan termination.

2. There has been a filing for bankruptcy.

3. The sponsor submits substantial evidence indicating that unless distress is granted, the company will not be able to pay its debts and meet its obligations.

4. Both of the following ratios: first, regular plan contributions divided by covered employee wages, and regular plan contributions divided by gross income would have to double over a stated period of time.

In the Senate there is S 1227, entitled Single Employer Pension Plan Termination Insurance Improvements Bill. This one covers most of the same provisions as HR 3930.

There is also S 1066, which would allow an employer to provide a cost of living adjustment under a defined contribution plan to supplement a defined benefit plan. Contributions would be without regard to the contribution or benefit limitations under IRC Section 415 or the deductible contributions under Section 404 of the code. There would be some limitation based on the cost of living increase. There is also an indication of limiting the overall maximum increase to 3% of the primary retirement benefit. Obviously, the industry is for this, and the Treasury is against it. Some of the reasons they are against it are: lost revenue; possible backloading; the anti-discrimination provisions of the Bill are not sufficient to meet their standards.

Although I do not have a bill name for it, it should be mentioned that on numerous occasions Claude Pepper has indicated that he would like to see faster vesting under pension plans even though he has been repeatedly told that this could have a significant cost impact. He also wants to see the 1983 Social Security amendments which increase the retirement age to 67 abolished.

Several bills seek to lower the eligibility age in the plan to 21: HR 2090, Economic Equity Bill; S 19, the Retirement Equity Bill; and S 888, the ACLI bill. This also covers other matters. HR 2553 would increase the IRA-type contribution from $2,000 to $2,500. HR 3525, the Permanent Tax Treatment for Fringe Benefits, would establish permanent rules for the taxation of fringe benefits; however, on the other side, there is S 135 and S 375 which would try to extend the now existing moratorium to further review the taxation of fringe benefits and in the other instances permanently prohibit fringe benefit taxation.

As you can see, we have had a lot of activity since the enactment of ERISA in 1974. In addition to TEFRA, we have had the 1976 Tax Reduction Act, the Revenue Act of 1978 and ERTA, the Economic Recovery Tax Act of 1981.

Favorable tax treatment can be divided into two categories: tax-deferred benefits, which are basically contributions to defined benefit and defined contribution or other capital accumulation plans; and tax-exempt benefits. Tax exempt benefits are essentially employer contributions to health and welfare or disability plans. Over the next several years, Congress and the IRS will be looking at these benefits even more closely. They will be comparing the social and economic gains to the cost of lost revenues, especially with the ever mounting Federal debt. Maybe I am pessimistic, but I think there will be some reduction in the existing favorable tax treatment of employee benefits mainly because of the anticipated lost revenue and also because fringe benefits are no longer fringe.

MR. JOHN ELKEN: As Sid indicated at the start, we are going to review the process and then proceed to go through the Bill more or less in sequence of the provisions of the Bill. Since we will be throwing it back and forth on the various elements, we will do it seated here so we do not waste time moving to the podium.

I am going to start with the process following the passage of the Stopgap Bill under TEFRA, and will not go back through the 2½ years preceding that.

The American Council of Life Insurance, following the passage of TEFRA, reorganized the Steering Committee under new leadership and began the process of attempting to develop a "permanent tax bill". They started out developing a set of basic principles and, based on those principles, attempted to put forth alternative tax schemes that might produce some agreement within the industry. That effort did not succeed. There was no agreement on a tax bill, so the Steering Committee decided that one reason for failure was that there were 20 Chief Executive Officers on that committee and perhaps fewer would be more effective. They appointed a Negotiating Committee of eight CEOs to attempt to hammer out a compromise in that smaller group. There was discussion of several solutions during those negotiating efforts, and no agreement was reached here either. Following the theme that less is better, two CEOs (Bob Beck and Ian Rolland) were appointed to a yet smaller negotiating group to try to find a solution. This did produce a compromise that those two could agree upon. That proposal was referred back to the Negotiating Committee first and received a favorable 6 - 2 vote in that body; however, when it was referred up to the full Steering Committee, it also failed. When the Chairman of the Steering Committee reported these results to the Board of Directors of the ACLI, they were understandably frustrated at not having a favorable report. They took the matter under their own direct responsibility and fairly soon shared the frustrations of the Steering Committee. In other words, no agreement could be reached there either.

The essential point on which agreement failed was on the so-called ownership differential, that is the additional tax to be borne by mutuals to make up for the difference in ownership between stocks and mutuals.

At about this time, Chairman Rostenkowski of the Ways and Means Committee delegated to the subcommittee on Select Revenue Measures the job of developing a permanent tax bill to fill in after the expiry of the Stop Gap measure. The Chairman of the subcommittee, Pete Stark, invited the ACLI negotiation committee to lunch on April 13. At this luncheon, Chairman Stark put forth his new approach which separated the taxable income into investment return and underwriting income. This concept found very little support.

In a press release on April 8, Chairman Stark asked several questions about life insurance taxation and sought responses to those questions at hearings that were held May 10-11. There was testimony at these hearings from the Treasury, mutual company groups, stock company groups, several insurance associations including agent groups, individual companies and independent experts. Following those meetings, there were technical meetings between the staffs of the Tax Writing Committees and representatives from mutual companies and stock companies on four main areas: ownership differential; the definition of life insurance; reserves; and a small company allowance.

This went on primarily during June of this year. Following that, on the 14th of July, Chairman Stark, along with minority member Henson Moore of Louisiana, surfaced a discussion proposal. "We are getting closer but we are not putting anything in stone" was the concept here. There were hearings on this discussion proposal on July 28. The discussion proposal was clarified and modified in closed subcommittee sessions on August 2 and announced at a press conference the same day. A draft of that discussion proposal as clarified was prepared by the staff during the recess in August (not everyone had a vacation) and was exposed in the week of September 12. There was an indicated two-week response time to that proposal prior to a markup of that bill, which occurred on September 27. During all of this time, through the summer, and particularly toward the end, there were intense negotiations with the staff, and members of the subcommittee, separately with mutual company representatives and stock company representatives. This included up to and during the markup on September 27. The subcommittee then reported the Bill up to the Ways and Means Committee. Ways and Means took final action on Thursday and passage by the House is anticipated this month. What happens on the Senate side is a little less clear, but there is certainly a chance that it could secure passage yet this year.

