RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 1

FEDERAL INCOME TAX

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This session reviews the status of Federal Income Taxation pending legislation with respect to:

Life insurance companies.

Policyholder taxation.

Current legislative outlook.

MR. JAMES P. A. KNIGHT: Our program has been in a state of flux as all of you can imagine, with pending legislation in both houses of Congress, and not knowing the outcome of that legislation as late as the end of last week. So, I'm not quite sure what the panel is going to say. They may know more recent developments than I do on the subject. If so, great and maybe they will know something more recent than you.

In the program this morning, we're going to start off with a little bit of background on how the federal tax situation has developed up to this point. Then we will follow with some discussion of the company implications of current legislation, then policyholder implications. Our panel represents both stock and mutual company views and to the extent that they differ and have different emphases, we'll also have a very brief commentary by the other member of the panel to bring out the different emphasis. At the very end, as promised, we will give you as current an outlook for what is happening and what may happen, as it is possible to give at this point in time.

We'll begin with a view of how we got to where we are, and for that, Virgil Wagner, Actuary at the ACLI, will speak.

MR. VIRGIL D. WAGNER: I'm always a little reluctant to do a background speech on this subject because we had so many of them last year, and some of you who have been closely involved with this are going to say, "Oh, no, not another one of those discussions of how we got Stark/Moore". But, I think in the interests of those who have not been quite as close, and for those who may have even forgotten a little bit of the process, I'm going to, very briefly, try to take us from the development in 1983 up until the 1984 session, after which, as Jim says, we'll talk about the bills themselves, and then we'll get into the prognosis on 1984 later.

First, let me say that today, probably more than any time in the past, the life insurance business faces a variety of legislative and regulatory challenges at the federal level. The taxation of life insurance companies and their products is the one in the forefront right now, or at least one of a couple, on the political stage in Washington. First, the background: Last summer, following several months of discussions with representatives of stock and mutual life insurance companies, the ACLI, the Treasury Department and the Joint Taxation Committee, the House Ways and Means Select Revenue Measures Subcommittee developed a proposed solution to the manner in which life insurance company income is taxed. This proposal, which was unveiled July 14 by the subcommittee chairmen Representative Fortney N. (Pete) Stark (D-CA), and Representative Hanson Moore (R-LA), envisioned a single-phase tax structure computed on a total income approach, making no distinctions between investment and underwriting income. The ownership differential, which had been much discussed up to that point in time, would be determined on the basis of a return on equity and would operate as a limitation on deductibility of policyholder dividends. A special deduction for small companies would be wrapped into a single provision, and stock life insurance subsidiaries (as of that time those 80% owned by mutual companies), would be treated as mutual companies. The effective date of all this would be January 1, 1984.

There were some policyholder provisions in there also. First, there would be no tax deduction for interest paid on loans from life insurance policies to the extent they exceeded some amount (which had not, I believe, been set at that point). And non-discrimination rules under Section 79 would be extended to retired lives, the $50,000 limit on free term life insurance to employees would be extended to retired lives, and there would be a definition of life insurance. Also in there was a change in the structure of the annuity withdrawal penalties.

Now, Rep. Stark and Rep. Moore developed this proposal in recognition of the fact that the various segments of the industry were unable to develop a consensus on an industry proposal. They emphasized that the proposal was developed for discussion, was not a finalized version of the bill, and invited a response regarding the proposal's impact on individual companies and segments of the industry, and also on the appropriate level of the aggregate industry tax burden. There were hearings held on these subjects throughout late summer and fall of last year.

On September 13, the House Ways and Means Select Revenue Measures Subcommittee released a draft committee print bill entitled "Life Insurance Tax Act of 1983". This bill, as you probably remember, was HR-4065 when introduced, and attempted to simplify and improve the income tax treatment of life insurance companies and their products.

The bill incorporated the tentative drafting decisions which had been made by the Subcommittee, and was basically unchanged from the proposal which had been advanced in discussion by Chairman Stark. As a thumbnail sketch the proposal was designed to provide about 2.9-3 billion dollars of tax from the life insurance industry. That was to be split 55% mutual, 45% stock. The bill would be a total rewrite of Subchapter L. A taxable income adjustor was set at 25% of taxable income, in other words, a flat deduction of 25%. This was the wrap-up of all the special deductions and so on in concept. The return on equity factor to equalize the stock/mutual tax burden was included, as has been stated. There was special provision for small companies. In this version the stock subsidiaries of mutuals would continue to be taxed as stocks; however, some different treatment in the equity calculations would really treat them more as mutuals. Policyholder loan limits were set at $250,000 for individuals, $500,000 for corporations. There was a statutory definition of life insurance. In fact, all of the policyholder provisions that I mentioned were included as part of the bill. That bill, 4065, was subsequently adopted as Title II of HR-4170, the Revenue Act of 1983.

On the Senate side, S-1992 was introduced on October 25, by Senator Lloyd Bentsen (D-TX) and 11 co-sponsors. This was nearly identical to HR-4065, and was offered as an amendment to a larger tax reconciliation bill by Sen. Bentsen. Although the House Rules Committee eventually granted a rule for consideration by the full House of Representatives of HR-4170, controversy continued over several provisions of the tax bill, all of which were unrelated to life insurance. Despite efforts by ACLI staff and representatives of many ACLI companies, the rule was narrowly defeated on a 204-214 vote, and HR-4170 failed to be considered by the House.

On the day following this defeat of the rule to consider the tax legislation, the House Ways and Means Committee Chairman, Representative Dan Rostenkowski (D-IL), and ranking Republican member Representative Barber B. Conable, Jr. (R-NY), issued a joint statement voicing their concern over the House's failure to consider the tax measure, and in particular, those expiring provisions such as the temporary stop-gap provision for life insurance company taxation. Rep. Rostenkowski and Rep. Conable said that they intended to press for consideration of the many elements of HR-4170 as early as possible in the next session.

Senate Finance Committee Chairman Senator Robert Dole (R-KS) attempted to have his tax writing panel adopt a comprehensive deficit reduction measure which he had proposed earlier in the year. Included would have been the basic provisions of S-1992, the Life Insurance Tax Act of 1983. Instead, the Finance Committee adopted a resolution proposed by Senator John C. Danforth (R-MO), supported by Sen. Dole, instructing the staffs of the Finance Committee, the Joint Taxation Committee and the Treasury to draft a deficit reduction bill for consideration in early 1984.

In a December 6 letter to ACLI President Richard Schweiker, Sen. Dole sought to assure the life insurance business that legislation along the lines of the Bentsen-Chafee bill would be reported by the Finance Committee early this year, with a general effective date of January 1, 1984, provided agreement could be reached on several unresolved issues.

In a December 12 letter to all ACLI chief executive officers and life insurance company income tax liaison persons, ACLI President Schweiker urged that several lawmakers be contacted in their state and district offices while they were at home during the holiday period. A packet of background materials on the life insurance company tax issue was prepared and circulated with a letter from Mr. Schweiker. ACLI member companies were asked to request their senators to support and, if possible, cosponsor S-1992, while House members were urged to support adoption of a rule to consider the tax bill and final passage of HR-4170. Mr. Schweiker's message was fairly simple - the life insurance industry, stock companies, mutual companies and agents were united behind Title II of 4170 and S-1992.

The revenue level envisioned by this legislation, approximately 2.9-3 billion dollars, is adequate and acceptable to the life insurance business. And finally, of course, that we need action on this legislation as soon as possible, as product design and selling and particularly tax planning are difficult, if not impossible, when the applicable tax laws are unclear or non-existent.

So, that's where we ended 1983. These bills are being considered with some changes which I will not get into, that's the job of the other panelists, but they are being considered and we ended 1983 at about that point.

