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U.S. FEDERAL INCOME TAX

Moderator: GODFREY PERROTT. Panelists: DALE R. GUSTAFSON, GARY L. MULLER, RICHARD S. ROBERTSON. Recorder: RONALD R. WEGNER

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

2. "Phantom" dividends

3. Reinsurance - will Section 820 Modco be replaced?

4. Future tax planning

5. Policyholder taxation

MR. GODFREY PERROTT: Federal income tax is a very dynamic area. I understand there is an article in Monday's National Underwriter which laments that the industry cannot present a united front. Apparently at the ACLI Steering Committee, it was decided to make one last try. I expect that Dick will tell us about this. Because the area is so dynamic, we will not follow the outline in the program very closely. First, Gary will talk about product design under TEFRA, then Dick will tell us what is happening at the ACLI level, Gus will continue where Dick left off, and Gary will describe what is happening at the NALC. After that, we will open the topic for discussion.

MR. GARY L. MULLER: With the current activity on the new tax bill which will replace "Stop Gap", talking about the impact of "Stop Gap" on product design is like teaching a class of airline stewardesses on what to do in the case of a crash, right before impact; but here it goes.

It is not practical to cover all provisions of Stop Gap which might affect product design, for this would require hours if not days. Thus, I will only attempt to touch upon key provisions of the bill.

Items which I will not touch upon are (1) the repeal of Section 820, (2) consolidation of tax returns, and (3) grandfathering of old contracts.

I will cover the implications of Stop Gap on the design of annuity and life insurance products separately.

There are three provisions of Stop Gap which had a significant impact on deferred annuities:

(a) Excess interest is 100% deductible for stock companies and 92-1/2% deductible for mutual companies on "Qualified" contracts.
(b) The policyowner is taxed on withdrawals, with interest assumed to be withdrawn first and policy loans and dividends considered withdrawals.
(c) With certain exceptions there is a penalty to the policyowner if funds are withdrawn prior to 10 years.

A "Qualified" annuity is a new term developed by Congress. A "Qualified" annuity must involve life contingencies at the time of issue, must provide for excess interest, and must have at least a 12 month guarantee.

I believe an opportunity exists to develop contracts which fit the particular needs of different markets. At least three different types of contract can be developed:

(a) A "Qualified" annuity which defers the taxes of the policyowner on interest income and excess interest is 100% (92-1/2% for mutual companies) deductible at the company level, but has the disadvantage to the policyowner of the 5% penalty on early withdrawal. Also, any policy loan or withdrawal is considered interest first and principal last.

(b) A non-annuity, or interest paid contract, has the disadvantage that the interest income is taxable to the policyowner at the date interest is credited; however, the interest paid is 100% deductible by the company and there is no penalty to the policyowner on withdrawal.

(c) Single premium life insurance is an annuity disguised as whole life insurance, with a high premium and excess interest. This contract theoretically defers the taxes of the policyowner on interest income indefinitely; excess interest and the original premium can pass to the beneficiary tax free, thus interest income may never be taxed. If a loan or withdrawal is made, the principal, not interest, is withdrawn first; the negative aspect is that excess interest is only 85% (77-1/2% for mutuals) deductible by the company.

The contract your company should develop depends on what market you are targeting. The high premium single premium life is ideal for individuals with large estates, whereas the"Qualified" annuity is ideal for individuals accumulating funds for their retirement, and the interest paid contract is ideal for the middle income American who is attempting to accumulate a fund for purchases in the near future rather than distant future. It is critical that your market be analyzed prior to product design. The use of the incorrect product in a market may prove disastrous to the company, the agent and the policyowner.

With regard to life insurance, more questions were left unanswered by Stop Gap than were answered, and your guess as to the ultimate answer to these unanswered questions could mean the solvency of your company.

But there are four provisions of Stop Gap that did have a significant impact on the profitability of life insurance contracts offered by insurance companies. These are:

(a) The limitation on the deductibility of dividends and the non-par deduction has been increased to (1) 100% of dividends on pension plans, plus (2) 85% (77-1/2% for mutuals) of other dividends and the non-par deduction. A slightly higher deduction is allowed for smaller companies. (Temporary through 1983)

(b) The Menge approximation for required interest was changed from arithmetic to geometric. (Permanent)

(c) The 818(c)(2) approximate revaluation of CRVM reserves for permanent plans of insurance was reduced from $21 to $19. (Permanent)

(d) A definition was developed as to what types of flexible payment life insurance contracts would qualify as life insurance. (Permanent)

The key provision affecting the profitability of many life insurance contracts, the increased deductibility of dividends and the non-par deduction, is only temporary and expires on December 31, 1983.

The major questions that were left unresolved were:

(a) Is excess interest a dividend?
(b) Are phantom premiums dividends?
(c) Is a graded premium whole life contract term insurance or whole life insurance?
(d) Does a universal life or an adjustable premium contract qualify for the non-par deduction?
(e) Does universal life qualify for the 818(c)(2) approximate revaluation?
(f) If universal life does qualify for the 818(c)(2) approximate revaluation, is it term insurance or whole life insurance?

The answer to these six unanswered questions can cause a product to go from a profitable to an unprofitable position.

I believe the most significant impact of Stop Gap as it relates to product development was that it increased the awareness of the importance of taxes in the design of a new product and the uncertainty which exists with regard to the amount of those taxes.

I would like to be able to discuss the impact of the provisions of Stop Gap and the potential impact of the unanswered questions on the profitability of each major type of contract: non-par whole life; adjustable premium whole life; participating whole life; universal life and term plus an annuity, but this type of analysis would require more time than is available. As a result, I will only briefly look at universal life.

I will look only at a company in tax situation A, where taxable gain from operations is less than taxable investment income, with a hope of giving each of you an appreciation of the potential impact of federal income taxes on the products your company is selling.

To start with, a product was designed to produce a profit margin net of the taxes of 5% at age 35 and 5.3% at age 55. It was assumed that excess interest and the phantom premium were not dividends and that the non-par deduction and 818(c)(2) approximation were not allowed. This is a middle of the road assumption.

If excess interest is a dividend, the impact on profits is a reduction in the profit margin of .9% at age 35 and 1.2% at age 55.

If the phantom premium is a dividend, the impact is even greater with a reduction in profits of 2.6% at age 35 and 3.5% at age 55.

The net result, if excess interest and the phantom premium are dividends, is a reduction in the net after tax profits to the unacceptable levels of 1.5% at age 35 and .6% at age 55. These profit margins become lower for a mutual company because of the lower percent deduction of dividends. The net profits become (.4)% at age 35 and a (1.7)% at age 55. If Stop Gap were to expire, the losses would become substantial for stock and mutual companies.

On the reverse side universal life could be allowed the non-par deduction. If this occurred, the profit would increase 2% at age 35 and 1.5% at age 55.

However, the most significant impact on profit, especially at the younger ages, is the 818(c)(2) adjustment. If universal life were classified as term, the impact would be to increase profits by 5.0% at age 35 and 1.2% at age 55. If universal life were classified as whole life, the impact would be substantial with an increase in profit at age 35 of 18.8% and 4.5% at age 55.