That is a brief rundown of the process. I turn it now to John Palmer.

MR. JOHN PALMER: Thanks, John. Before I get into the Bill itself, I shall just comment about one thing on the process after that rapid run through. I think it is worth noting for the record that a lot of praise is due to the tax writing staff people involved in this effort. They came to this area fairly cold in general and coped quite well with a complex subject. Having worked with them closely and seen them in action, I think that the degree of dedication and enthusiasm and knowledge they bring to the whole process is remarkable. In my experience, they are all quite well-intentioned and are not out to get us or anything of that sort. They are slightly paranoid about some issues, but I think that they are generally an extremely competent group of people, and we can be happy that we have such a group available for this kind of thankless task.

We are going to go through the provisions of the Bill more or less in sequence as they appear in HR 4065. John and I will trade topics back and forth, but we are going to try to make it reasonably brief so as to allow plenty of time for questions at the end. There is no way you can cover something as complex as this in a brief period of time without shortchanging somebody's favorite topic. I might also note that we are not a whole lot more expert in this than a lot of you are because it is an area where I do not think there are any experts yet.

From a historical perspective, I think you can say that the income tax provisions prior to the 1959 Act were more or less cast in a mutual company mold and looked primarily at investment income as the basic tax base since the mutual companies

selling permanent individual life insurance were the dominant force in the industry. The 1959 Act might be viewed as a transitional scheme where an element of gain was brought in. In that kind of line of succession, then, this bill would be properly characterized as cast in a stock company mold. The basic computation is of a gain from operations, which is quite similar to the gain from operations we are already familiar with, but with some fairly important exceptions. It was decided early on that the Holy Grail here was a single phase tax system. Nobody could understand all of the present phases. Nobody could understand the 1959 Act, neither the Congressmen nor their staff people, and they concluded that there is no reason taxation needs to be all that complex, so with some good common sense we can get something simple, and certainly something single phase. As a result, nobody will ever call this bill anything other than a single phase tax act, at least nobody in Washington.

Having gotten our more or less standard gain from operations with income and deduction items as for normal taxpayers (with those few exceptions for insurance companies), we come down to the dividend items. One of the basic premises in this bill is that all benefits to customers in their capacity as such should be deductible at the company level. That implies for stock companies, whose customers are customers pure and simple, that all benefits to those customers should be deductible. In the case of the mutual company, the ownership piece comes into play. Mutual companies' policyholders are deemed to be both customers and owners. Hence, it becomes necessary to sort out which part of a benefit to them is being paid in their capacity as customers and which part is being paid in their capacity as owners - a difficult problem. One of the ramifications of this model is that henceforth when we look at the policyowner taxation, we will not be able to justify tax deferral at the policyholder level because of the existence of some sort of proxy tax at the company level. That argument has now gone away, so that we will have to defend the social value of life insurance on its own merits and not on the grounds that there is already some kind of a tax being collected at the company level.

John will get into the limitation on dividend deductions later as it is in the later sections of the Bill. The general premise, though, is that some part of the dividend is a return to the policyholder in his capacity as owner, and since a stock company does not get to deduct what it pays its owners, neither should a mutual company. The trouble comes in figuring out how big that piece is.

The main differences in the gain computation from what we have been familiar with are (1) that the reserves and the change in reserves item is calculated differently, (2) that there is a somewhat different computation of the proration of the dividends received deduction and tax exempt interest, and (3) that there is no proration applied to 100% dividends (that is, to so-called qualifying dividends to affiliates). This third provision was a more or less last minute change. It is of particular benefit to the mutuals who cannot form upstream holding companies to take dividends from affiliates. Stock companies have generally done that rather than pass the earnings of affiliates through the proration formula. Now they need not bother either, so it is generally beneficial to everybody.

Let me push on to the next couple of major differences. Once we have got this gain (called a tenative "LICTI," Life Insurance Company Taxable Income), we get two special deductions with respect to this gain. One is what has been called a Taxable Income Adjustment. This is simply 25% of the gain otherwise computed and is taken as a special deduction. It is not a special deduction of the old sort which would go into

the Phase III deferral mechanism. It is a permanent deduction. In effect, it transforms the corporate tax rate from 46% to 34½%.

The second item is a so-called small company deduction. The Congressmen had trouble understanding how a company with so many millions of dollars of assets could be a small company in anybody's book. They were used to the corner dry cleaner as their concept of a small company. Once they got over that conceptual hurdle they found that a small company was one that had less than $500,000,000 in assets. There is a special deduction for such a company: 60% of the first $3,000,000 of its tentative LICTI, graded out prorata over the amount of tentative LICTI between $3,000,000 and $15,000,000. In a previous version of the bill, this was lower: the limits were $1,000,000 and $4,000,000, but it was found that small companies needed more help than that, hence the limits were increased.

The Treasury is rather nervous about this 25% Taxable Income Adjustment and the notion of having a sub-46% tax rate for some group of taxpayers. They are concerned about other people sneaking into that tent. Hence there is a provision which excludes the tentative LICTI attributable to non-insurance businesses from this special treatment. It is a little unclear what the provision means. It says that non-insurance business means any trade or business which is not an insurance business - not too helpful a definition. It goes on to say that for the purposes of that preceding definition, any business which is not an insurance business but is of a type traditionally carried on by life insurance companies for investment purposes shall be treated as an insurance business. It is hard to say what that means - possibly operating something that you foreclosed on for a while, joint ventures, or things of that nature. One open question here is what do you do with operations like Administrative Services Only business or fees for pension consulting services that you offer clients. Are those insurance businesses or are they not? Is it fair that you get taxed on your piece of that kind of a business at 34½% while third-party administrators, if they have a gain, are taxed at 46%? That is the kind of question that inevitably arises when you have a differential in the effective tax rate.

It is worth noting that in computing the tentative LICTI limits all life companies are combined. Also, in the asset test, all life and non-life affiliates are combined. Hence, if you have a small life company that belongs to a giant manufacturing company, then that company will fail the small company test. Also, there is obviously a big danger in this 25% piece. It is a real sitting duck. Senator Dole now, or somebody else later, could just easily say "that is absurd" and take it off or at least reduce it. I would not want to spend any of the money one would save from that item right away, or price with it long term.