MR. KNIGHT: Thank you, Virgil. So, we've now gotten to this year, and at least as far as the ACLI is concerned, the entire industry was all united behind two different bills. At this point I'm going to ask Harry Garber, Senior Executive Vice President and Chief Financial Officer of the Equitable Life Assurance Society, to talk about both of the bills and their implications on company taxation.

MR. HARRY D. GARBER: Thanks, Jim. I thought as one is always troubled with how to pitch a talk like this because there are people here who know much more about the technical details of the subject than I do, and there are probably people who don't know much about the subject at all, I'll try and talk about things generally, skipping most of the detailed subject matter. To the extent you want to ask detailed questions later on, we can get into that at that point.

I think it's necessary in talking about Company taxation, to go back a little bit and start with what the 1959 law had left us with, I think that enables us to understand a little better how we got to where we are.

The 1959 act was a very finely-tuned act for its time. It was designed to produce a specific amount of revenue and to divide that revenue in a specific way between stock and mutual companies. No one in drafting that legislation conceived of interest rates at the levels we currently have, and this is part of the reason that the 1959 act fell apart in the late 1970's. The other reason was that the way of distinguishing between stock and mutual companies was to create a category which we called non-par policies and a category called par policies, and to treat them in a black and white fashion, that you had either one or the other, but there was nothing that could be treated as gray in this world of the 1959 act. Also, the 1959 act created some problems for us in that it appeared on its surface to contain a lot of special breaks for the life insurance industry. We ended up with big numbers on the tax expenditures list. There were a lot of special deductions and deferrals, so it appeared as though the life insurance industry wasn't being taxed up to its full potential. Other industries paid less than we did, but we were considered a favored industry during the period. Finally, the whole question of taxation of the inside build-up appeared to have been deferred in 1959, and there was a lot of agitation during the period on that issue.

This all came to a head two or three years ago; first, a lot of gray products began to be produced, SPDA's, universal life, variable life, indeterminate premium policies, not participating policies but certainly not the kind of fixed cost non-par policies the 1959 act envisioned. The IRS came to a point where they didn't know how to rule on these policies. If they ruled that they were non-participating, then a big hole had been opened up in the tax act, and they could see the revenue base disappearing completely, and if they ruled they were par policies, they were really going contrary to fact. And, in fact, they were given no definitional room in the 1959 law to come to any other conclusion other than that they were par or non-par.

The use of Mod-Co, by the mutual companies primarily, also began to erode the revenue base significantly. In 1982 there was a significant movement to repeal Mod-Co, to put in place some temporary tax provisions to keep the life insurance industry going. TEFRA as finally enacted was limited to 1982 and 1983. It put a floor under dividends in a way that no one had to decide whether the amounts of interest paid on SPDA contracts, for example, were dividends or not because in fact there was a floor to protect you in either event.

And finally, all the action took place in the Senate; the House was never involved. They were kind of unhappy about that, and it was clear that they never really accepted stop-gap as having any meaning because they didn't have their "fingerprints on it", as they say in Washington.

So, we came to the spring of last year with eight months to go before our legislation ended, and in a chaotic state. The stocks and mutuals were fighting over what kind of law there should be, what the share of the respective segments should be, what the tax formula should be. Congress was looking at this, and in his early discussions Rep. Stark began to talk about policyholder issues, including the inside buildup and the policy loan interest deduction. The companies were talking about how our revenue level compared with property and casualty companies and banks, and so on. We didn't want hit with a tax burden that was much higher than our competitors in the financial services business. And, finally, once you got into what are called the policyholder issues, which John Palmer will discuss later, of course the agents got involved here as well, so there needed to be negotiations with agents' groups. The process, I think, for a democratic state was an ideal one. As Virgil mentioned, all of the staffs of the various committees were brought in. There were separate panels of mutual and stock company representatives, and I was privileged to sit on the mutual company group. We met extensively with staff, discussing all the issues, the policyholder issues and the company issues, so that we had our chance really to explore all of those in detail. I think that as legislation goes, the process that was used couldn't have been a better process. I don't know that that says it will turn out to be a perfect law, because it certainly won't. But, the way in which one went about it was pretty well done.

Finally, as we got to September, there was agreement struck by Rep. Stark and Rep. Moore with both the stock and mutual segments of the industry and with the agents. Those agreements covered everything that was in 4170 except the variable contracts, which I'll come to and talk about. Regardless of how we felt about various provisions of the bill, those agreements meant we accepted the bill as a whole, and that in subsequent discussions with other committees, we really were handicapped in trying to attack any of the main provisions of the bill.

Now, let's talk about the conceptual basis of the law. For stock companies, and stock companies were the model for this legislation, I would describe this, with few exceptions, as a plain vanilla corporate tax law. It looks much more complicated than that because there are a lot of special provisions and so forth, dealing with reserves and other subjects. But, really, stock companies are being taxed on their income as measured on the accounting basis that's in the law. The phase system is gone, most of the special deductions that were features of the 1959 law are gone. Essentially, it is still based on statutory results, but with some changes in definition, particularly on the reserve side. When we got to the comparison with other industries, and this really is what set the revenue level here, Congress had a tough time. They know that, because of the treatment of tax exempt interest and other provisions, that the property and casualty companies and the banks really pay very little tax. The record in this respect is fairly clear. They hope to deal with both banks and the property and casualty companies in terms of their particular tax laws and rates. But in the meantime, they propose to take care of our situation with what was known as the taxable income adjustment or as it is called in the bill, a special life insurance deduction. In the House bill it is 25% of your taxable income as otherwise computed, and in the Senate bill it's 20%. What this deduction does is essentially lower the tax rate in the House bill to 34.5% and in the Senate bill to 36.8%. The revenue effects, as best judged, are probably about $200 million difference, and so it's somewhere around 2.9 billion in the House bill for 1984 and 3.1 in the Senate bill. The bill addressed the issues of tax exempt interest and the dividends received credit, which are available to most taxpayers, but again we were left with a proration formula. It's a different proration formula than was in the 1959 act, in fact there were two proration formulas in the 1959 act. My impression is, this is probably a little bit better than the Phase I proration formula, and a little worse than the Phase II formula, although I stand to be corrected on that. I think we really don't know where we are yet on that proration formula.

For the mutual companies, we take the stock company formula and then have an add-on in the law that will not appear as an add-on, it'll appear as a limitation of total deductions and credits. The reason it appears that way is there are certain legal and constitutional issues, I think, as to whether you can actually have an add-on. But the mathematics are that it is an add-on, and I think you can work your way through on that considering it as an add-on.

The essential theory here is that mutual companies, who do not have shareholders, will include in the dealings with their policyholders, whether it be dividends or additions to reserves or whatever, amounts that are similar to the (aftertax) dividends paid to stockholders. Thus, there must be a limitation on the deductions for mutual companies to equalize treatment of the two types of companies. This is the essential theory. The practicality and politics of it was that once you put together a plain vanilla corporate tax law for stock companies and you want the division of the total tax between stocks and mutual companies to be a certain result, (and this was determined by the committee to be 55-45), there must be some arbitrary element in the mutual company formula that permits you to do this. The add-on was that arbitrary element.

The add-on is computed by taking three elements, one is an imputed earnings rate, the second element is called the Average Mutual Company Earnings Rate, (that's an all-mutual company item, the imputed earnings item is an item that applies to all companies), and you apply that to each company's equity base. Now, the imputed earnings rate is 16.5% for 1984. After 1984 it will be an adjusted rate, which looks at the 50 largest stock companies and takes their earnings rate for the three years preceding any taxable year, and divides that rate by the three years that preceeded 1984, and multiplies by 16.5. So the 16.5 goes up or down, depending on whether the stock companies' earnings rates go up or down. These are not the investment earnings, but the corporate earnings related to their equity base. It's a numerical average of stock companies, so it's not weighted by the largest companies, and the Secretary of the Treasury has considerable discretion in classifying particular transactions as to how they should affect that earnings rate.