Under the best circumstances the stock companies profit would be 25.8% at age 35 and 11.3% at age 55. For mutual companies the best circumstances would produce profits of 25.5% at age 35 and 11.1% at age 55.

Under the best scenario I have assumed that the contract is non-par, excess interest and the phantom premiums are not dividends, and the policy receives the permanent whole life 818(c)(2) approximate reserve reevaluation of $19. Receiving favorable treatment on all these items is highly unlikely.

The actual impact of each of these items will vary from company to company, but the relative impact would not change significantly.

As I review the impact of the potential federal income taxes on the universal life contract, it is obvious that taxes may be the most significant, no, is the most significant factor in pricing a universal life contract as is shown by the wide swing in profits depending on certain answers to the six unanswered questions. How your product is designed, the wording of the policy form and how the product is marketed could impact the answer to the unanswered questions, so, care must be taken in the initial design step.

The potential swing in the amount of federal income taxes is not as great on other types of life insurance contracts, but it is so significant that none of us can overlook its impact if we are going to remain profitable and yet competitive in today's marketplace.

MR. RICHARD S. ROBERTSON: The chore has been given to me to bring you up to date on what is going on in Washington with respect to taxes. Probably the best place to start would be the passage of the 1982 law - TEFRA. The fact that this law by its terms expires at the end of 1983, automatically creates a need for all of us to do something. If nothing is done, the 1959 law will go back into effect without section 820 and without some of the other benefits that we found as favorable to the industry. There is almost no support for that to happen -- not in the industry, not in government. The 1959 law at this time is thoroughly discredited as being a reasonable method of taxing life insurance companies.

Recognizing that an effort was going to have to be made to obtain some kind of legislation to take effect after 1983, the ACLI reconstituted its Blue Ribbon steering committee to try to develop a position that the ACLI could take with respect to new legislation. The steering committee had been the group that had developed Stop Gap and pushed it through to a successful conclusion. This group was reformulated and expanded. The chairman of the committee was given the charge to work out a proposal that the industry could put before Congress to be enacted this year as permanent legislation.

Meanwhile, the government players in Washington also recognize that something needs to be done. The principal players in Washington are the two houses of Congress and the Treasury.

On the Senate side, Senator Dole and his staff have been doing research work trying to develop some concepts as to what they think might represent an appropriate way to tax the life insurance industry. They have asked some questions of the industry. We are in the process of developing some answers to some of the questions they have posed. They have not gone so far as to schedule hearings or develop specific proposals as of yet.

On the House side, the Ways and Means Committee organized a special subcommittee to deal with the taxation of life insurance companies and assigned Congressman Stark of California to chair that subcommittee. I will tell you more about what is going on there later because that's where most of the action on Capital Hill is now.

The ACLI Steering Committee has been meeting with some frequency now for about six months. It does not seem that long, but we have been struggling valiantly with the issues, trying to identify where we might have a common ground and trying to work out solutions that are at least acceptable to the many factions within the industry where we do not have a common ground. There have been times where we thought we were pretty close and times where we thought it was absolutely impossible to come up with something. Right now we are closer to the latter than the former, but we have not given up yet.

This steering committee has 18 companies represented, half stock and half mutual. The effort was made to try and obtain some balance between different types of stock and mutual companies: both large and small and with different types of markets. I think it does have a pretty good representation. One of the problems with a group that large is that it is impossible to try to work out some kind of program when you have got that many people around the table. The people referred to are those from the 18 companies, often several representatives, the ACLI staff and representatives from other companies interested since many of the meetings are open. The first effort that was made was to appoint an eight company subcommittee that was characterized as a negotiating group. That group included four stock companies and four mutual companies. My company was part of that group. We met several times. We came out with one proposal which was successful in getting the support of neither stock nor mutual companies.

Last March we went back to the steering committee and reported that we had been unable to come up with any kind of program that appeared to have any chance of industry support. The steering committee found that completely unacceptable. It was their perception, and appropriately so, that if we enter the legislative process as a divided industry, we are all going to get

hurt. We are going to wind up with something that none of us like. They charged the negotiating teams to go back to work to come up with something else.

So we went back to try again. We came up with another proposal. This proposal did not even get the full support of the negotiating team. The main problems with this proposal were on the stock company side although I had been told the mutual companies found it barely palatable as a last effort to try to get together. But it became apparent that this proposal too did not have wide-spread industry support.

So as of about two weeks ago, this was reported back to the steering committee and at this point it became pretty clear that it was not going to be very fruitful to ask the eight company group to get back together again and I do not think they would have done it if they were asked. So we agreed to disagree. Each of us went to our paid lobbyists and said "All right, its over now and its everybody for himself." So the last week and a half we have had our people around Capital Hill trying to explain to our elected representatives our point of view.

Let me now go back to what is going on in the House of Representatives. Congressman Stark has taken the charge that he has been given very seriously. He has spent a great deal of his own personal time trying to understand life insurance companies and life insurance company taxation. He has charged his staff to do further research. He has borrowed staff from the joint committee and they have been helping him. He has come up with a proposal and his proposal involves having some kind of a proxy tax representing the tax on income earned by insurance companies on behalf of their policyholders. If this sounds kind of vague and not very well put together, then you probably got the right message.

This proxy tax will be supplemented by some kind of a corporate tax on the remainder of the income of insurance companies. Congressman Stark called together the eight companies represented under the industry negotiating team plus three or four others to explain this proposal. He received a unanimous opinion from this group that his proposal would not be supported by any of the companies in that group or by the industry. Nevertheless, he is very firmly committed to try to pursue this or something very similar to it as far as he believes he can take it. He has scheduled hearings for May 10 and 11.

The fact that these hearings are coming up has been a very strong impetus to the industry to try and come up with some position. We have thus far not been successful in doing so. When we met last Tuesday, the agenda topic was "Is there anything that we can agree on to testify to at these hearings?". And, as of this point, there is not anything. But we did agree that we are going to make one more try. Instead of the eight companies that have been working on it for the last couple months, four new companies were appointed. Northwestern Mutual is one of these four companies, which means that Dale Gustafson is going to have his try. They are to meet and report back to the steering committee on the May 16. All of us are very fervently hoping that we will have at least something that we can put together as an industry position to take before Congress.

That is where things stand. What is going to happen next? I do not know whether Northwestern Mutual and the other three companies are going to put

together something or not. If they do, it is going to be very difficult to get the companies represented on the steering committee to accept it. And even if the steering committee accepts it, we will have even more trouble with the rest of the membership. I would say that at this point getting a proposal that we can agree on is a long shot at best.

I do think that at some stage we are going to have an industry proposal. We have got to. What is going to have to happen is that as the tax legislation works its way through Congress, some of the things that some of our companies thought were possible we will learn are not possible. We will learn that the range of options that might be available to us is much less than it might appear to be at the present time. We will also learn that there are things that might happen to us that are totally unacceptable. This process will, by its very nature, force us to try to band together and salvage the best we can out of what has taken place thus far. The problem is that in the process the things that are going to happen to us are not going to be favorable. I have heard people say that if there is one thing a politician likes, it is a divided group before him. He can take the best of what he likes from each group and put that together and let him be the one that draws the concensus to serve his own ends. That is something that is not in the interest of us, our company, our industry or our policyholders.