Tax reserves are currently computed with reference to minimum state standards. The government people are unhappy with the degree of latitude we had in establishing tax reserves in the past, where in general whatever the actuary set up was good enough for tax purposes. They want to impose a good deal more control on us. You will compute a minimum actuarial reserve based on the appropriate Commissioner's Method with interest at the highest rate permitted under state law and using the most recently promulgated table for the kind of benefit in question. That is the actuarial reserve. A tax reserve, however, is the larger of that reserve and something called the net surrender value. The net surrender value is the cash value less any surrender charge that would be assessed on surrender (other than a market value adjustment). However, in no event may this tax reserve exceed the statutory reserve you actually hold. How can it exceed the statutory reserve if the tax reserve is defined as the minimum? It

can because of the peculiar way interest rates are determined. The method to be used is the Commissioner's Reserve Valuation Method or the Commissioner's Annuity Reserve Method for annuities. There is also language providing for similar or consistent methods if there is no such method prescribed for the contract in question. There will be room for discussion in this area. The interest rate is the highest permitted by 26 states. You list in descending order the interest rates permitted by all the states and draw the line at state 26, and that is the interest rate that you use. If you are licensed in a state that is in the bottom 24, and not licensed in any of those states above, then you may have for tax reserves an interest rate that is not one that you are actually using for statutory purposes.

There is an exception for pre-1948 business where there were no Commissioner's tables applicable. Also, for supplemental benefits such as ADB and Waiver, one is allowed to use statutory reserves. There is an open question as to whether you perform your comparison with a cash value before or after adding supplemental reserves to the basic reserve. The approach we have tried to sell has been that one should do it on a benefit by benefit basis, that is, compare the cash value to the basic benefit reserve and then add the other reserves, in cases where those supplemental benefits give rise to a separate premium. In cases where they are automatic, as might be the case on traditional policies, or where you look to the cash values to find these benefits, as might be the case in a universal life policy, then it would be the other way around - that is, you add all the actuarial reserves and then compare the total to the net surrender value.

Before I leave reserves, the most interesting feature is what is now called the "Fresh Start" provision, which before we became politicized was called the "forgiveness" provision. Reserves are computed on the new basis on 1/1/84, and the old basis is disregarded. This, in effect, relieves us of the coming back into income of any of the older higher reserves. In addition, the "Fresh Start" provisions discontinue the effect on income of any of the Section 810(d) reserve change spreads that had been set up prior to the effective date of this bill. There are a couple of exceptions to "Fresh Start". There is a concern on the part of the Treasury about some kind of game playing toward the end of the year, knowing that "Fresh Start" is in the wind, so there is a provision which denies the extension of this "Fresh Start" treatment to reserves associated with contracts that were the subject of reinsurance agreements entered into after September 27, 1983. It is also denied to reserves associated with "any reserve strengthening". It is not totally clear yet what "any reserve strengthening" means, whether that also is limited to post September 27, 1983 actions, or exactly what they had in mind. Clearly the intent was, though, to try to mimimize the amount of game playing at the 11th hour. I think, as an editorial aside, that although it may be in somebody's individual best interest, it would certainly not be in the industry's collective best interest to engage in a massive exploitation of whatever kinks still exist by trying to play a lot of reserve games at the end of the year. One of the worst things that could happen would be for this bill to get stalled in the House this year, get in the Senate next spring some time, and have horror stories emerge about a lot of reserve games that were played by the industry. There are already enough paranoid people who think we are up to no good whenever we are given a fair chance to do so. I think it would be extremely poor for us to be caught at those kinds of games.

John, I shall pass it on to you for the next sections (808 and 809) on dividends.

MR. ELKEN: Thanks, John. The section on policyowner dividends defines them broadly, or as some have called it, anything that moves. It appears they have included

some things that do not move. There are four elements in the Bill; first, those items not fixed by contract depending on the experience of the company or discretion of management; second, excess interest; third, premium adjustments; and fourth, experience rating refunds. So dividends are defined fairly broad. Under prior possible permanent solutions, the definition of dividends would have been a very important item. The way this finally came down, the definition is of much less importance, but still of interest and of significance. We shall get into that in the discussion of proration.

The next section deals with what has been called the ownership differential, or the limitation on deduction of dividends. Let us go back and touch a little bit on the original Stark-Moore proposal.

It might be helpful in understanding where this final add-on concept came from. That original Stark-Moore proposal said that each mutual company would compute its minimum tax base by multiplying an imputed earnings rate times its mutual company equity. That was to be the minimum tax base. If their Gain From Operations (GFO) after dividends was less than that return on equity, the return on equity would be the tax base. It would say that the differential, or the extra tax base for that company, would be the difference between that imputed return and their Gain From Operations after deduction of 100% of dividends. The mutual companies, in the negotiating process, were very concerned about many aspects of that minimum tax concept and pushed hard for a redistribution among companies of that extra tax to be borne by mutuals. The changed approach is an add-on and was proposed in a mutual company task force by Harry Garber of the Equitable Society (it has been called the Garber Add-On), and is similar in some respect to the original Stark-Moore proposal in the sense that it deals with an imputed earnings rate, but in this case it subtracts a mutual company industry rate on equity and multiplies that difference times each individual mutual company equity, and then adds that back to the GFO after deducting 100% of dividends.