This is a complicated issue because these are not in fact, tax return numbers, but these are numbers based on annual statements. I think the quality of the auditing of what the stock companies submit is a serious question, because an IRS auditor will not collect any money from the stock company he is auditing based on whatever is submitted here. The question of the quality of those numbers is one that mutual companies are concerned about.

The average mutual rate is really in fact the total of all the statutory earnings for the mutual companies, divided by their equity base, and that's a weighted average. Of course, some companies carry more weight than others in those rates, again based on annual statement information.

Each company's equity base is its surplus plus its not-admitted financial assets, plus the difference between its statutory reserves and its tax reserves, plus its Mandatory Securities Valuation Reserve, plus 50% of the dividend apportionment for the following year.

The equity base, of course, includes all of your subsidiary companies, because they are a part of your assets. You average the beginning and end of the year numbers.

I just want to spend a minute on the form here, because this was an important mutual company issue. When the original proposal was published in July, it had a different form. Each company would look at the imputed earnings rate times its equity base; if its taxable income was above that product, then the tax was based on its taxable income. If its taxable income was below the product of the imputed income rate times its equity base, its tax would be based on that product. This was a problem for the mutuals because a company whose tax was based on this product had no marginal rates for any transaction, and the taxable income was determined by multiplying its equity base by some arbitrary rate. In this situation nothing a company did during the year, whether paying dividends or changing premiums or writing business, had any effect on its tax bill.

The mutuals were very unhappy with this proposal. In the end, since this was the arbitrary element of the formula the mutuals were going to have to pay to produce the 55-45 split, they opted for what I would label as a "socialistic solution". That was, they shared this burden among themselves, by taking into account the average mutual earnings rateand basing the additional tax on the difference between the mutual and stock company earnings rates. Now every mutual company will pay an additional tax on that basis, regardless of how much they're earning. So those who have very high earnings rates are ending up with a burden they wouldn't have had under the original bill, and those with very low earnings rates are ending up with a benefit. But, it does put us all in the position where we have marginal rates associated with every transaction, investment or insurance, that we have.

Finally, the form of this, in that it is a limitation not on dividends, but a limitation on all of your deductions, recognizes that in the world we have today any return to policyholders can be in a lot of different elements and not just in dividends. Also, it kept us from having to define what a dividend was, which was getting to be a very complicated issue these days.

Another important item was variable contracts. In 1959 and then in 1962 when the variable contract legislation was put in the 1959 act, you were allowed a full tax exemption for variable contracts on qualified products; but on non-qualified products there was considerable concern among the investment industry that our products would be superior to mutual funds and so forth. So there was put in the 1959 act an effective tax on realized capital gains from variable contract accounts. This doesn't appear as a tax on capital gains, instead it's a deduction you don't have, but the effect was to create a tax on these capital gains.

We had a session on variable products as part of this open process, and John Palmer and I were both there with the staff, on the variable contracts. Unfortunately, we didn't spend much time on this issue of the capital gains. That came up late in the session, and we had spent two-thirds of the session on an issue that really was very trivial, but was a matter of principle. When the House bill came out it continued the tax on capital gains. This has really kept us out of the variable annuity market, and it would have put us out of the variable life market, so it was a very serious problem for us. There was suggestion by the staff that we could make an adjustment in the policyholders basis, but that wasn't very helpful. So, this issue was carried over to the Senate. The Senate bill, as passed, treats variable contracts the same way as other contracts. I have talked this over with some of the House staff and also with some Congressmen, and I believe we have some good reason to believe that when this bill gets to conference, the Senate version will be retained. So I think this has generally been accepted now.

*In the category of reserves there are some important changes. All the cate-*gories were kept as for the last, 1959 act, but we have adopted here for the first time the concept of federal standards for reserves. In general before they were computed as for statutory purposes, plus 818(c) adjustments. The basis in the legislation is that the companies receive credit for the greater of any cash value, using cash value in a broad sense, or the reserve determined on a federally-prescribed standard. That standard deals both with the methods used to compute your reserves (for example on life insurance it's CRVM for the prescribed standard) and the mortality and interest rates used. On mortality and interest rates, there are a lot of technical rules, but essentially they call for the prevailing state rates, which means using the interest rates and mortality tables for any particular benefits that are in effect in a majority of the states. There is an additional category of supplemental benefits, for which you can use statutory reserves. If you use cash values for the basic policy, then you can add the reserves for the supplemental benefits. Supplemental benefits are accidental death, convertibility reserves, disability, guaranteed insurability, and substandard extra. And then there's some others that would be permitted.

There are a couple of special deductions, one is the small company deduction that was in the 1959 act. It has been enhanced considerably, and applies to companies with assets of less than half a billion dollars. It can be as high as 60% of the income otherwise computed. All the members of the family are taken into account in computing this. Of course, the special life insurance deduction, the one that equates us with other industries, still applies after the small company deduction. Then the Senate has added something which we technicians call "ARC" but which is called in the bill "the alternative life insurance company deduction", which was supposed to cut in above for companies that are subject to the small company deduction. It is essentially a special deduction of 20% of new individual life and health premiums. It takes the place of the small company deduction and the special life insurance deduction. This is supposed to phase out over five years, as it is in the Senate bill.

The transition rules here are pretty important, and I've listed two items as transition rules. One is that for reserves you essentially have a fresh start, which means that to the extent that the federally prescribed reserves differ from the reserves you are holding at the end of last year, the difference doesn't have to be brought into income at all at any point. The other thing which I've listed under transition, I realized later on I probably shouldn't have because it's a regular operating provision. (That shows my mutual company upbringing.) The Policyholders' Surplus Account was a big issue between stock and mutuals, and the end result is that any amounts that exist in the Policyholders' Surplus Account at the end of last year stay there. There's nothing new added, but there are no limitations on what you can hold in that account. And of course you continue the Shareholders' Surplus Account as in the past with some new definitions of income and outgo. To the extent there are any distributions to shareholders that exceed the amount in the Shareholders' Surplus Account, you'd still have to go to the Policyholders' Surplus Account and pay a tax on it. So that amount stays in place, could be taxed, but in the normal operations of most companies would probably not happen. I think that covers the company tax issues, gentlemen.

MR. KNIGHT: Thank you, Harry. Next, we'll have John Palmer, Senior Vice President of the Life Insurance Company of Virginia, speak on the policyholder questions in the two bills.

MR. JOHN J. PALMER: Let me start off with a couple of supplementary comments on the company tax issues that Harry did such a good job of covering, in a brief period of time. He's got the more difficult task, because he has to cover a great many more provisions than I do in just covering the policyholder provisions. I think some of you may have had time to get fairly familiar with HR-4170 or some of its antecedents. The Senate bill, however, is fairly recent, and there's a fair number of changes. As a general matter, I think that a great many of the changes that we see between the bills are in the nature of technical amendments and so forth, and I would expect that the surviving bill that comes out of conference, assuming we ever get that far, will probably more closely resemble the Senate bill than the House bill. So, it may be worth paying some attention to the differences. There are a few cases where there is a real political difference between the House and the Senate, but by and large, I think that the differences tend to be on the technical side.