Will there be a tax package this year? It is hard to say. It is very difficult to see how legislatively we can get a long term solution to life insurance taxation passed this year given all that Congress has to do. I do not think that the 1959 law will be allowed to be restored. If that perception is correct, then that means we will see some kind of additional temporary bill that will carry us through until such time as Congress can come up with a permanent solution to the bill.

It is possible that it may be simply an extention of the present law. Another possibility would be the extention of the present law with some modifications, either to produce more revenue or correct what is perceived by Congress as problems with the current law. It is even conceivable that we could have a whole series of temporary measures. This happened in the 1940's and the 1950's. I certainly hope not; that would be very painful for all of us in the industry in the process of trying to do this. It will make tax legislation a full-time job for those of us that would rather be doing something else. But it is certainly something that could happen.

It is possible that Congress will pass something this year. Congressman Stark and his staff think they can do it. Maybe they can. People in Congress certainly do not want this thing to drag on forever. This is not the kind of activity that is productive for the things that interest a congressman. There are not a lot of votes in passing life insurance tax legislation.

I am not going to spend much time talking about what shape bills are likely to take. There are a lot of proposals being thrown around on Capital Hill. There is a mutual company proposal, there is a stock company proposal and there are variations of these proposals that various subgroups are promoting. There are various things that companies like and dislike. People on congressional staffs have their own perceptions. The Treasury has its own ideas about the shape the tax legislation can take.

We have heard from the treasury and from the staffs of both Houses of Congress and there is one thing that probably is going to receive a lot of attention. They are all concerned about some products that are being marketed today as primarily tax shelters. There is not a consensus as to what these products are. I have seen stacks of advertisements that have been gathered by the staff of congressmen and senators or by the Treasury regarding things that do not look right to them. I am sure many or all of you have seen some of these advertisements.

There will likely be an effort in some way to identify life insurance products that are being perceived as being abusive from a tax perspective and to eliminate these tax abuses. What form that elimination will take, I do not know. I do not even know how to identify what these abuses are. At this point I think everybody has his own ideas of what is abusive from a tax perspective, but there is no question that this will be a major area of activity in tax legislation.

There is my perception of how things are going and where they are. Perhaps at this point it might be helpful for Dale to add or subtract from that what he thinks is appropriate.

MR. DALE R. GUSTAFSON: A side comment occurred to me as Gary was talking. Gary pointed out the difference in the deductibility of excess interest payment on annuities: 100% for stocks and 92-1/2% for mutuals. If you will check ACLI numbers for 1981 or 1982 when they become available, you will discover that the mutuals do not write excess interest annuities or any other kind at the moment. So much for that kind of differential not having any impact on marketing. This differential put us out of that type of business.

One of the things that Dick said that I will disagree with is that the 1959 Act is thoroughly discredited. A document was distributed a few days ago to a group of mutual company people. It had come to us through one of our Washington representatives who had picked it up either from the Treasury or on the Hill. It is a statement of position by a group of unnamed stock companies. It is thoughtfully done and it goes on at great length. What it says is, "You did it right in the first place Congress; the 1959 Act is just exactly right." So there is active support for no action this year by some of the stock companies.

I could dispose of my responsibilities on this panel very easily by simply making a few brief comments on the entries in the program.

As for product design, the Northwestern Mutual does not sell universal life. We sell virtually no annuities because we do not have a new money contract and we think that the modified premium whole life contract designed to take advantage of 818(c)(2) is one of the most obvious abuses of the tax law to ever appear.

We do not have phantom dividends, ours are real. We do, however, believe firmly that if it moves it is a dividend.

We do not think Section 820 will be replaced with some other form of reinsurance; at least not with anything nearly as beautiful as the late lamented 820.

How can you engage in future tax planning when the current law expires at the end of the year and there are virtually an infinite number of possibilities for the future?

As for policyholder taxation, we do not believe in it.

On the other hand, it probably would not be fair to you or the Society to stop at that point. Rather, I would like to step back a bit and take a look at where we are, a little about how we got here and a few comments on what I think is one of the most important current issues.

Under the 1959 Act, we have noted for many years at the Northwestern Mutual that the fastest growing item in our financial statement has been our federal income tax. Its compound rate of growth has been very substantially greater than the growth of any other financial element.

With continuing high interest rates and inflation, we were rapidly approaching a 100% marginal tax rate. Our Update Program and modco contracts were responses to this absolutely intolerable federal income tax situation.

Of course, once the stock companies explained modco to us, things happened very rapidly. The repeal of modco and Stop Gap were the culmination of this flurry of activity.

As I am sure you are all aware, very intensive efforts have been under way since last fall through the ACLI attempting to develop an industry tax proposal. As I am sure you are also aware, those efforts have thus far been fruitless. Efforts are continuing although we have all gotten pretty well acquainted with each other's hot buttons. In the meantime, the House Ways and Means Subcommittee has scheduled hearings for May 10 and 11. At this time it would appear that there would be differing positions expressed by the industry people who testify at those hearings and meet privately with people on the Hill. The split will be largely along stock - mutual lines.

Chairman Ian Rolland of the ACLI Tax Steering Committee characterized our inability or unwillingness to come together as "absolute insanity". I agree although the phrase I have been using in reporting to the people at Northwestern Mutual is "an unending nightmare".

Throughout these deliberations some of the stock companies have consistently asserted that the mutual companies should pay a very substantial extra tax on what is known as the "free investment income". That is a term that was invented some 60 years ago to describe the investment income that exceeds the interest rates guaranteed in the contract. A full tax on the free investment income of the mutuals is identified by some as an appropriate ownership differential tax. Of course, these people say there should be no such tax of any kind applied to a stock company even if it issues an identical product.

On the other hand, the mutual companies have insisted that there is no sound tax policy or actuarial or legal rationale that justifies such a punitive tax. We simply do not believe that there is some sort of punitive tax that should be imposed on us simply because we are not stock companies.

In fact, there is an ownership differential in Stop Gap in the form of a 7-1/2% different limit on the deductibility of dividends plus the financial

effect of the special deductions and deferrals which are almost entirely available to stock companies only. In the aggregate these differences amount to a very tidy sum under Stop Gap. They represent pure practical political compromise in the development of Stop Gap and are not based on any articulated or accepted theoretical basis. Of course, many of the specials have their origin in the 1959 Act where they were the product of the same kind of horse trading.

When serious attempts have been undertaken to quantify what the pragmatic actual tax difference might be between a mutual and a stock issuing the same product, it readily becomes apparent that if there is any real difference, it is much smaller than the aggregate amounts desired by the stocks and thus, so far, no such discussions have reached any useful conclusions.