The original minimum form and the add-on form produce exactly the same revenue if GFO after dividend for all mutual companies is less than the imputed rate times their equity, and GFO before dividends is greater than the imputed rate of return times equity. That may not hold true for every company in the industry, but certainly the exceptions would be minor, and I think essentially that the two bills come down to the same total mutual company revenue. The equity piece of the process is defined as: statutory surplus and capital plus nonadmitted financial assets, plus the reserve adjustment John Palmer discussed (statement reserves less Stark-Moore reserves). Other reserves are added - the Mandatory Security Valuation Reserve, deficiency reserves, and "voluntary reserves". This will be an area that will result in a lot of discussion between company tax experts and revenue agents. Another addition is 50% of the dividend liability for the succeeding year. Under the tax bill, the sum of all of those items is now equity. The imputed earnings rate for 1984 is 16.5%. That was set to produce revenue from the mutual segment of the industry of 55% of the total estimated revenue for 1984. The revenue estimate for 1984 had to be driven off of estimates of stock industry gain from operations after dividends because that would esentially be the base for their tax. Then taking 55/45 of that estimate produced the target revenue from mutual companies. Working back with the estimate of what the mutual company equity would be during 1984 produced the 16.5% imputed rate to begin this process. In the future, that imputed rate of return will be that starting rate of 16.5% times a ratio of a current stock rate of return to a base year stock rate of return so that 16.5% will be indexed to changes in stock rates of return. The stock

rate of return is GFO after dividends divided by equity (similarly calculated for a stock company). These calculations will be performed for 50 large stock companies (including all affiliate life companies in the controlled group). Thus, the rate of return will be calculated for each of those 50 groups. These rates will be summed and the numerical average will be used. The base rate will average 1981, 1982, 1983, and as you move forward in the future, a similar three-year average would be used to calculate the current rate of return. Note particularly that this rate is a numerical average, not a weighted average. The principal reason for using a numerical average was to minimize manipulation potential. When the results of one segment of the industry determine in some significant measure the taxes of another segment of the industry, potentials for manipulation are high on the list of concerns. The thought was that it would be harder for a few stock companies to manipulate the results if it was based on a numerical average rather than a weighted average. The mutual company rate of return, which is used in the differential is, as contrasted to the stock rate of return, the sum of all gains from operations after dividends of all mutual companies, divided by the summation of all their equity. So it is a weighted average on the mutual side and a numerical average on the stock side. The concept, as I understand it, is that the mutual rate of return to be used for the tax year 1984 will be determined from 1982 results. I understand those are producing about an 8½% mutual company rate of return. Final numbers are not available, but I think that is the likely number. So, tax returns for 1984 would be filed using that number which produces an 8% differential, 16½% minus 8½%. Then, at some time in the future (about two years) when the 1984 actual mutual rate of return is known, an adjustment to that year's tax base will be made to "true up" for the difference between the assumed mutual rate of return (8.5%), and the actual 1984 rate of return times the 1984 mutual company equity. So there is a mathematically pure "true up" to an actual rate of return in 1984.

I mentioned that this bill has been discussed as an add-on, and numerically it is accurately that, but in the Bill it is expressed as a limitation on deductibility of dividends. There are a couple of reasons for that. There was concern that there may be a constitutionality issue on adding back something to your income base. Others disagree with that, but nonetheless, that is a factor. It also impacts the proration element, so it is meaningful. With the idea that there may be some company out there whose dividends were less than its add-on, that is its gain from operations before dividends would be less than GFO after dividends, plus the add-on. That eventuality is covered because then you limit the deductibility of reserve increases to allow the full addition to the tax base. They covered quite a few bases, I would say.

I mentioned, as we went throught the process, that the stumbling block in all of the negotiations within the industry was this add-on or ownership differential concept. And just to give you a little flavor of why that was such an issue, I would like to give my viewpoint, and I believe it would be shared by other mutual companies. There are some problems that exist under the ownership differential in the Bill. The mutual companies generally have never been convinced that there is a rational argument for an ownership differential. Merely the stock form of ownership produces a given tax result is not sufficient cause to penalize the mutual form through taxes. Pragmatically, mutuals have agreed to an additional tax to balance the consequences of shareholder dividends of stock companies. It is not clear what basic problems will emerge from this return on equity concept that has been adopted. We are very nervous about that uncertainty. The fact that I mentioned earlier, that mutual company taxes will be driven by stock results is to say the least, a very unusual facet of tax law. It is clear that the 55% segment balance that was plugged into this law,

stems from historical shares driven by the 1959 Act. Revenue had become excessive for companies under that act whose tax was impacted by Taxable Investment Income. Not exclusively mutuals, but heavily mutual companies were involved in that. The index approach carries that historical heavy tax through the future lifetime of the permanent bill. In addition that balance, which existed under the 1959 Act, dealt with a significantly higher differential between traditional participating contracts and traditional nonparticipating contracts. The so-called non-par deduction was a significant element there and that element is not carried over into new law. All of the differential is placed on new products. That element contributes to the problem. With that, I shall pass it back to John.

MR. PALMER: Thank you, John. Let me add a couple of supplements to John's comments on the dividend limitation. That, of course, is the heart of the difficulty between the stocks and the mutuals, why we were unable over the course of several years to reach an agreement, why we had six to two votes, and why the ACLI was unable to function to bring us together. The stocks generally believe that the rationale underlying the proposed bill makes sense. There is an economic difference in the ownership of the two kinds of companies, as I alluded to earlier. The technique involved uses segment balance as a benchmark with which to set the dials on this taxation machine. The segment balance number (55%) was used to solve back for the 16.5% imputed rate. The mutuals "point of view" is that the mechanism is used to perpetuate an iniquitous tax burden that arose under the 1959 Act. The actual tax distribution in 1978 was more like 62% mutual, 38% stock. Of course, one can argue about what a proper segment balance should now be after adjusting for passage of time. I think the stocks would generally believe that 55% is generous to the mutuals as far as reducing the burden imposed by the 1959 Act. One final comment on the 16.5% and the Bill's adjustment mechanism to bring that rate forward using a change in average stock returns: it is not totally clear to me, and probably not to anybody outside the Treasury, exactly how they got the 16.5% and what went into it. Presumably, one picks an estimated stock company tax under its side of the Bill, divides by 45% to get the total burden, then looks at the estimated mutual equity in 1984, and finally solves backwards for the 16.5% rate. It seems then that the adjustment mechanism ought to be a function of what that 16.5% was predicated on. It is not clear how that is going to work or how accurately it will work, or what in fact the Treasury estimators used to get the 16.5%. Most of the numbers are still inside a black box in the Treasury, so we really do not know what went on. It still remains to be seen whether this will be a source of happiness on anybody's part.