One difference in reserves is in the treatment of deficiency reserves. The House bill, I believe, just repeated the deficiency reserves definition from the 1959 act, which was based upon deficiency reserves as they were defined in state laws prior to 1976 or 1978. Between the time the House bill and the Senate bill were written, I think the Senate staff became aware of this change in state law and expanded the definition of deficiency reserve to cover the new quasi-deficiency reserve. Also, in the special life insurance company deduction, the 20-25%, the SLIC as some people call it, there's a provision added which is of benefit to some companies. Where you have two life companies in an affiliated group and they're not filing a consolidated return, and one is a loss and the other's a gain company, you would not have to offset the loss of one against the gain of the other to compute the TIA or the SLIC.

On the deduction itself, the 20-25%, we may end up with something in-between or maybe 20 or maybe worse. But, I think that if you read the committee reports describing that provision, you will not be comforted in counting on it being around for a long time. They go out of their way to characterize it as a temporary expedient to avoid the trauma of change in the level of taxation. That gives you a bit of a problem in pricing, where you may count on a 34.5 or 36-37% rate forever, but the likeliest result is that you will have that low tax rate when your up-front costs come and the higher tax rate of 46% when your income comes back in down the road. So, I think it's not a thing that one can count on forever. Perhaps the same thing is true with respect to the small company deduction, although those specials in the 1959 Act seemed to survive and they had only a little more rationale than this. It's interesting to note that the reserve methods in the act are not necessarily the prevailing reserve methods, as the mortality and interest assumptions are, but rather they are the methods prescribed by the NAIC. So, once the NAIC prescribes it, you apparently need not get any adoption by anybody for it to take effect for the purpose of computing tax reserves.

Also on the reserve issue, there's generally a lowest reserve concept invoked where you have a choice of reserve assumptions to use, according to the state law. Where reserve standards could be based on a variety of tables for minimum standard purposes, you're obliged to use the one that produces generally the lowest reserve.

A couple of semi-political comments. On the revenue level, the $2.9-3.1 billion and the 16.5% imputed tax for the mutuals, both those hang together. But they're based on revenue estimates that are very dodgy at best, I think. Nobody wants to talk about it any more. Once they got everybody to agree that 2.9 and 3.1 are the numbers, then the concern all goes away. But, in fact, the likelihood that the result will come out very near either estimate is fairly small. It's of some concern to the stocks because the 16.5% imputed number apparently was based on those estimates, and there does not seem to be an automatic correction mechanism if it turns out to be otherwise. If the segment balance, the 55-45 split turns out to be otherwise, then we must I think rely on those studies of segment balance, etc., for remedy.

Also, regarding the proration of tax-exempt investment income, Harry said the numbers generally come out somewhat better than Phase I and worse than Phase II. It can get worse than either phase in a stock company, because of the kind of things that are now swept in as dividends, excess interest and all sorts of other things, can cause your company share to be fairly low.

Let me turn now to the policyholder tax issues. There's one main area here obviously, and that's the definition of life insurance. There are a number of smaller areas. I think I'll hit the smaller areas first so that I can go into the main one in some detail without running out of time and not dealing with the miscellaneous items.

First, as a miscellaneous item, is something that didn't happen, and that's the inside buildup tax. That was the main thrust of Rep. Stark's on-slaught at the beginning. It was dropped fairly early on, and tax-free inside buildup seems to be safe at least for a while. Obviously it's of very critical importance to us. We can talk about our tax rates relative to the other financial intermediaries, but the tax advantage at the product level or the customer level really has to be factored in there as well, and I think the government folks are well aware of that.

In the area of annuities, the Senate bill is a bit more generous than the House bill in what they did to annuities. They still have done away with the ten-year escape from the 5% penalty on premature distributions, but they've taken a different view of distributions in the event of death of the policy-holder. Here, the Senate bill generally follows the rules for IRA's and so forth, that is, when the contract holder dies, the spouse steps into the decedent's shoes to continue the contract, and distribution rules are the same. A non-spousal beneficiary distribution must occur in five years, and for a minor child, the annuity can be kept until 21 and then distributed in five years. A handicapped person can continue it to age 21 and then pay out over life. The House bill, if you'll recall, had the entire amount included in the decedent's income in the year of his death. The effective date on the annuity rules is for issues six months or more after the date of enactment of the bill.

Another section that's totally new in the Senate bill is sort of a curiosity piece - Section 1035. The old, seldom-noticed provision of 1035 was that the life insurance and endowment contracts that qualify for 1035 exchanges must be issued by companies taxed under Section 801, meaning life insurance companies, under Part I of Subchapter L. That means that for a company that is taxed as a P&C company and sold a life insurance contract, that contract would not be eligible for the 1035 exchange. That would have bothered, for instance, some companies who sold universal life out of a P&C company, taxed as a P&C sub, and executed roll-overs. This is something that was not noticed by very many people, I think. Apparently somebody on the Senate staff noticed it. The new definition of 1035 says that it covers any insurance contract sold by any insurance company taxed under Subchapter L. The novelty of this is that it applies to all exchanges past and future, providing a total retroactive removal of any problem that might have existed in that area. So if you never noticed it but should have, you don't have to worry about it even now. Assuming that it passes.

Group term life insurance: Virgil alluded to some of the changes there. Briefly, the bill extends the $50,000 limitation on tax-free group term life insurance to group term life for retired employees. Imputed income on excess amounts are computed on the same table used for active employees, which means that it's in effect capped at the age 63 rate. So, even if you're 95, your group term life imputed income is based on a rate that's more or less calculated at an age 63 level.

The non-discrimination rules are extended to retired people as well, but slightly different than the House bill in that they would apply separately to retireds and to actives, as two separate groups. If you fail the discrimination test, the tax attributed is based on the actual costs of the benefit and not on the Treasury table. The effective date is generally 1/1/84, except for plans in effect on 1/1/84 and with respect to employees in such plans that are age 55 or over on 1/1/84.

Another non-item in the House bill is the Section 264; that is, changes relating to minimum deposit plans. This was dropped entirely from the Senate bill and in the House bill had a very distant presence, with very high limits - what one staffer characterizes as "the shadow in the doorway" type of provision. I think that's about as much as it was, but it has been dropped altogether in the Senate bill in deference I suppose to the agent association or other pressures. I think it was not dropped because any Congressional people who understand it like minimum deposit particularly well, but simply as a reflection of the political muscle of the agents' groups. In fact, I know they don't like 264 too much, because we had some conversations with them about extending it to universal life, where you have a flexible premium. Our concern was that, because you have no premium due, you can't possibly pay 4 out of the first 7 premiums due by some means other than borrowing, and we'd like that clarified a little bit so as to allow for the triumph of substance over form. We got absolutely nowhere on arguments of level playing fields, and so forth. They don't seem to want to extend the ambit of minimum deposit to anything that doesn't already have it.

The House bill had a section dealing with non-deductible IRA's, basically allowing you to put in up to $1,750 into an IRA, but you wouldn't get a deduction for it, you'd just be able to shelter the income. That's been dropped in the Senate bill.

Another new section in the Senate bill is an exception to the IRA distribution at age 70-1/2 rule in the case of a contract with a company who can't make the distribution because it's bankrupt.

Now, let me turn back to the major part of the bills affecting policyholder taxation, and the one of most interest to a lot of us here because of the product design implications that it has; that's the proposed Section 7702, which defines life insurance for all purposes of the Internal Revenue Code. In this it differs from TEFRA (Section 101(f)), which really dealt only with the definition of life insurance for the purposes of the taxation of death proceeds, the 101(a) exclusion. The TEFRA provisions in 101(f) have now technically expired, so we're now really operating under a kind of de facto extension of 101(f) under a letter that the Treasury put out. They've agreed to refrain from adverse action pending Congressional action on the permanent bill. 7702 continues the general principles of 101(f) in that it has two alternative tests, but it has tightened things up a bit to limit still further the possible investment orientation of a qualifying life insurance contract. A life insurance contract has to be, first of all, one that is treated under state laws as a single, integrated contract. In variable life, you have to redo a new test every time the amount of the death benefit changes, but no less often than once a year.