What makes this situation the most frustrating is that both Treasury and the Congress are open and receptive to a new law that would put us on a better basis than we have ever had. The alternatives are either some form of return to the 1959 Act or an extension of Stop Gap, significant revenue raising modifications. In a realistic sense none of those alternatives should be palatable to any segment of the industry. It is incredibly naive on the part of some of the stock companies to assume that a simple return to the 1959 Act would solve their problems because all of the necessary increase in revenue would come from increasing the taxes paid by the mutuals.

Both Gary and Dick referred to "abuses" in the emphasis of investment in the life insurance contract. Abuse is a very difficult word. My company, among quite a number of others, is engaged in selling life insurance contracts that are tailored for specialized markets. We do, indeed, research the law very carefully, and we believe that the contracts we are issuing are within the law. Thus they are not abusive in that sense. But it is true that there is a wide range of products which some may call abusive; for example, the single premium life insurance contract under which the face amount increases at 4% per year. The cold hard fact is that there is virtually no net amount at risk in a product such as this. There are a number of others. So the Treasury and Congress rightly look on those contracts as an abuse of the intent of the special tax treatment that life insurance has.

What is at stake? If an appropriate solution satisfactory to the Treasury and the Congress cannot be found on such so-called abusive contracts, it is virtually certain that we will lose the specialized, socially desirable tax advantages that life insurance has: the inside build-up, the deductibility of policy loan interest and so on.

It is up to the industry to come up with a definition of life insurance that will define out the so-called abusive contracts. The Treasury is very explicit in its statements that it would like very much for the industry to develop such a definition.

John Chapoton, the Assistant Secretary of Treasury for tax affairs, said they have no interest in attacking the inside build-up of garden variety life insurance products. We, the deputies of the steering committee, spent an hour and a half with Andy Pike, who is a key staff person in Treasury, probing what his thoughts are on the process. He is not an actuary; he is not a detailed expert but his remarks were clear. We need to define out some of the abuses.

Now the difficulty is that one man's abuse is another man's favorite product. There are some difficulties between the conventional products and universal life products. The definition in TEFRA was satisfactory to eliminate the then obvious abuses of the universal life contract. However, it is not a tight enough definition to control some of the other kinds of abuses. We will need in this area, as well as in some others, to find some statesmanship among the various groups or we are going to end up with not only too much revenue but perhaps very serious and possibly fatal damage to the whole life insurance contract.

MR. MULLER: As was mentioned earlier, I serve as one of the members of the NALC tax task force and have been part of the process of the ACLI. Based on the situation that had existed before the last steering committee, the NALC's tax task force had met and made a decision, based upon the information that was available to them, that they had to take a position either in favor of the proposal by the mutuals or the stocks. They have taken the position to support the Stock Information Group's (SIG) tax proposal and principle, but there are many questions within the proposal that bother members of the group; however, in total the proposal is supported.

One of the items in the SIG proposal that bothers the members is that it produces some tax revenue splits between stocks and mutuals that seem unrealistic, but no more unrealistic than the proposal by the mutual companies as far as the split of taxes. The stock companies' proposal produces taxes that are very low for stock companies, naturally, and the mutuals propose taxes that are very low for mutual companies. The thing that has amazed me is that the two proposals do not result in zero taxes for their segment, but get them very close to it.

The NALC feels that, as changes are made to the SIG proposal and the negotiations with either the mutuals, Congress, or the Treasury, the NALC's position must continue to be monitored as to what they should support. The NALC tax task force continues to meet and is still in the process of looking and developing their own proposal as a possible alternative should the SIG proposal appear to falter or become unacceptable to the NALC. The NALC, as well as many other industry groups, will have a spokesman at the Stark hearings on May 10 and 11 to give a position of the NALC organization.

MR. GUSTAFSON: The NALC did have some difficulty in choosing between the mutual company proposal and the stock company proposal because they both proposed no taxes from the NALC companies.

The four companies that were asked by the steering committee to make one more try at seeing if we could find common ground are the Northwestern Mutual, the Travelers, the General American and the American General.

MR. DAVID B. ATKINSON: I would like to ask the obvious question. Could you tell us where the conflicts are between the mutual and the stock companies in a rough summary form?

MR. GUSTAFSON: I would characterize the mutual's approach as being that life insurance companies should be taxed on their economic income. We further believe that the statutory financial statements are close to representing the economic income and, with relatively minor adjustments, from a sound basis for taxation. Thus, we do not support non-economic factors, which gets us into all kinds of trouble with everybody. All the specials,

the deferrals, 818(c) and all that garbage has got to go. The stocks do not like that because it makes them pay their fair share.

MR. ROBERTSON: The main problem with that proposal is that it is widely believed, especially among the stock companies, that the amount of tax that will be paid by mutual life insurance companies would be very close to zero. And they think that that is both unreasonable and politically impossible to achieve. They also recognize that while stock companies have, by definition, stockholders for whom they are expected to earn a profit and ultimately pay dividends, the role that is performed by a stockholder is performed by the policyholders in a mutual company. Stock companies are not entitled to deduct the dividends that are paid to their owners and they do not believe that mutual companies should be allowed to either. And here is where we get into long arguments about ownership differential. How should it be measured? What is the nature of a dividend? This describes quite well the major area of contention between stock and mutual companies.

Many people have been able to come up with a theoretical basis for measuring this ownership differential. In doing so the measurement has ranged all the way from 30% to zero percent of the dividend that a mutual company pays its policyholder. That is to say, this percentage of the dividend really represents an ownership payment.

One of the things that the stock companies are looking at very closely is what portion of the total tax will be paid by stock companies and what portion of the total tax will be paid by mutual companies. They are saying that it is not reasonable to expect stock companies to support a tax measure that would result in a significant increase in their tax without a comparable increase in the tax of the mutual companies. The stock company's biggest objection to the latest proposal of the eight member negotiating committee was that they perceived it as representing an increased tax burden on the stock companies without being such on the mutual companies.

MR. GUSTAFSON: The first thing that Dick mentioned was the fear by the stock companies that the mutual companies, because of their peculiar structure, would never have to have any gain from operations. May I add that this fear is also shared by the Treasury. We feel very frustrated about that because while it is certainly true that a mutual can afford to take a longer planning horizon than can a stock company, at least a publicly held one which is influenced by quarterly earnings per share, we still have to have earnings. At every stage we have expressed willingness to develop and include in the tax law some form of a minimum tax that would be paid even if we did have a zero gain from operations. Several different proposals of that kind have surfaced and we are willing to try to respond to that fear.

One of the mutual companies' primary interest has been to focus on a level product by product playing field. The point being, we cannot continue to sell traditional participating insurance if it has a significant tax disadvantage in contrast to say indeterminate premium life or universal life. So we have focused on this concept of a level playing field.

Let us examine a hypothetical and highly stylized situation of two companies, one mutual and one stock, issuing identically priced participating products. Let us further presume they experience the same mortality, expenses, lapses and interest rates. Let us assume that the stock company follows the commonly used limitation on profits from participating business,

that is, 10% of the gain from operations before dividends, and for mutuals this 10% would go to the policyowners. The stock companies agree that it is not appropriate to tax the mutual policyholder because those dollars flow to him as owner. However they feel there should be a tax on the mutual company to offset the extra taxes that both the stock company and its stockholder have to pay.