From here on we are going to hit the topics in a bit briefer fashion, since we have already covered the big ones. There is an interesting change in the accounting provisions in the Bill. Old Section 818(a), which was the source of a lot of discussion with regard to the Standard Life case, has been changed. Whereas the old law said "except as provided in the preceeding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement," the parallel provision now says, "To the extent not inconsistent with the preceding sentence or any other provision of this part, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement." The explicit purpose of this was to reverse the Standard Life decision. What I think it also does is open a lot of new questions about accrual accounting. It in effect turns around the current primacy of annual statement accounting, so that accrual accounting now appears to have gotten the upper hand. So we are back to tax accrual, all events test, accounting as the primary standard and annual statement accounting as what you do if they tell you to do it, but otherwise not. This has a

potential for a whole lot of mischief going forward, and efforts have been made to get this changed (so far unsuccessfully).

MR. ELKEN: The proration rules I referred to earlier, now read that the company's share is the excess of net investment income over amounts in the nature of interest paid or credited and dividends deductible, so it is here where the fact that the add-on is expressed as a limitation on the deductibility of dividends has a real bearing on the proration calculation. It is our understanding that this represents the significant reduction in the company share as compared to prior law for at least most companies.

MR. PALMER: I shall skip over the foreign company and the contiguous country branch provisions and get on to Phase III, or what used to be Phase III. We have no phases now, of course, so this is not Phase III anymore. But there is a provision that says that the policyholder surplus account existing under the 1959 Act is frozen in amount, in the sense that there are no more additions to go into it (the 25% special deduction does not go into it, nor does anything else). However, deductions may come out of it. Deductions would be those called for under the operation of the shareholders surplus account, as it would have generally operated under prior law, and any tax thereon. Essentially, this is what is called "Option Four" in the Joint Committee pamphlet which described what they had in mind before the Bill was drafted. This is as close to forgiveness as you can get without actually forgiving. It leaves everything up and running as it was, with taxable income less tax going into the shareholder surplus account. You still have distributions deducted, and if you run out of shareholders surplus, you get into the policyholders surplus account. A lot of us are going to have less likelihood of getting into Phase III simply because there is going to be a lot more taxable income going into the shareholders surplus account. That generally covers it, except to note that the policyholders' share of tax exempts and dividends received, as well as capital gains, are no longer added to the shareholders surplus account, to eliminate alleged double counting.

MR. ELKEN: The next section deals with the definition of an insurance company and life insurance company. For the first element of that I would like to read from the Bill. "For purposes of the preceding sentence, the term insurance company means any company more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or reinsuring of risks underwritten by insurance companies." If that is a precise statement for most of you, I will be happy to hear your comments on it. The life insurance company determination is the same 50% of reserves: life reserves must be 50% of total reserves. Total reserves have been redefined to exclude reserves at interest not involving life, accident, or health contingencies. So those amounts are excluded both from the numerator and the denominator of the fraction.

MR. PALMER: My next section (new Section 817) is a special section now covering variable contracts. What this does essentially is what Walt Miller described this morning in a variable life session, that is, it preserves the same treatment that previously existed with respect to the variable annuities, both qualified and non-qualified. They were treated differently, and they still are. It also makes explicit how variable life is treated, and the way it makes it explicit is to say that it is treated essentially like non-qualified variable annuities. That leaves us the old problem of capital gains treatment. The provision takes out of the increase in reserves (or the decrease in reserves) for a variable contract that portion of the increase (or decrease) related to unrealized appreciation (or depreciation) of the assets, but it does not excuse you from a capital gain tax on the assets. That excuse is granted in the case of

a qualified variable annuity but not for other variable contracts. We did not get this unfortunate treatment because of any lack of effort to get a correction. However, we lacked a high visibility effort, with all the other grander issues being thrashed over, such as deduction of dividends and reserve standards. This area was, in the overall scheme of things, fairly small potatoes and did not receive all that much attention. When trying to get a congressman interested in something, you have about five minutes and maybe one easily remembered topic, so you do not get down to this level of detail very often. My understanding is that the technical staff does not have much problem with the general idea of extending qualified plan treatments to all these contracts. The big hangup is in the political side. The investment company people are not happy with this idea. They were not happy with it several years ago when the current treatment got put in, and they are still not happy with it. They probably do not care that much in the case of variable life, but they do care much more in the case of variable annuities, because these products appear to be more directly competitive with mutual funds and the other things that they sell. The congressmen are not intested in bringing down the wrath of the investment company people, so unless we can get the investment company people to acquiesce in a favorable change, we are probably going to have trouble getting a good result this time around. I might also note that there is a more or less explicit recognition of variable universal life insurance in the definition of a variable contract. The original draft had a problem in this regard but HR4065 as it turned out defines a life contract as one for which "the amount of death benefit (or the period of coverage)" is adjusted on the basis of investment return or market value. The parenthetical phrase was not there before, and without it the definition might have accidentally excluded variable universal life, where one might say that the period of coverage and not the amount of death benefit is what varies with the investment return.

The definition of life insurance, for discussion purposes, is split into two parts. One is the flexible contract rules, which I will cover, and John will take care of the application of the rules to non-flexible products. What we have in the Bill is new Code Section 7702, which defines life insurance. The general outline of the new definition of life insurance is very similar to that found in TEFRA in Section 101(f). That is, it is a dual test. You have two different ways to meet the definition. The first test is a cash value or net single premium test, that is to say, a limitation on the relationship of the cash value to the net single premium for the benefit. The other test is a somewhat more complex guideline premium test, under which the sum of the premiums paid in cannot exceed the greater of a guideline single premium or the sum of certain guideline level premiums. There is a subsidiary cash value test embedded in the guideline test, which compares the cash value to so-called corridor percentages. The corridor percentages are a bit different. The old ones were based on 140% graded down linearly from age 40, while the new ones are based on 250% graded down non-linearly from age 40. Stark and Moore originally had 250% graded down linearly, but they were prevailed upon to take a slightly more curved view of the world, so we now have a scale that dips a bit. It dips irregularly (first differences and second differences aren't very satisfying), but it does produce a slightly more generous result at the more critical ages. The guideline level and guideline annual premium definitions are similar to what they were before. There is a change in the "first computation rule", for those who are familiar with the jargon. The computation rules in this definition essentially limit the types of benefits that can be taken into account for purposes of computing the guideline premiums, which serves as limitations on the amount of premiums that may be paid in. Certain kinds of benefits cannot be taken into account. In general you cannot take into account increasing death benefits under a contract. The definition as we have it now would preclude you from putting in

enough premium to prefund, on a single premium basis, an increasing death benefit policy. This computational rule was the one, in a slightly earlier draft version, which said that the amount of death benefit cannot increase beyond its initial amount. Now it says the amount of death benefit shall be deemed not to increase. I think that this provides a sort of rachet definition, so that if the benefit decreases, you cannot take into account later increases for purposes of prefunding. This is to avoid the so-called "valley problem", where you might have a high initial death benefit, drop it for a while, and bring it back up again, allowing for a quasi-SPDA effect in the "valley period".