There are two tests, as there were before. First a cash value accumulation test, which requires that the cash surrender value of the contract be no greater than the net single premium for the future benefits under the contract.

Future benefits here mean death benefits and endowment benefits. You must assume the contract matures at least at age 95, or beyond. This rule allows for a recomputation of the test based on current and future benefits only. This is a clarification in the Senate bill. It's a little difficult to tell under some of these changes of wording just what they were driving at. One of the computational rules deals with the least amount payable by reason of death of the insured as a limitation, and the apparent intent was that you don't have to look back before the date of the current test to a lower amount payable by reason of death of the insured.

There's an interesting definition of the cash surrender value in the Senate report. It's defined as the cash value of any contract, i.e. any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow, determined without regard to any surrender charge, policy loan or a reasonable termination dividend. They refer to New York law about what reasonable is for a termination dividend, and $35/$1,000 looks like their idea. There's an exception for credit life insurance for amounts returned on full payment of the debt. They're not counted as cash surrender value, since they're generally not available for borrowing. It does raise a question as to what happens if the amount that you can obtain on surrender and the amount subject to borrowing are different amounts, as might be the case in a variable life contract, which might limit policy loans to 75-90% of the cash surrender value. I'm not quite sure what they would do there.

To calculate the net single premium, one takes interest at the greater of 4% or the rate guaranteed at issue in the contract. Rates guaranteed at issue, if not explicit, are taken to be those reflected in the contract's non-forfeiture values - here there is a little bit of new language - assuming the use of the standard non-forfeiture law method. Mortality is taken as that specified in the contract or the basis used for statutory valuation.

What's the point of the new language about assuming use of the standard non-forfeiture law method? Well, I saw a contract, a single premium whole life contract that had a guaranteed cash value accumulating the premium at a 3% interest rate only, with no mortality at all: it was just a pure interest accumulation. It paid excess interest and the death benefit at any time was equal to the cash value, whatever it was, converted by the net single premium at 3% 58 CSO, producing a kind of cash value corridor. I think the intent here is to say in this case you can't use 3% as the basis for computing a net single premium, because your non-forfeiture values aren't really 3% non-forfeiture values, they're really something like 3% plus the mortality charge. On a guaranteed basis that contract shows an increasing death benefit because there's no mortality taken out of the run-up of the cash value. So, I think it may be this kind of a product that this added phrase "assuming use of standard non-forfeiture law method" was intended to attack.

There are some items called qualified additional benefits which can also be taken into account. These are guaranteed insurability, accidental death and disability, family term insurance (but not business term), and waiver of premium on disability. These are allowed in the funding of the contract, and they're taken into account by treating as future benefits the charges for such supplemental benefits. That's essentially how the cash value accumulation test works.

The alternative test that you can use is the guideline premium test, familiar to those who have dealt with universal life. The general approach is very similar to what 101(f) has for the guideline premium test, that is, you compute two premiums: a guideline level premium, which is the amount necessary to fund future benefits on a level premium basis, where level premiums have to be assumed to extend at least to age 95; and a guideline single premium, which is the amount necessary to fund future benefits on a single premium basis. The limitation then is that the sum of the premiums paid under the contract cannot exceed the larger of the sum of the guideline premiums or the guideline single premium. There's kind of a cross-over effect that is permitted. You can put in a guideline single premium up front, and then when the sum of the guideline levels exceeds it, which it will because there's no interest reflected, you can skip over to the guideline level premium sum as the cap on premiums.

This is essentially a different orientation than that in the cash value accumulation test. It concentrates on limiting the amount of money put into the contract, as opposed to limiting the amount which can accumulate under the contract. The assumptions for calculation are also specified. Interest is the greater of that guaranteed in the contract or 4% for the level premium, and 6% on the guideline single premium. Mortality is that guaranteed, or the statutory reserve rate if there's no explicit guarantee. You take into account expenses as explicitly specified in the contract. The test does not completely ignore how much the cash value accumulates to: it has a cash value corridor test as a supplement. It's less stringent than the control under the cash value accumulation test, but the tests in both bills now are more stringent than those under TEFRA. TEFRA had a limitation that the death benefit had to be at least X% of the cash value at various ages. The limits ran from 140% grading down to 105%. The new bills grade from 250% down to 100%, in a fairly irregular pattern.

A very important part of these tests are the so-called computation rules which do not strictly control the amount of benefits you can provide under a contract, but control the kinds of benefits which you can take into account in doing your computations for the purpose of making the tests. The first rule says that the death benefit must be deemed not to increase at any time. That means, for example, that you can't have a contract such that death benefit starts here and then drops and then goes along and goes back up again. I think TEFRA had a rule that simply said that the death benefits can't exceed the amount of risk at issue, which would have permitted this kind of valley effect.

The second rule says that the maturity date is deemed to be at least 95, but no later than age 100. There is a little new language here that may be worth reading. The maturity date, including the date on which any endowment benefit is payable, (that phrase is new), shall be deemed to be no earlier than on the day on which the insured attains age 95, and no later than the day on which the insured attains age 100. Thus, the deemed maturity date generally is a termination date set forth in the contract or the end of the mortality table. These are quotes from the Senate report, not from the statute.

I think they've gotten more paranoid, as they see more contracts, as to what kinds of things people can do; and they're trying to prohibit, let's say, pathological mortality tables that go beyond age 100 and have high q's way on out there that can be used and combined in various fashions to justify high funding. There are a lot of things that are perhaps theoretically possible, that they're intending to forestall with some of these changes. I think that they're as paranoid in this area as in any area I've seen. I think there may be some rationale for it. After all, even paranoids have enemies.

The third computation rule provides that the amount of the endowment benefit, or the sum of the endowment benefits, cannot exceed the least amount payable as a death benefit at any time under the contract. The first computation rule limited the increase of benefits. Now, there is in the Senate version a limited exception to the non-increase rule which generally allows for qualification as life insurance of contracts which provide a return of cash value in addition to the base amount on death of the insured. For the cash value accumulation test there is prescribed a net level reserve limitation on the cash value; that is, you can't exceed the net level reserve for this kind of return of cash value benefit (or option 2 benefit, as the universal life people call it). There's a new phrase in the Senate bill that seems to make it clear that you can't switch from the net level reserve test to the net single premium test.

So once you've opted to qualify your increasing benefit contract on the net level exception, you can't go back to the net single premium. I wonder what one does with paid-up additions under such a contract, which would presumably have to qualify on a single premium test. If you can't mix and match, I'm not too sure how you can handle them. That's a question to which I haven't got an answer. There's a lot of those in here, by the way.

In the guideline premium test, one is permitted to compute the guideline level premium assuming the increasing death benefit, but not the guideline single premium. We've managed to justify this exception, at least for the universal life guideline premium test situation, by a demonstration that the investment orientation of the contract permitted under this rule would not be increased, where we measured investment orientation as a return on surrender at various points during the life of the contract. That was essentially the way that this kind of liberalization was justified in the minds of the Treasury staff.