First, all of the earnings allocated to the shareholder are not paid out in the form of dividends. Some of them are retained in surplus, so you have to argue about what proportion goes out now and what proportion is held. Second, with regard to the proportion that is paid out to the shareholder, approximately half of that is paid to entities that are not taxpayers; for example, holding companies upstream. With regard to that piece and also with regard to the piece that is retained in surplus, the stock companies state that the shareholder has to pay a tax on it eventually. That is right. It is deferred as far as withheld earnings are concerned and then, when it is taxed because he sells his interest, it is taxed at a capital gain rate.

A very complex beautiful actuarial problem is involved in studying what those various proportions should be and determining what interest rates to discount at. It is all an interesting exercise. We have never made such a calculation and even though this would produce real numbers, it is my belief that the numbers would not be big enough to satisfy the stocks.

With regard to revenue estimates, there is this sensitivity on segment balance. We talk about market share and how the mutuals' market share has been declining over the years. We argue about how much it is and how fast we are declining, but it is not possible to put together estimates of what the future is going to be like. Our industry is in such a period of rapid change. Where are you going to go to get estimates? Who's numbers will you believe - particularly when there are a number of companies who will not give you any numbers? And so we have no statistically reliable basic data to work from, and it is all guess work.

MR. DENIS W. LORING: I wonder if anyone has proposed an approach something like this: First begin with your notion of an economic tax; that is, tax a life insurance company as though it were any other corporation. No 818(c), no deferrals and no phases will be allowed; full deductibility of dividends and everything else that moves presumably for stocks; and full deductibility minus a factor, which I will call X, for mutuals to account for the "ownership differential". This would be one degree of freedom. Then tax the insurance companies like any other corporation. However, at the bottom line a surtax on the mutuals would be made, which I will call Y. This would be a second degree of freedom. This surtax would try to address this segment balancing problem; that is, avoiding the situation where stocks pay much more in taxes than mutuals. That gives you two degrees of freedom: one dealing with the ownership differential, one with the segment balancing, but retains the general theory of taxing as an ordinary corporation on an economic base.

MR. GUSTAFSON: That sort of thing has been discussed and the factors you just named were specifically included in the mutual company proposal. The aspect that was unacceptable was it did not go far enough. The numbers were not big enough and we, the mutuals, insist that the segment balance thing has got to be temporary. If there is a current imbalance, we are

willing to try to address it. However, we do not think it is economically sound for us to accept forever an arbitrary unjustified significant level of taxation just to get over a transition. So we have insisted that if such a product existed, it would have to be phased out. We were never able to get into any meaningful negotiations on those subjects.

MR. ROBERTSON: That is not a whole lot different than the proposal of the negotiating team. There was not a surtax in that proposal. There are a lot of different ways to build this ownership differential in. Surtax is one, percentage of dividends another, some other tax percentage of assets or a percentage of premiums. Each method has problems associated with it.

The biggest problem you have with this approach is that we have not yet found a way that gives a reasonable level playing field in the marketplace, and that a reasonable share of the tax burden is assumed by the various segments of the industry. It may be that you have two unsolvable equations here. We are in agreement that there should be a level playing field with respect to products. However, you will not get an agreement as to when such a condition exists.

MR. MULLER: One of the things that is most interesting is that the only time anybody is ever interested in a level playing field is when they are on the bottom. When they are on the top, they are not interested in the level playing field. And this is a unique set of circumstances where both the stock and mutual companies feel they want a level playing field. It leads you to believe that both of them feel they are at the bottom.

One of the key issues in reference to taxes is neither the stocks nor the mutuals want to pay more taxes than they are currently paying. It is very difficult for them to put themselves in a position of paying additional taxes and cutting their bottom line income along with their competitive position.

One of the items that has not been brought up, which is important to most stock companies, is GAAP taxes. Many of the issues and many of the items that mutual companies want to throw out have substantial impact on GAAP taxes for stock insurance companies.

MR. ROBERTSON: I find that completely frustrating. The basis of calculating taxes in a GAAP statement has no foundation in logic. Everybody agrees to that. Even the accountants who wrote it agreed to that. The people that use financial statements know that the taxes in those statements have no meaning so they discount them and use whatever kind of proxy they have to try and figure the earnings of the company.

Yet, here we are getting ourselves stuck in a difficult legislative situation because of something that has absolutely no sense of reality to it -- the amount of deferred taxes in a life company statement. It is happening, and I just deplore it. There are even companies that use tax planning based on the amount of deferred taxes. Taxes are what you pay.

MR. SHANE A. CHALKE: A couple of comments on the ownership differential. First you had said that the ranges that you have heard vary anywhere from 30% down to 0%. Yesterday I heard one that was negative so I think the range is much wider. I agree with Dale that there is no theoretical basis laid out as to why there should be this differential or how much it should

be. I am not sure that it matters right now. If you look at history you can see that there is about a 15 to 20 year lag between the time that theory becomes generally well accepted and when it shows up in legislation. So obviously that puts us a little late to be working on this tax bill with techniques such as theory and logic.

Nevertheless, here is my stab at Stop Gap 1993. I do firmly believe that there is a theoretical and a sound basis for a differential. Mike Davlin and I have recently written a paper which I think does provide a sound mathematical basis with a minimum of politics. The main point that I am trying to get to is that one thing that we can do as actuaries is start trying to find some theory now if there is such a thing as a tax theory. We can start working on at least some consistent ideas, which is what we should have done in 1959 or 1960. We would be a lot better off now because there is a lot of floundering around and there really is no theory involved whatsoever.

MR. ROBERTSON: Negative differential, that is interesting.

MR. GUSTAFSON: I was surprised to hear that. I am aware of it in history. I think it was in the 1920's where the big argument was not ownership differential but it was the other way around. The argument which almost made its way through Congress was that the mutuals, because of their cooperative nature and social policy, should have a tax advantage. That would have been a negative differential. But I was not aware of anyone having the temerity to suggest it again today.

MR. ROBERTSON: It sounds like a negotiating ploy to me. Although, when you negotiate you are supposed to start here and move together. I am afraid we are starting here and moving further away.

MR. GUSTAFSON: I was a little surprised of the 0 to 30% range because my recollection is that the Aetna paper came out at 40%. That is, mutuals should be able to deduct only 60% of their dividends. Am I not right?

MR. ROBERTSON: Let me talk a little bit about theory. Your problem is correct. There is no set sound theory underlying taxes. Under sound taxation theory, neither mutuals nor stock companies will pay any taxes. Nor any corporation. A corporate tax itself is not sound. So when we try to get back to first principles, there is nothing there. That makes it hard for us.