One thing that is still unsettled is the treatment of so-called option 2 benefits under universal life or other kinds of plans (option 2 being the type of benefit that used to be called the return of cash value benefit). The Treasury was unhappy with allowing prefunding for such a benefit. The initial draft of the bill prohibited option 2, as it still does. Representations have been made that option 2 is not really an unduly investment oriented type of benefit. There may be a compromise here where we shall find that option 2 type prefunding will be allowed, but only for purposes of computing a guideline level premium, not a guideline single premium. I suppose that this would necessitate an analogous net level premium reserve on the cash value test side.

What are the consequences of failure of these tests? What happens is that all past income under the policy becomes currently taxable, and henceforth each year as income emerges under the contract, that becomes currently taxable. In the event of death, the amount at risk under the policy would be passed tax free under 101(a) and tax would have already been paid on the other piece. Income here is defined as the change in the net surrender value plus an imputed cost of insurance less the excess of premiums over dividends paid. Cost of insurance is supposed to be figured on either a uniform premium table yet to be promulgated or a stated charge in the contract, if less. As to transition rules for flexible premium policies, you comply for 1984 issues if you comply under current section 101(f).

MR. ELKEN: Issues under plans providing for 20 level premium payments or more submitted to one or more states before September 28 will be grandfathered as long as those plans are "on file" in those states. So as I read that, that is open-ended grandfathering for a current series even if it is at the stage of submission to the states for approval as long as that happens before September 28. John, you are going to help us understand the changes in the annuity distribution.

MR. PALMER: There were a lot of annuity changes proposed which tightened down the screws under TEFRA. Not many of these actually came to pass, but two changes were retained. One, the penalty tax now applies notwithstanding the ten-year aging rule that is in the Code now in Section 72(q). You do not now get to withdraw and avoid the tax penalty after ten years. The second change is that in case of death before annuitization the amount of cash value of the annuity contract is treated as distributed to the holder of the annuity contract immediately before his death. However, any amount includable in gross income on that account is treated as a premium paid and does not affect the basis. John, back to you for Section 264.

MR. ELKEN: Those of you who are still alert at this hour probably realize that we have slid from life insurance company taxation into policyowner taxation. That happened back when we started talking about the definition of life insurance. There are several other provisions affecting policyowners. One was in the policy loan area. Originally, interest on $50,000 of loans was deductible, but the excess over that was not

deductible. This has been liberalized considerably, largely as a result of agent groups (AALU and NALU) negotiating with the sub-committee. Now the deductible interest for individuals on a joint return is on $500,000 times the rate used for tax deficiencies. For a single return that is a $250,000 item. For corporations, partnerships, proprietorships, or other entities engaged in trade or business, the limitation deals with the concept of a qualified employee. The entity uses the deficiency rate multiplied by $500,000 per qualified employee. A qualified employee is one for whom the entity carries an individual whole life insurance policy, the amount of which is at least 10% of the highest amount of life insurance that is carried by that entity for any employee. In addition to that limitation there is an unlimited carry forward of unused deductible interest, so if there is any amount by which your deductions for interest is less than the maximum you could have deducted you get to add that amount on to next year's deductible interest, and if you are short that keeps building up.

In the original version of the Bill, there was a change in the basis of the gain on surrender, that is a deduction of the mortality cost. That provision has been dropped.

There is a change on group life for ex-employees, principally targeted at retireds, extending the $50,000 limitation on free insurance. Exactly what that means with respect to the Table I rate that will be used is not known at this point. That table does not extend above age 64, and you can either relax and say they will use that same rate forever for ages above 64 or be very concerned how much absurdity they will build into those older age rates. For the older ages there is significant grandfathering in this provision in that current amounts of coverage are grandfathered for retired and active employees.

MR. PALMER: I shall make a general comment or two on the policyholder tax items in general. First, never underestimate the power of an agent's association. It is absolutely unbelievable how much they were able to accomplish. From our point of view, having the change in cost basis removed was a terrific boon. Nothing would have been more pernicious than to have that into the Code, because it makes a lot of theoretical sense and it would be very difficult to get out again. As our customers become more sophisticated, especially when we get into such products as variable contracts, the cost basis advantage will become a more and more significant edge for us as other differences get chipped away by competitive pressures. This difference will become more and more relatively valuable, so it is a particularly happy thing that we were able to retain it.

With respect to the Section 264 minimum deposit rules, I would like to pass on one comment a practiced observer of the scene made after seeing what happened in the final markup to Section 264. He threw up his hands and said, "My God, this rule not only has no teeth, it has no gums." The agents, of course, see it as a camel's nose under the tent or shadow in the doorway, or something of that nature, and they may well be right. It has now been established that there is a limit, but we just have not finally come to grips as to how high or low it should be yet.

With respect to the sections providing for studies, the Bill mandates revenue reports annually starting July 1, showing actual versus expected results; that is, what this bill was expected to produce versus what it actually did produce. There was moderate dissatisfaction with the revenue results under TEFRA, vis-a-vis what had been suggested might be received, and what is desired is a systematic method of keeping track of revenue results. There is also a section of the studies title which calls for reports on segment balance: actual versus ideal, supplementary studies to determine what ought

to be ideal considering things such as assets, gain, and so forth - all sorts of things which may or may not be relevant to determining what segment balance should be. Presumably, segment balance ought to be in proportion to taxable income, but that tends to beg the question. The section on segment balance calls for interim reports in 1986, 1987 and 1988, with a final report in 1989, so this could be viewed as a reopener type of provision.

The final thing we shall discuss, which I will just hit briefly, is a new title added to the Bill in the Ways and Means Committee dealing with nondeductible IRA contributions. This provision would allow for up to $1,750 per year of nondeductible money to be put into an IRA, with the income thereon sheltered from current taxation. There are various rules about order of withdrawal, separate record keeping, and so forth. It is generally a liberalization of the current IRA rules.