There is very little language in the law itself regarding adjustments. What happens if you change benefits under a contract? There is more talk in reports that give you some guide as to what they might have in mind. Essentially you make attained-age adjustments of the entire contract under the cash value accumulation test and you make attained-age adjustments which reflect only the changed benefit under the guideline premium test. Generally, I think they seem to envision something consistent with what current practice appears to be. There is a new item of some use in the report, mainly of interest to guideline premium test users. It says that an automatic change in benefits due to the growth of cash values caused by interest credits (and here's the new part) and by payment of guideline premiums, does not produce an adjustment. This is useful I think. It wouldn't have crossed most peoples' minds that it would have caused an adjustment, but it did cross Treasury's mind, and they threatened that such was the case and that they did have the authority to invoke adjustment rules when you continued to pay premiums after you reach the corridor, for example. This would seem to prohibit them from doing that. However, happiness from this may be short-lived, because it goes on to say that all these rules can be changed at will by the Secretary of the Treasury in promulgating regulations. So whatever you make out of the Report's comments on adjustment rules, you can't really count on being permanent.

Another interesting point. Both bills make it clear that any amounts disgorged from contracts on account of the adjustment rules (if you drop the benefits and have to pull money out) get taxed under Section 1031. The report makes it clear they are explicitly intending to catch money disgorged in the case of a universal life contract where you go from the option 2 increasing death benefit to an option 1 benefit. They suspect that there's some engine of abuse there, that you can start off funding on an option 2 basis and then switch.

The final two points I have to cover here are the treatment of failed contracts and the effective dates. Failed contracts certainly get your attention much more in the Senate bill than in the House bill. Generally, the treatment of a contract that fails the definition of life insurance is that it is treated as a term and annuity combination. The term piece keeps on as life insurance, the annuity gets subject to the annuity provisions including, in the case where the cost of the term charges of the term piece are not covered by the premiums put in, a deemed distribution from the annuity contract to cover the shortfall, subject to all the normal distribution rules for annuities. This is the same as it was in the House bill.

The new part in the Senate bill is that something happens at the company level when a contract fails. If we have a contract that is treated as life insurance under state law as an integrated contract, and if that contract fails the statutory definition in 7702, then the company must pay an excise tax equal to 10% of the net surrender value under the contract on date of failure, and it must report the fact of the failure to the policyholder within 30 days, subject to the pain of the usual reporting penalties if it doesn't. Furthermore, the company is not allowed to pass the 10% excise tax on to the policyholder, directly or indirectly. The mechanism to control that is that the company has to pay another excise tax of 100% of whatever it passes on.

What is the impact of this? Nobody would have intentionally, I think, written non-complying contracts anyway, except possibly for use in qualified pension plans where the tax treatment was arguably such that it didn't matter anyway whether the contract failed. You may have some problem by intentionally failing universal life contracts for a pension plan because of the excise tax. Maybe you can escape it by not having the contract treated as an integrated contract under state law. But this again is a new item that hasn't received a whole lot of dissection by the analysts.

As to effective dates, the rules generally apply after 12/31/84. Thus 1/1/85 is the general effective date for plans in existence, that is, filed in at least one state on 3/15/84. The exception to that, is that for any increasing death benefit policies with funding more rapid than 10-year level premium, there is an effective date of 1/1/84. They really don't appear to like increasing death benefit policies, and are trying to do as much damage as they can to them.

TEFRA 101(f) applies to flexible premium contracts during 1984. It's okay to exchange an existing contract for a new contract and have the new contract grandfathered in under whatever grandfathering exists.

MR. KNIGHT: At the beginning of John's talk, he made some comments about company tax issues seen from a stock company view. Before going on, I want to give Harry Garber a chance, if he's got any policyholder tax issues as seen from a mutual company view, that he might want to cover.

MR. GARBER: I'll just add two small items here, and these aren't mutual items. But, on the policy loan interest change that was made in the Senate, John referred to these as being agent caused, and I think it's important to note that the agents' associations, the major agents' associations, were parties to the agreement and they, in fact, were not involved in the Senate discussions. There were a number of large agents and general agent types who were not parties to the agreement, in addition to some small business owners. The whole issue here took the question of whether in fact policy loans helped sustain small businesses. At the hearings Senator David L. Boren (D-OK) and Senator Alan K. Simpson (R-WY) brought in small business people from their particular states who alleged that it was very important to have the ability to borrow on their policies in order to keep their businesses going. I think that was the main cause there, and it was not the agents' associations that were doing it. That whole question is still to be determined in conference. The House is very sticky on this one. They felt they took all the "heat" in order to introduce this limitation in the first place, and that they didn't like the Senate to give it away. I think that's an issue which is not yet resolved. I think the history of attempts by government to decree you can't pass through taxes to customers is replete with failure, and I would doubt that the last thing John talked about would be any different.

MR. KNIGHT: As both John and Harry have mentioned, there are a number of issues that people don't know the answers to, that aren't resolved completely between the two bills. Maybe we aren't quite sure how they will get resolved in conference, as is being suggested.

To talk about just what we might expect over the next couple of months, Virgil Wagner is going to give you a view of where things stand as of last week.

MR. WAGNER: Now that all the provisions of the bills are totally clear, I will go into the predictions, which will be even less clear. I'm not really going to try to give you a specific prediction, naturally. But, what I will try to give you is the status, the climate, and share with you what some of the players are saying, and then you will be in a position to maybe better develop your own prognosis as to what you think might happen, in the next week even.

These comments on political climate and so on are not mine alone, but better than that, are prepared for me by some of the more political members of our staff in the federal and tax departments of the ACLI. As of today, that is the opening of today, the situation is this. The Ways and Means Committee has ordered HR-4170 reported with some technical amendments which we have talked about already. The Finance Committee, only slightly behind the House schedule, has also reported a bill with a fair number of differences which have been reported on. This week both the House and the Senate are scheduled to take up their different versions of the tax bill on the floors of their respective chambers. Senator Howard H. Baker, Jr. (R-TN) planned as of the end of last week to bring the tax bill to the floor of the Senate today. House floor action as part of the 1985 fiscal budget reconciliation is expected to begin on Wednesday. The tax provisions are scheduled for action on Thursday. Unlike the Senate, the budget and tax has been wrapped into a deficit-reduction package; in the Senate they're still being tracked as independent measures.

Now, as I said, I'll tell you what some of the players are saying as to prognosis, and if that's clear, you can let me know what you think of this.

Last Wednesday in Chicago, House Ways and Means Committee Chairman Rep. Rostenkowski, said that he is quite optimistic about passage of a tax bill by mid-summer. In addressing the Securities Industry Association, Rep. Rostenkowski said he expects the House bill to go to conference committee with the Senate after the Easter recess, but he gave no indication of areas where he might be willing to compromise with the Senate at the conference stage. As he put it, "like any good poker player, I'm not showing my 'hole card' until I have to". Now, while he said he was optimistic, he also had a warning. He said achieving the $49.3 billion in tax hikes was surprisingly difficult. As I say, that was kind of a damper on the earlier optimistic statements.

Addressing another group in Washington on Thursday, Rep. Stark, who was Chairman of the Select Revenue Measures Subcommittee, commented that the House democratic leadership may not have enough votes to pass the tax bill. Rep. Stark told the Federal Bar Association Tax Law Conference, "I've heard we're shy of votes in the House as a result of the measure's proposed cap on state industrial development bonds." House Minority Leader, Representative Robert H. Michel (R-IL), had agreed to deliver 90 Republican votes for the tax bill, Rep. Stark said, adding that Michel will not be able to do that unless President Reagan gives at least reluctant approval to the measure. If President

Reagan says he will veto the tax bill or that it is absolutely unacceptable, Rep. Stark continued, there won't be a bill. The big story in the House is as Rep. Stark indicated, not so much in the life insurance provisions, as in the rest of the bill, which is where we were last year.

In the situation where the President has limited control over the Congress, the legislative process is very disorganized. It becomes difficult to pass even non-controversial legislation because there are all sorts of interests waiting to attach riders to anything that looks like it will pass. Moreover, the majorities in the House Ways and Means and Finance Committees are in favor of a package provision that will raise a modest amount of revenue over the next several years. Now, this whole project is just on the edge of political respectability since the President has repeated his position that he wants some adjustments, but not a real tax increase. As particular adjustments begin to hurt a constituent group, a legislator can merely decide that this is an increase and then oppose the whole bill.