MR. PETER F. CHAPMAN: Dick, I applaud your desire to get back to first principles, and I have a question that I want to ask. I can appreciate and understand the stock company position. I do not want my taxes raised. I do not know of any individual or group of individuals or corporations or group of corporations who will volunteer to pay higher taxes. However, if we go back before the distortive effects of Section 820 modco got into the picture and take a look at the last clear year that we were operating without the assistance of modco under the 1959 Act, we would find embedded in that tax distribution between stocks and mutuals a number of historical conditions that grew out of the compromises of the 1959 bill that went back to 1956 and 1958 that tend no longer to be operative and tend to work in favor of the stocks as opposed to the mutuals. Specifically, the marketshare, the marginal tax difference which was different than during the late 1950's, the

concern that the market could be preempted by low marginal cost dividends and the fact that a non-par product had a different meaning then.

If we go over these differentials, how then do we introduce an element that will equalize the tax load as it exists today, not as it existed in 1957?

MR. ROBERTSON: You will not get an agreement as to why these differentials were introduced in the 1959 Act or whether they are still needed. A case is being made that the need is at least as strong today as it was 25 years ago if not stronger. I am not going to try and make that case. Everything in there can be defended. It would be nice to be able to go back to what is right but everybody has his own perception of what is right.

MR. CHAPMAN: How do you go about equalizing without increasing, at least on the short term, the tax load of the stock companies as opposed to the mutuals?

MR. ROBERTSON: The stock companies would say that equalization should probably reduce the burden that is paid by the stock companies. They feel they were hurt by Stop Gap. They would prefer to go back to where they were on the 1959 Act in terms of the balance.

MR. GUSTAFSON: I do not have access to thorough numbers. I have only the very fragmentary data that I have looked at which has come mostly from the ACLI member compilations. These numbers are very seriously distorted, not that they are wrong, but they are not as meaningful as we used to have them in 1981 and 1982. This is particularly true because of the effect of modco during 1980, 1981 and 1982. It has been a temptation for the mutuals to say that what the 1959 Act did was to seriously increase the mutuals' tax and really give the stocks a deal. When you look at the bottom line results, what were the aggregate federal income taxes paid by the stock companies compared to their statutory gain from operations? For the most part they had been paying a respectable amount of tax. The difficulty from the late 1960's through the end of the 1970's was that the mutual's tax was not respectable. It was moving upward in the order of 70% to 80% of the gain from operations. Stop Gap changed the rules and the mutuals certainly are paying less under Stop Gap than they did in 1978 and 1979 under the 1959 Act. The stocks are paying less under Stop Gap also.

Now the difficulty is that the revenue being raised currently is not adequate. And there are no first principles or theoretical concepts to revenue.

MR. ROBERTSON: I would not agree that the revenue is not adequate.

MR. GUSTAFSON: I am sorry but there is a perception in Congress and the Treasury that it is not.

MR. ROBERTSON: It depends on what you are comparing. The proportion of the corporate income tax paid by the life insurance industry has gone up considerably in the last few years. Everybody else has gotten goodies that we have not gotten.

MR. GUSTAFSON: I appreciate and agree with that.

MR. CHAPMAN: I would like to ask you to predict what will happen if we do not agree. Is it likely that the mutual company proposal, being so much simpler, will be more appealing to Congress?

MR. ROBERTSON: No. We will probably have our taxes at least doubled and they will get their share from each of us.

MR. MELVIN MASSEY: Could it be that the failure to generate the billion dollars of additional taxes that were supposed to be generated by TEFRA was due to the poor sales experience in the last year or two and eventually the taxes will come through if we wait a while? What are your thoughts on this?

MR. GUSTAFSON: Yes, you are right in pointing to that.

MR. MASSEY: Dole and Chapman are telling us that we are not paying enough. A change was made but it does not result in enough taxes. Shouldn't we be telling them why don't you wait a while?

MR. GUSTAFSON: You are right. 1980 and 1981 have not been particularly good years for the life insurance business. Let us not even mention group health losses. We can reconcile pretty much what the revenue is to what it might have been expected to be. There may be a couple hundred million missing here and there. My difficulty, and I am not a real tax expert, is that Stop Gap was just that. Stop Gap. It is not a very tight kettle. It is full of holes.

MR. MULLER: You asked the question in reference to what can potentially happen. One of the big areas of concern that is infrequently mentioned is that if no permanent bill comes into existence in 1983 and an extension is required, such an extension will not come free.

In addition to that, there is a great deal of discussion today about taxation of property/casualty companies. Getting the life insurance industry caught up in a potential taxation of property/casualty companies, at least from my perspective and many companies' perspective, is not an exciting possibility. The positions which exist today for many companies might change dramatically if we got caught up in a position of taxation of life and property/casualty companies together.

MR. PERROTT: At the moment the life insurance industry is in the budget for a projected revenue of $4.7 billion. TEFRA is expected to produce about $2 billion if it expires, and the 1959 Act, except for modco and a few other things will get it up to over $3 billion. Once the budget gets passed, I believe that Congress cannot pass a revenue raising act which does not meet the budget amount.

MR. GUSTAFSON: We have had this sort of thing reported to the steering committee frequently and I think the numbers you stated are about right. But my memory tells me that we got conflicting remarks as to what number was going to be in the budget and what it meant. I remember just shaking my head and saying to myself, I am glad somebody else is worrying about trying to keep that straight because I cannot. Have you got it straight Dick?

MR. ROBERTSON: My interpretation is exactly the same as yours. I do not think this is going to be that serious technically. The problem is going to be a more basic one. That is, Congress is desperate for revenue. They are

going to get it wherever they can. I guess the best thing is that they are not going to be able to balance the budget based on the life insurance industry. The billion or two billion involved is only peanuts to them. It is not going to be that big of a deal in terms of the overall scheme of things.

MR. GUSTAFSON: If you would like to have your level of terror raised, I might suggest you contemplate the 1959 Act with 818(c) removed.

MR. ROBERTSON: You are talking $6 or 7 billion with that type of contemplation.

MR. RONALD MCKINNEY: Mr. Gustafson made the comment earlier that he did not want policyholders to be taxed. Perhaps he could explain to us who it is that is preventing the ACLI from testifying to that effect at the Stark hearings.

MR. GUSTAFSON: That is a fair question. Congress has reiterated through the years that it believes there is a social advantage to life insurance and has, on several occasions, reaffirmed the tax aspects of life insurance; that is, no tax on death and no tax on the increase in the cash value of the inside build-up.

This issue was raised at the steering committee meeting a couple of weeks ago when it was seen that we were not going to have a proposal. We felt that ACLI should be perfectly free to testify at the Stark hearings and elsewhere on those subjects on which we do not disagree such as the inside build-up.

We are all in comfortable agreement that we believe in the inside build-up, but the issue was with the degree of differences between the mutuals and the stocks. But we all felt that it was too risky to expose the ACLI, however carefully we prepared testimony, to argumentative and nasty questions that might arise from Congress and other people. Also, we wanted to avoid the risk of having the ACLI, in all good faith, say something that would be objected to by some group of companies. Therefore, the steering committee concluded that the risk was too great for the ACLI to appear publicly. We all love the ACLI and we will continue to work with and through the ACLI with our staff support.

MR. ROBERTSON: Those are the arguments that were put out. Actually, it is an emotional thing. On this issue, Dale, the mutual companies are being pretty unreasonable, although I will admit that there was strong provocation.