MR. LEBLANC: Thank you, John Palmer and John Elken. We now have time for questions. If anyone has a question, would you please come to the microphone and identify yourself and your company affiliation.

MR. JOSEPH MORAN: It was interesting to note that there was no point anywhere in the Stark-Moore Tax Bill where there was any differentiation between individual life and health insurance and employee benefit plan coverage, either life and health or pensions. Under the TEFRA law, pensions were walled off and avoided certain taxation. But now we have lost ground on the taxation of pension business in mutual companies by having certain pension liabilities thrown back into that equity base. Any comment as to the background for failing to preserve the progress that had been made or to make any more progress on that score.

MR. LE BLANC: I may comment on that a little bit. First of all,you can deduct 100% of your dividends, so on your pension line of business your tax is on gain primarily, so you are talking about the surplus tax and how that affects the employee benefits, group and pension. The manner of that impact depends on how you allocate your surplus tax to the lines of business, which is a non-simple proposition. There was some discussion with the people on the hill as to whether there should be some difference on these lines because if you have a tax on surplus,it hits pension and employee benefits harder than it should, and there should be no differential there. The response was that if you need more surplus in group insurance, you should have a higher return on your group business, so, therefore, there should be no distinction. There was very little sympathy for any type of variation on the ownership differential to reflect any proportion of your business in employee benefits.

MR. ELKEN: I might add that when the Bill had the shape that would have the definition of dividends and the deductibility of dividends very much an issue, there was considerable discussion about differentials in the deductibility of dividends between the various lines, let us say pension lines and so on. Even during that time, there was something short of complete enthusiastic acceptance of the concept of difference in the deductibility of dividends across those lines from the staffers, and when the deductibility became a non-issue, those arguments were even less effective.

MR. BILL WELLNITZ: In the Bill prior to markup, in reference to the calculation of the reserves for tax purposes, the interest rate was to be determined as controlled as of the date the contract was issued. The valuation table was kind of vague, but it gave us the impression that whatever table was currently available was to be used. Has that changed at all coming out of markup?

MR. ELKEN: I have not seen the Bill as it has finally come out of the House Ways and Means Committee, but the Bill that came out of the Subcommittee markup still has that problem. Some read that to say that there is not a problem, others would much prefer it to be clarified. I do not think that is intentional, so my guess is that there is a chance for that to be clarified either in a further modification of the Bill or else clarification committee reports.

MR. PALMER: I think that is right. You are going to find a lot of ambiguities and peculiar wordings and so forth, in the reserve section particularly. The people that wrote this were not actuaries and had a fairly recent knowledge of most of the things they were writing about. If you find some peculiar things in there, it is generally not with malicious intent, it is due to confusion, and they are open to suggestions for reasonable remedies and interpretations. It is not totally clear how treatment of substandard reserves will be handled, among a variety of other questions. An earlier version allowed you a choice of interest rates in years when the maximum rate changes, that is, the current one or the one at the beginning of the year. That choice has been removed with respect to annuities in the belief that there was too much game playing potential in that area, but it was retained for other products. You might eventually see some more generous grandfathering than we have got now. This is still an early stage, and there is room for plenty of nonsubstantive avoidance of nuisance changes before the Bill finally passes.

MR. WELLNITZ: Do you have any idea if the intent is to fix the valuation basis at the date of issue?

MR. PALMER: Yes, that is my understanding. That is, the intent was to fix everything at the date of issue so you do not have to revalue every time standards change. That is certainly the intent, imperfectly carried out perhaps, but that was the intent.

MR. PAUL LEFEVRE: I find myself quite confused as I get questions from agents on the new annuity wording regarding annuitization prior to death, and it revolves around whose death and whose tax return, specifically between contracts that could have different owners than annuitants, and could have owners that are not people, such as trusts and corporations. I do not know if you can lend any clarification to that, but to me it is very confusing because most annuity contracts have death benefits revolving around the death of an annuitant. Recently there has been, depending on your outlook, either use or misuse of such provisions as contingent owners and contingent annuitants, and I am uncertain where this is taking us right now.

MR. LE BLANC: I think we are in trouble, we do not have any annuity writers on the panel. Would anyone like to take a shot at it anyway?

MR. PALMER: I certainly would not. The language is quite vague. You can read it, but you cannot tell how to apply it. I do not have any personal knowledge of the background that would lead me to be able to tell you what it is they thought they were doing. Someone in the audience might be able to help.

MR. STEVE LARGENT: I have a question as to how the adjustment clause works in the definition of life insurance. Specifically, if you have a contract with an increasing face amount, and the cash value in any year is no larger than the net single premium for the death benefit in that year, will that comply in spite of the computational rule, which says the death benefit is deemed not to increase and the computational rule

which says that the endowment cannot exceed the minimum face amount, and if we were to return to the TEFRA rule limiting the amount at risk increasing instead of the death benefit increasing, would it still comply?

MR. LEBLANC: Did you have a one-word answer to that, John?

MR. PALMER: Probably. That is quite a number of questions. I think that you started off asking about the adjustment rules. The adjustment rules are the same as they were before, as I understand it. It is still unspecified in the Bill as to exactly how they are applied. You have an adjustment when you get to the point where you can take into account a benefit under a computational rule that the computation rule previously prevented you from taking into account. If the death benefit goes up every year as you progress through time, you can take into account, via the adjustment rule mechanism, each step up in benefits. It may or may not be enough to keep you out of trouble with your particular product.

MR. LARGENT: Can you do that even if the death benefit is scheduled to be increasing?

MR. PALMER: Yes, I think that is right. All the computation rules do are specify what it is you can count, that is, what you can look at in computing your guidelines. Then you can take more and more into account simply on account of the passage of time, recomputing under the adjustment rules. On that topic, I might add that the adjustment rules at present under TEFRA are not totally crystal clear, and they are probably going to be up for reexamination this time around. There will probably be a harder, more detailed look at the adjustment rules than we had the last time. We may not have merely a colloquy between Dole and Bentsen to rely on for fleshing out the adjustment rule language.