The Industrial Development bond issue is much in point. The tax committees, especially Ways and Means, are concerned about the rate at which states and localities are extending the umbrella of their tax exemption to private business financing. Many governors as well, are deeply concerned that ultimately we could end up with a very different tax system in which nearly all business debt financing would go through states or localities and the value of tax exempt financing for traditional government activities would then be debased. Biting on bullets is very hard for a lawmaker not on the tax committee. Immediately he hears from some constituents that this legislation will threaten some particular project in his district and wipe out some jobs, then voting against the bill is very attractive. There will be opportunities for a member to say, when a life insurance company representative approaches him, "yes, I favor the life insurance provision, but I'm not going to vote for the bill". If the bill does go down, we will have to try to strip out our provisions along with some other provisions, those that are expiring provisions which really have to have attention, in the hopes that a smaller bill can be passed. But, this would be an uphill fight. The best prospect for life insurance is to get the big bill passed, and how do we do that? Well, I would say go to the phone as soon as you leave this room, call whoever in your company is the appropriate person to make contact with legislators. Have them urge your representative to vote, number one, for the rule affecting the tax bill, and number two, for the bill. As I say, the bill is scheduled to be voted on Thursday as the schedule is set up now. Of course, those things change and he of course should know when that is. But, get him to vote for that bill. Let's get the big bill passed. Because carving out and all those nice things are a lot easier said than done.

MR. KNIGHT: At this point we want to entertain some questions from the floor, if there are any.

MR. ARDIAN C. GILL: I wonder what your views are on probable tax strategies for mutual and stock companies, respectively, assuming that the Senate version of the bill is passed in essentially its present form. There's clearly an incentive for a mutual company to distribute surplus as opposed to accumulating it. There's an incentive certainly for a mutual to de-mutualize. I guess there's some incentive for the 50 largest stock companies to decrease their equity base and increase earnings on that thereby, and thus shift some of the tax burden to the mutuals, and so forth. I just wondered if you have any thoughts on likely actions on those two types of companies.

MR. GARBER: What you've described here are generally self-destruct strategies. My sense of strategies says they ought to make economic sense as well as tax sense. Distributing large amounts of surplus might be a fine thing to do if you have plenty of surplus, but if you're not that fortunate, then it's a way to Chapter 11. You may save some taxes along the way, but I think it's hardly a sensible way to approach the world. What the mutual companies will do if the stocks choose to "stick it" to them, I cannot say, but again I assume the stocks will be acting in their own economic interests primarily. The question of actions they would take, I think, would be more concerned with their own tax strategies than otherwise. I think there are strategies that can be developed here. I think that one needs to work a lot with the fine print of the law and really with the mathematical underpinnings of it and you learn something new every day on it.

I think that one thing you did mention was de-mutualization, Ardian, and I have five reasons why companies should de-mutualize, the tax is the fifth reason in order of importance. So, I don't think that that's an important area. It seems to me that tax strategies will be, as they've always been, to promote your total economic gain after taxes. You don't take actions which save taxes, but damage the institution otherwise, but you do take taxes into account in everything you do and it will affect investment strategies, policy strategies and everything else, but I think the situation has been uncertain and fluid enough so that detailed tax strategy planning is just now beginning, and we really haven't proceeded very far along.

MR. PALMER: I would agree with Harry that it's a bit too early to come out with strategies. After all, it took 20 years or so for all the opportunities in the 1959 act to really be flushed out of the woodwork. That brings to mind something that Harry described in his talk in some detail, the form that the mutual imputation tax takes. There aren't very many personally-named items in this tax bill, but the Garber add-on amendment is one that has been talked about, which Harry described quite well.

One of the effects of that form that struck me, not being a mutual company person, is what was called in the stock company camp the "beggar thy neighbor" effect because it seems to work in such a way that if one company exercises it, say one mutual company takes action to lower its tax, because the effects at the margin are as Harry described, and because it's kind of a closed-sum affair, the tax on everybody else goes up a little bit. So there may be a race out of the barn on that, and you can imagine all sorts of results. As Harry would probably say, the other grand economic realities of life really do constrain that kind of thing quite a lot, so it's more of an imaginary problem than a real one. But that is, I think, in the nature of a mutual company strategic effect that should be noted.

As far as stock companies go, it appears that a great deal of the latitude for creativity that existed in the 1959 act has been squeezed out of this one. You haven't got the phase system, which was full of opportunities, and you haven't got the liberality allowed for setting of reserve levels, such as picking your own deductions, depending on how much surplus you've got. You haven't got that kind of latitude. So, there's a great deal less in the way of opportunities for strategies, if strategy means creativity on the tax front. There are probably some that exist, we'll probably be discovering them for as long as the act lasts, however long that will be. But, I think it's refreshing in a way that we can perhaps focus back on the realities of what our business really is, instead of fretting quite so much about all the bizarre tax consequences of things you do.

MR. GARBER: On the question of strategy, I might mention that there is a provision in 4170 which will have an effect on strategy. That is that the treatment of discounts on bonds is being changed. If you purchased a bond at a discount up to now, you were able then to take the discount and not have to accrue that as an ordinary income item throughout the life of the bond, but you in fact took that market discount as a capital gain at the time the bond matured. That is being changed with respect to bonds issued after some effective date of the law, and I don't remember precisely what that is, but this, of course, was an important element of tax planning under the 1959 law and would have been under this law. It still will be with respect to bonds that were issued before the effective date of this change, but for bonds issued after that effective date, that provision will no longer apply and, in fact, you're going to have a two-tier bond market here because some of them will carry more valuable provisions if purchased at a discount than will other bonds. So, that's one element of tax planning we're going to lose here.

MR. PALMER: Is anybody trying to fight that off, or is everybody so fatigued from the rest of it they are not even bothering?

MR. GARBER: It's one that's hard to fight in theory. I feel a little handicapped in fighting the theory of it, although the main argument you have is that you have a two-sided transaction where the person who is selling you the bond is taking a capital loss and therefore you on the other side should get the gain as capital gain. But, the Treasury has developed a theory concerning the time value of money. They're looking at a lot of transactions in terms of time values and money and recognizing that a dollar today is worth a different amount than a dollar five years from now. So, this is one of those elements of change. It's difficult for us to fight the theory of the change, I think. And, I think they've persuaded enough of the members that the theory is right that we would have trouble weighing in against this one.

MR. PALMER: Let me take a minute to add to Virgil's exhortation to call your Congressman. I think it really is important. We've found with our own we've had trouble with them. You'll get put off by them saying, as Virgil says, "we support your provisions, but we have to look at all these other things". We had that back with TEFRA. Our Virginia people did not vote for TEFRA because it had a tobacco tax, we have a tobacco tax this time in the House. But this time we told them don't count on another dime from us unless you vote our way. This is make or break. We understand all the problems, but it's too bad. Unfortunately, we don't go to Washington but once every 20 years, and we haven't got that kind of continued presence that some of these other lobbies have. The clout isn't all that great, but you need to be not at all bashful in pressing your case with your local representative.

MR. KEITH GUBBAY: I have a question of Mr. Palmer. John, which of the two definitions of life insurance, from a product development point of view, do you think is better, and I'll leave open the definition of better for you.