MR. RALPH E. OLSON, II: Following up on that last question, has there been any discussion, and I realize that this might be unpolitical, allowing both stocks and mutuals to deduct, say 90% of their dividends, but then making them taxable to the policyholders at, say, 90% of the dividend or some such percentage?

MR. ROBERTSON: I think you would get unanimous opposition on something like that. I do not think anyone likes that direction.

MR. CARL B. WRIGHT: Having recently been employed by a small stock company and prior to that having served as Tax Director for six years for a large

mutual company with three stock subsidiaries, of which at least one was taxed as a casualty company, I have the fortune, or misfortune, as the case may be, to be quite familiar with all sides of the insurance tax issue.

I first wish to make a comment that I prefer not to make. I was initially involved in the ACLI meetings as far back as 1979 and 1980. I have been appalled at what I see as a consistently parochial and unstatesmanlike attitude on the part of most of the companies who have been involved and I can only say that if that kind of parochialism continues, then we can probably expect a bill, such as Pete Stark's, to be our tax law of the future.

I have two areas I wish to comment on. The first is in relation to the stock-mutual differential. Regarding this, my comments proceed from the premise and belief that most stock and mutual companies are and should be profit-making enterprises. I believe that for a mutual company to say that all of its surplus belongs to its policyholders and will someday be paid out to them or back to them is false.

A mutual company needs capital and surplus the same as a stock company if it wishes to continue to operate into the future. If a mutual and stock company write the same amount of business and offer the same lines, then their capital and surplus needs ought to be identical. Therefore, from an economic standpoint, they both need to earn a profit and of course tax must be paid on that profit. Thus I think that the fear that a mutual company will "dividend out" its operating gain to zero is a fear without foundation.

The point I wish to make is that a stock company does need a way to reward its stockholders by the payment of some level of dividends on the stocks that they own. However, no stockholder expects his full return on investment to come from dividends alone. There is some level of dividends that is appropriate and what that level is, I do not know. Somehow from this, one could then determine an appropriate or reasonable stock-mutual differential. But the argument that no differential should exist makes sense only if one presumes that the companies are going out of business. In that case it is true, assuming that expenses do not bankrupt the company first, that the mutual policyholders will, in fact, receive all of the surplus of the company and will be properly taxed.

The second area I wish to touch upon is the question of the phantom premium or the difference between the maximum premiums stated and the actual premiums charged for an indeterminate premium contract. It is my experience that no one would charge the maximum premium stated in the policy, at least not generally. The whole rationale of the maximum premium for indeterminate premium contracts is to avoid the issue of deficiency reserves. From a tax standpoint, if there is in fact any dividend at all, that dividend should be nothing more than the difference between the indeterminate premium and the guaranteed cost premium that the company would be willing to charge. And this is considerably less than the maximum premium. Again, the level of the maximum premium is motivated by the desire to avoid deficiency reserves which, if such reserves were held, would not be recognized for tax purposes anyway. So to assume that that is the base for measuring any dividend is significantly overstating the dividend. In order to develop such a differential, it would be important that a company establish what assumptions would be used for guaranteed cost products as opposed to indeterminate premium products.

MR. ROBERTSON: People in stock companies know a lot less about how mutual companies operate than they think they do and, similarly, people in mutual companies know a lot less about how stock companies are run than they think they do. As a result, there are some perceptions that develop that really do not have a sound basis. I agree with you that mutual companies are not going to be able to pay out all of their earnings in dividends and basically for the reasons that you state.

There was a problem under some proposals that would involve, for example, the ability to deduct net level reserves even though statutory statements have CRVM. If you get 100% deductibility of dividends and if you have that kind of provision, you probably could reduce the mutual company taxes to a very low level.

MR. GUSTAFSON: Give me 100% and 818(c) and I would not pay any taxes.

MR. ROBERTSON: Most mutual company proposals now do not have both of those. The proposals typically involve CRVM reserve or statement reserves. However, you still have tax exempted investment income that can be used as a way to build surplus on a tax-free basis.

I think the current perception is that with CRVM reserves and 100% deductibility of dividends, you have a level of tax under most formulas that is less than under Stop Gap but not zero. Of course, it also depends on what else you build in there.

The phantom premium is a difficult problem for some of the reasons you state. To try to impute income for something that is there only theoretically or contractually has difficulties, both practical and theoretical. Among the practical problems, what do you do if there is no maximum stated? Guaranteed renewable health insurance is that way, for example. You could have, at least theoretically, an unlimited ability to increase the premium.

Your solution of trying to compare it to something like a guaranteed cost product has a lot of merit. Of course, the problem is how do you determine the guaranteed cost? One solution I have seen so far would be to use the difference between the amount actually collected from the guarantees subject to some kind of percentage limitation, say, no more than 25% of the premium. But it is far from ideal.

MR. GUSTAFSON: In the early developmental stages of the last six months' work, when the deputies were charged with exploring the development of the phase-less tax system, the sort of question you have raised about the indeterminate premium and similar questions that come up with regard to universal life, led to a unanimous agreement. If dividend deductibility was going to be limited by more than a token amount, then a broad definition of dividends, including such things as the phantom premium and excess interest, would have eliminated some very difficult level playing field product problems. If I can only deduct half of my dividends and an indeterminate premium contract does not have any corresponding factor with regard to it, then I will convert my products to an indeterminate premium form, just like that. I do not want to. There are some disadvantages in my view to the design of such a product. But it is that sort of thing that led us at that point to say, if everybody got 100%, we could avoid some very tough issues.

MR. ROBERTSON: One of the features of the negotiating team proposal was that by providing 100% deductibility of stock company dividends, you avoided that problem. However, the problem still existed that mutual companies should have a lesser percentage that was deductible. The mutual companies typically do not sell these products so that you can go ahead and adopt a very broad definition and no one gets hurt.

MR. GUSTAFSON: At 7-1/2% I would not be motivated to go to the trouble and expense to convert my product to something I do not like. But you make that differential economically large enough that it really hurts, and I ca not bear it; then I will switch.

MR. MULLER: Basically, what Dale is saying is a correct statement. It also goes back to the item in reference to stock subsidiaries of mutual companies. If the differential becomes too great, there is no question that the mutual companies will start selling their products in stock subsidiaries, which is an issue that has been addressed frequently. I would agree basically with what Dale has to say.

MR. ROBERTSON: Stock companies are presenting basically the same argument. If it looks like a mutual company and acts like a mutual company, then they should be taxed like a mutual company.

MR. MULLER: You can add another issue to that. What about stock subsidiaries of property/casualty mutual companies?

MR. GUSTAFSON: That would be my first reply. If you come along and say we are going to fix you guys so that you cannot get out of paying your fair share by saying that if you are a stock subsidiary of a mutual life insurance company, then you get taxed as a mutual. All I would have to do is reinsure my permanent insurance in my subsidiary and become a mutual casualty owner. So now you have got another fight on your hands.

MR. MULLER: There is an easy solution. Just get rid of all mutual companies and make them all stocks.

MR. GUSTAFSON: We thought public policy was more on the other side.