MR. LARGENT: Do you think it holds for the endowment limitation also? If you have a traditional whole life policy which endows for five times the original face at age 100, that is not prevented by the fact that the endowment cannot exceed the smallest face amount.

MR. PALMER: I think that is not permitted to be taken into account for limitation computation purposes.

MR. SYED ALI: I have two questions. Number one, under the guideline premium test, premiums are calculated using an interest rate at the lower of four percent or that guaranteed in the contract. Does it mean that companies going to the 1980 CSO and guaranteeing six percent will be at a disadvantage, and if so, should companies refrain from going to 1980 CSO at this time? Question number two: in the computation of the gain from operations, how will surplus relief treaties be taken into account where artificial reduction of losses occurs?

MR. LE BLANC: John, do you want to try question one?

MR. PALMER: The consequence is there, as you described it - the guideline premiums are lower. Whether it is enough to cause you to refrain or not, I do not know. That is up to you.

MR. LE BLANC: The second question was on surplus relief. I would assume that if

you had a surplus relief treaty, it would reduce your tax surplus and, therefore, anything that applied to tax surplus.

UNKNOWN: In response to the person who asked the question about annuities before, our lawyers, for what it is worth, believe that it is the owner of the policy who determines the tax on death, not the annuitant. A question to the panelists: we have all heard rumblings that Senator Dole is not happy with revenue raised out of the Bill, first of all is that correct, and if it is correct, in your view, having been in Washington recently, is it likely the Senate would tamper with the structure of the Bill or just tamper with things like the 25% artificial deduction?

MR. LE BLANC: I would think it would be unlikely they would tamper with the structure of the Bill, but they may tamper with the revenue level. Let us get some more opinions on that.

MR. PALMER: I think that not only is Dole unhappy with the revenue, Treasury is not happy with it either, nor were Stark and Moore wild about it. They thought they were heading for $3.7 billion instead of $3.0 billion, and an estimation error in effect caused them to back into the current level. Stark and Moore were essentially committed to the various parties, on account of having struck deals with them, to adhere to what we see in the present bill. Dole has struck no such deal with anybody, and he is perfectly free to do anything he pleases, including changing the structure. I think he would be disinclined to try to do that because it was so difficult to get this far, and it is hard to imagine what kind of political capital could be achieved by playing around with the structure, absent some increase in the revenues. He can get the increase in the revenues just by twisting a dial a little bit.

MR. ELKEN: I would say it is not entirely clear how unhappy Dole is with the revenue level. He might be unhappy with how it got there. That is to say, he has publicly stated $3 billion is "an appropriate level of revenue from the industry" on more than one occasion. My guess is he would much prefer to have been the one to reduce it from some higher point to $3 billion than have it presented to the Senate at a $3 billion approximate revenue level.

MR. ARDIAN GILL: I have two questions on investment income. You mentioned proration and company share. Have you or any other companies done any calculations on the effect on marginal tax rates on tax exempts? What is the impact of the law in accrual of bond discount?

MR. PALMER: As far as marginal tax rates for investment purposes go, we have done some computations. The Bill does unpleasant things to them. It depends on the effect of the Bill on your policyholders share. The proration in the original committee print was peculiar because it prorated over total income, not just investment income. We have restored at least what looks like a rational basis. In the numerator now we have dividends added under this expansive definition of dividends which includes other things like phantom premiums and a lot of things that stock companies are not used to thinking of as dividends or even computing. So the adverse effect varies greatly from company to company. In our case it is fairly substantial, and takes the Company's share from 60% to 40%, roughly, and when you plug that through the numbers, you get a sizeable disadvantage. Just the lowering of the marginal tax rate from 46% to 34½% does some damage to deep discount bonds since you have narrowed the difference of what you are deferring from 46% versus 28% to 34½% versus 28%. I do not know of any direct change in treatment of the accrual itself.

MR. LE BLANC: I guess one other interesting aspect is that whereas now for many companies an increase in investment expense was good, now it is bad, but the staff has saved us embarassment of using each other's arguments by having some allocation rules in the Bill.

MR. DAVID ATKINSON: I am curious as to what is happening with the policyholder and shareholder surplus accounts.

MR. PALMER: The policyholder surplus account is frozen to the extent of no new additions, and you subtract from it whatever deductions would be called for under the old law in order to fill up the shareholders account for distributions and pay the tax thereon. The shareholder surplus account continues to operate generally as it has in the past.

MR. HARRY GARBER: I wanted to just add some thoughts on the variable life to what John had said because I was part of the group that met with staff on that question, and John, I think, has the impression the staff is satisfied to have capital gains on variable life and variable annuities not taxed. My impression is staff is universally opposed to that and like what they have in the Bill, so that in trying to overcome that, we do have to overcome the staff objections to it and not just what the ICI thinks. I think they were using the ICI as an additional wedge. We questioned them quite closely on this, and they said they believed that capital gains should be taxed. It was not just Treasury or Joint Committee or Ways and Means Committee staff, it was, in fact, the view of all the staffs combined. I think their sense is a matter of proportion. They are probably not satisfied that the inside buildup should not be taxed, and as it gets up into bigger and bigger numbers, they become less satisfied, and although it is not logical, they feel that a line should be drawn somewhere, and this is the place that they want to draw it. I do not think that means we cannot get a political decision in the Senate on the question, and the mutual companies were able to get the issue left open and not to be part of the signing on to the Bill and the stocks the same way. So, in fact, it is an open issue, but it is not one where we have staff support. So, we will have to work against that on this one.

MR. PALMER: Thanks for that comment, Harry. I know that the mutuals have probably pushed this issue more than the stocks have, maybe because they had more opportunity, but I appreciate that additional comment. One other thing I would like to mention in the variable contracts area. One thing that might have happened but did not: there was an early threat that any kind of a contract that gave a choice of investments was automatically so investment oriented that it could not be salvaged by any kind of risk versus investment test. But it was fortunately a notion that has not borne fruit in the Bill, so we have a playing field for all kinds of contracts, both variable contracts and nonvariable contracts.

MR. LARRY ROBINSON: Do separate account assets count into the asset base for determining the small company exemption, the $500 million?

MR. PALMER: Yes. Every asset you have is counted.

MR. LEBLANC: This concludes our presentation. I would like to thank our speakers for their fine presentations and the audience for their participation.