MR. PALMER: I'm not sure what sort of answer you expect of that. I think it's pretty clear that the guideline premium test was constructed on behalf of flexible premium contracts. TEFRA originated by having that definition alone, the cash value piece was put in as something of an afterthought, as I understand it, and now it has elevated to equal status with the other test. The cash value accumulation test has been worked on from the point of view of satisfying the needs of traditional fixed premium contracts. So, assuming that all the "worker bees" have done their job well, then I would say that the guideline premium test is unequivocally the best test for universal life and that the cash value accumulation test is unequivocally the best test for fixed premium contracts.

MS. BARBARA A. KELLER: I do product development. I have two questions for Mr. Palmer which are perhaps unanswerable, but I thought I'd give it a try anyway. First of all, in universal life, where you start out with a level death benefit, and very soon, even if you do put in the guideline premiums, you run into the cash value corridor test which is the supplementary test for the level premium test. I have not been able to figure out from reading of it, just how this limitation that the death benefit is deemed not to increase is going to work, when like most companies when this happens we make an adjustment in the death benefit in order to preserve that corridor between the death benefit and the cash value. John Palmer, you had touched on this and you said it was not going to be treated as an adjustment. Question is, how will it be treated or will we be allowed to make that kind of adjustment in order to keep in compliance?

MR. PALMER: I think, if I understand your question, you run into the applicable percentage, the cash value corridor test, because of the operation of let's say excess interest or something.

MS. KELLER: Absolutely true. And they haven't put in too many premiums.

MR. PALMER: The "deemed not to increase" rule is a rule for computation purposes when you're computing your guideline limitations to begin with. You don't have to go back and do something new in the way of computation for the guideline premium because you've bumped into the corridor on account of excess interest. You still have to keep the corridor percentage up there, but you're not prohibited from changing the death benefit that way. You could rarely get into the case where you're computing your guideline premium to begin with, and you find that on guaranteed interest you reach the corridor; then you can take the increased death benefit into account for the guideline level premium test, but not for the guideline single premium test. Chris DesRochers there probably knowsmore about these details than I do, and he may want to follow up with some comments on this after I'm done. But, I think that you haven't got a problem because you've bumped into the corridor on account of operation of excess interest combined with paying your premiums.

MS. KELLER: So, it is permissible, then? Thank you. The second question was, I'm sure that at least 26 states have passed the 1980 CSO amendments to valuation and non-forfeiture. Now, suppose as a company you have not yet elected to comply with the section that has you using the dynamic interest rate and the 1980 CSO tables. Now, for tax purposes, can you use the interest rate that goes along with the 1959 law, in other words, not the Section A of the model law, for your tax reserves, or must you put it on dynamic interest rate in 1980 CSO reserves in order to calculate the taxes?

MR. GARBER: I think it was after 1986 that the 1980 CSO table is specified.

MR. DALE R. GUSTAFSON: I think I know the answer to this question. Harry is right in referring to this provision in the House bill that in effect says, in spite of the 26 state rule, you don't have to adopt the 1980 tables until 1986. Seems to me it's two years earlier in the tax law than in the model bill, so that if you decide to wait until the last year to introduce new policy series or what-have-you, you're still going to have to make computations on the new table in 1987-8 for tax purposes. But, I believe you have to move to the dynamic interest rate immediately. There's no grandfather or transition for that. As soon as the 26 states popped in, then your tax reserves are on that basis from that year forward. It's a mess.

MR. GARBER: The provision of the House bill says the House report expresses the Committee's understanding that the use of the 1980 CSO table will be required for contracts issued after 1986, so presumably 1987 issues.

MR. PALMER: 1986, I think, is for the table. When the interest rate changes, as I understand it, you can wait a year. You can use last year's rates for non-annnuity contracts, but you have to use this year's rates for annuity contracts. There's a question of how that couples with the 1980 CSO. This is an example of a lot of fairly picky questions. Because the timing put out by the NAIC and some of their operations isn't the neatest in the world, the fact that we are now in a mandatory environment as opposed to an optional environment is going to, I think, cause a change in the way the NAIC is asked to frame some of their actions in the future. There's going to be a very heavy eye on the tax consequences of what NAIC does. To some extent, I think that some of the battleground, or let's say discussion forum, will change from the federal level to the state level.

MR. HAROLD CHERRY: Further to Ardian Gill's question on tax strategy. We hear a lot of talk, and apparently there's been some action, that a number of mutual companies may have attempted to or may in the future, attempt to reduce their statutory surplus by selling off assets at market values which are currently below their book values, perhaps with some offsetting changes in reserves or elsewhere, so as not to reduce their statutory surplus too much. The idea behind this, of course, is to reduce their equity base and equity base tax. Do you have any comment on that?

MR. GARBER: I'd have the same comment I had toArdian, in that it may take place. But, there are limitations based on your present finance, statutory financial position, so that it's an advantageous thing for the companies based on their position.

MR. PALMER: I think that a really mammoth move in that regard would probably have some ultimate fallout, as kind of a corrective measure. I think there may be that kind of limitation on the degree to which that sort of strategy would be exercised.

MR. GILL: I don't think that's a real issue. If my mental arithmetic is correct, if you reduced your surplus by one hundred million, your tax savings that year is like 3.1 million. So, I don't think there's going to be a massive move out. Mortgages, of course, are the big target area, because there is no MSVR against those.

I have a question I think is for Virgil. There was something like 35 or 40 amendments in a couple of lists that came out of Washington a week or so ago. Virgil, do you know the fate of those? Are they imbedded in the bills that are going to the floor, or where are they?

MR. WAGNER: There are about 30 amendments, I believe, still pending. They have not been incorporated into the bill yet. And those, I believe, Senator Howard M. Metzenbaum (D-OH) made some comments about those, that he would speak to each and every one of them, and at the end of that conversation indicated that it was a preposterous tax reduction for the life insurance industry. And that's an interesting point we haven't talked about, that you can view it as a tax reduction of course, because the 1959 act is currently the tax law. If you use that line, then of course we have a tax reduction in this bill.

MR. CARL HERMAN ROSENBUSH, JR.: I have a couple of questions. On a standard type of endowment contract, like endowment to 65 where the cash value is less than that single premium, does that fit within the limits for being a life insurance contract. And the other on the reserve for tax purposes, when you go to a certain basis, depending on the mortality table and interest, does that apply to all years of issue, or just the current years of issue, and does it apply to insurance written in foreign countries?

MR. PALMER: With respect to your question on endowment contracts, I think your endowment at 65 contracts are going to fail when they get to 65 because you're not going to be able to meet the tests. So, you could write contracts that endow for some lesser amount than the face, for example, to meet the test, but they recognize that the proposal does wall off those kinds of contracts.

MR. GARBER: On the reserve issues, I believe I'm right, it's the reserve that would be applied by the majority of states to that particular contract whenever it was written. So, to the extent that state laws apply to contracts issued during certain periods that would be the state laws used in making the measurement. Foreign countries,... I'm at a complete loss. I don't know what provisions are in foreign countries. You have to get the bill and read the fine print, I think.

MR. KNIGHT: I don't know about the foreign countries, but there are some special provisions for very old policies, I think it's before 1948, and for small companies to provide some relief in the calculation of the tax reserves.

If there are no further questions, I'd like to add my voice to those of everyone else up here in imploring you to go out, and we'll even let you out 4-5 minutes early to go make your call-back, to get your CEO to place his call today to your Congressional representatives. I think many of the issues are not really settled, we won't see the answers until it comes out of conference. I know I'm reminded of one that I've been talked to about on the annuity payout provisions. The Senate changed them to comply with what's being done for your qualified plans. Unfortunately, they also changed what was being done for qualified plans, and so there's still a difference. Details still need to be worked out. The staff in the Senate and the staff in the House are not completely talking to each other, I guess. It's an interesting world, and probably next year we can have a session telling us what really happened and then find out it was all different from what we discussed here today.