MR. ROBERTSON: For some of the reasons you have mentioned, you cannot try to impute a tax on a company based on who owns it. You get into all kinds of problems. You then begin to talk about foreign ownership, partial ownership and the like. Furthermore, if in fact we have got a fair tax and a level playing field, then the incentive to misuse a subsidiary will not be there.

MR. GUSTAFSON: If the tax law is such that I am motivated to do my business through a stock subsidiary, it is because the tax law is wrong. I do not want to do that.

MR. JEFFREY D. MILLER: When the Stop Gap law came through last year, there were a surprising number of policyholder tax changes in the Stop Gap law. We have been talking a lot about company tax changes. If we were to define a company tax formula that had 100% deduction of dividends and all the things that would minimize the company taxes but not produce an acceptable level of revenue, then the next question is where do you get the revenue and the answer is from policyholders. Has there been any discussion in the most

recent committee meetings on what further changes could be made in policyholder taxation to produce the desired revenue?

MR. GUSTAFSON: The steering committee would like to oppose and fight off any change in policyowner taxation. Therefore, we are not in agreement on who is going to pay it, but we are in agreement that we should find a way to pay enough revenue from the company so that issue can be avoided. That is why some of us have spoken so heavily on the so-called abusive investment oriented products.

MR. ROBERTSON: Tax the company at the appropriate level. There is no need to go to somebody else for revenue. We do not see a strong relationship between policyholder and company taxation. We believe the policyholder taxation is a separate issue and should be dealt with as such.

MR. ALLAN D. GREENBERG: First, with respect to Dick's earlier comments regarding the GAAP deferred taxes, I agree with his qualitative evaluation of them. But I have to disagree as to whether or not most of the stock companies are correct in their evaluation. I think it is fair to say that they are terrified of what distortions in GAAP deferred taxes will bring about with respect to their stock prices and outsiders perceptions of their earnings. I agree with you Dick that outsiders have no understanding of GAAP deferred taxes and their reaction is to look to the bottom line for earnings. It is something that perhaps a change in the method of calculating deferred taxes by the accounting profession might solve the problem. Until that is done, it is a very real problem.

The second issue, with respect to a lot of stock companies and I hate to disagree with my very good friend Carl Wright, but Dale himself said that with 818(c) and 100% deductibility of dividends, mutual companies would essentially pay no taxes. For some stock companies, especially for those of us that are very small, a little bit of money means a lot. When we hear statements like let us have 100% deductibility of dividends and to make up for lost revenue, let us cut out 818(c), it bothers us. We see cutting out 818(c) as a real harmful thing to us and yet it is a way to have mutual companies pay some tax. Nonetheless, we find it a very fearful thing and we would prefer to see some other method used to have some sort of tax paid by mutual companies.

MR. GUSTAFSON: I have been a little bit puzzled by one aspect of this. The Treasury and some other people in Congress have quite obviously targeted the special deductions and 818(c), particularly, as something that they do not see any tax policy justification for. So I am a little puzzled that the small companies have not considered trading off 818(c) for something else that is not as vulnerable. There is no policy disagreement with the need for a small company tax factor. Why do you want to cling to something that everybody says has got to go? Why not switch to something that would not be so controversial and get the same result?

MR. GREENBERG: There may be a difference in perception as to what the elimination of 818(c) will bring. There are two possibilities. One is to use the statutory reserve. However, then the very large companies would be able to utilize their surplus to generate large reserves and therefore eliminate paying a lot of taxes. Small companies do not have the surplus to do it.

A second method is to have a defined valuation system. I read it and, at first, reading it sounded very nice. I then thought about how much it would cost small companies to implement it. Maybe it would cost us 10% of what it would cost Prudential to do something, but we are far from having 10% of the surplus that Prudential has. It is cheaper for us to do it than it is for the giant companies, but to us it means a lot of money. I cannot see why small life insurance companies would like a bill like this.

MR. MULLER: There has been some discussion in the area of the 818(c) adjustment that if it should be removed, it might survive for small companies. The NALC, even though it is not strictly made up of small companies, is looking at these kinds of issues. They are trying to maintain their competitive position with the large companies and are looking at different approaches on how they might arrive at that point. This becomes part of the negotiation. Right now it is difficult to add something else on top of either the mutual or the stock side for small companies because there is not anything else.

MR. GREENBERG: The 818(c) in no way acts against the modified reserve basis. The 818(c) goes back to the days when only one or two very large companies had computers and reserve interest rates were 3%. It was a sanctioned approximation based on averages in 1956 and 1957. The 818(c), as it presently stands, is a license to steal. Of course, I am talking here about 818(c)2.

MR. ROBERTSON: 818(c)2 is the approximate revaluation whereas 818(c)1 is the right to revalue to net level on an exact basis.

MR. GREENBERG: That is correct; we are talking about approximations. The companies that maintain that they cannot afford to do an exact net level revaluation are the same companies that can afford to do statutory reserves, GAAP reserves, and where it is called for, purchase accounting reserves. I wish somebody would explain the discrepancy to me.

MR. MULLER: I strongly object to the statement made in reference to 818(c)2 as being a license to steal. It is a provision of the tax code that exists. On that basis, I would have to say the use of modco by any company was exactly the same and there are a lot of other provisions that you can come up with in the tax code that someone else, depending on whose ox is being gored, might be in the same position. Accelerated depreciation is such an example. It depends on your perspective as to whether an item is appropriate or inappropriate.

MR. GREENBERG: I would not disagree with you on modco, especially in view of the fact that the revenue code is quite explicit; a reinsurance transaction involves a genuine transfer of risk.

MR. ROBERTSON: The arguments that are being used to defend 818(c) today are largely over its role as a form of deferral. There are many of us that feel there have been abuses in the term area or the graded premium whole life area. In fact it probably helped nobody other than the buyers of life insurance.

I do not agree with your perception as to how the market interprets deferred taxes. I could not help observing the inconsistency between expressing concern over tax provisions that increase deferred taxes without increasing

real taxes while also expressing concern over 818(c) which increases real taxes without increasing reported taxes. The two are exactly the opposite. What you are really saying is that both are important.

MR. WILLIAM C. WELLER: 818(c) basically says that it makes no difference what reserve basis the policy was issued on, it can be valued on a different basis. If you say that this is not right, then how can one go through and do a project update such as the Northwestern Mutual did and say that is a fair tax advantage but 818(c) adjustment is not?

MR. ROBERTSON: I will defend you Dale. You act on what the law is and not what you think it should be.

MR. GUSTAFSON: Do not impute to me the inflamatory remarks that came out there on the floor. I identified $21 a $1,000 for modified premium whole life as an abuse and I will defend that, but I do not consider the utilization of 818(c)1 or 2 by any company an abuse.

MR. WELLER: I was not talking about 818(c)1.

MR. ROBERTSON: Even 818(c)2; it is there and you have to manage your company recognizing the reality.

MR. WELLER: We are not arguing that it is there Dick

MR. GUSTAFSON: Would anyone care to guess whether the Northwestern Mutual uses 818(c)1 or 2?

MR. ROBERTSON: Whichever is to your greater advantage.