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FEDERAL INCOME TAXES--INSURED AND ANNUITANT PERSPECTIVE

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There are several proposals for changing the tax law with respect to the taxation of personal income. This session will cover:

- A general discussion of the tax climate that led to these proposals
- A description of the major proposals (including the Treasury proposal) pending in Congress
- How these proposals will affect the design, marketing and sale of individual life and annuity products

MR. JOHN T. ADNEY: What the panelists want to do today is talk about the currently pending set of revisions to the tax laws affecting life insurance products, and about why we again have a set of revisions pending in the Congress as well as assess that situation. It's my job to begin by giving a background of how we got to this point.

While the life insurance industry has seen considerable revision of the tax laws affecting both companies and products in recent years, it wasn't always that way. There was a time, before the 1980s, of considerable stability in the tax laws. I think that was because there was considerably greater stability in the products the industry sold, and in the economic environment. Carrying over into the 1980s were a lot of changes that started in the 1970s, caused by creativity within the industry generally, and by the actuarial profession in particular, and also by the inflation that was squeezing everyone. Life insurance

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policies which, for years, had been sold in the form of whole life, endowment policies and term insurance, began undergoing change. Previously there had been no particular need to define what a life insurance policy was in the tax law; you knew one when you saw it, and you really didn't need to go through the exercise of defining it except in some fairly rare circumstances. As a result, there was not much of a definition of what a life insurance contract was in federal tax law, nor was there taxation on the cash value build up. Various tax critics over the years had said that the annual increments in the cash value not attributable to premium payments looked like interest increments on savings deposits and, like those interest increments, perhaps ought to be subject to tax. But at least since 1913, there had been no serious effort to place a tax on these amounts. Indeed, in some cases litigated as late as the 1960s, the taxpayers were taking the position on some surrendered endowment contracts that the IRS should have collected tax on this inside build up back in some closed tax years, and the tax court said: "Of course not. These amounts are not constructively received, they're not income." As a result, there was no current tax on these amounts; Section 101 of the Internal Revenue Code, which has predecessors back to the Revenue Act of 1913, exempted the death benefit from taxation in the hands of the beneficiary. Section 72 of the Code, which also deals with annuity contracts, said that amounts, when they are surrendered or withdrawn, would be taxed but only after premium had been fully recovered. Loans under life insurance policies were treated like any other loans, not income. Interest paid on the indebtedness would, with several significant exceptions, be deductible for tax purposes by those who itemize. This was the tax treatment of the life insurance contract; fairly favorable. And, as policies began to change with inflation and the rise in interest rates, interest credits (through dividends, excess interest and even variable contract appreciation) became a more dominant portion of the inside buildup. Those who sold insurance and annuity policies, particularly those who sold single premium deferred annuities (SPDAs), emphasized, exploited and capitalized on the fact that this interest buildup was not taxed until the monies were actually taken out, if at all. These items, otherwise subject to tax, would not be subject to tax. A very favorable treatment. So it was that, as the interest element became more significant, attention began to be focused on it. There arose concern with the very favorable treatment under Section 72 of the Code.

There was concern that

- o perhaps the tax system needed to change to reflect the fact that life insurance contracts were being designed that looked much more like investment instruments than the older style contracts, perhaps because of the predominance of the interest build up, and

- o annuity contracts needed to be subject to greater tax regulation to the extent they were used as short-term investment vehicles, rather than the historic purpose for which the deferred annuity was used, the retirement instrument.

The government therefore sought change in the law, first for universal life contracts, which has their own interesting history of ups and

downs within the industry, and within the tax laws. In 1982 TEFRA created Section 101(F) of the Code, defining what a life insurance contract was in the case of universal life policies. If a universal life policy met its mathematical requirements, premium limits or the alternative cash value limits, the benefits under that contract would be treated just like any other life insurance contract benefits. And if it didn't meet those requirements, that arrangement would be treated perhaps as a combination of annuity and term insurance, meaning the entirety of the death benefit would not be free of tax. Or else, it might be treated as a savings account and term insurance, meaning that there would be current tax on the inside buildup. That was Section 101(F). TEFRA also brought changes in the distribution or withdrawal rules in the case of annuity contracts. The old presumption was that amounts were distributed before annuitization on a premium recovery first, which meant no tax first, basis. That presumption was reversed in order to basically penalize those who took advantage of partial withdrawals from annuity contracts, with the idea that these contracts would be used much as savings accounts rather than as retirement vehicles. So, to reverse that presumption, a gain-out-first rule was created, sometimes called a last-in-first-out, or LIFO rule. In addition, Congress placed a 5 percent penalty tax on premature withdrawals. That's what TEFRA did on individual life and annuity contracts.

We might take a side trip over to the area of employee benefits because TEFRA didn't exactly leave those alone. There were insurance products implicated there, too. Group term life insurance for years had been provided, basically, tax-free to employees. In 1964 Congress placed a $50,000 limit on that tax-free insurance and taxed at favorable rates those contributions for amounts of excess coverage. In addition, there were no nondiscrimination rules as in the area of qualified pension plans. TEFRA solved that problem by introducing a number of more complicated rules, particularly the Section 79(d) Discrimination Rules. Regulations should be out soon describing what those requirements are. But there was a concern that a life insurance benefit was being given to employees along with some kind of impermissable subsidy of the tax law insofar as those benefits were favoring the very-highly compensated, the key employees, in a highly discriminatory manner.

We also saw another old insurance product, the immediate annuity, repackaged in a new form in the late 1970s and early 1980s. The result was the structured settlement annuity, a means of liquidating tort damages, primarily, paying injured victims that juries decided were entitled to compensation, but paying them in a stream of income payments over life rather than in a lump sum. The structured settlement annuity seemed a good deal on everyone's part in that the losing party was not charged as much and the annuitant, the injured party, perhaps would receive more over time. On the tax treatment, the Congress stepped in (after a series of rulings) and enacted the Structured Settlement Annuity Act of 1982. It basically assured that no investment income on any of these arrangements would be taxed to anybody in the stream of the issuing insurance company, the holder of the contract which the Code refers to as the Third-Party Assignee, and we know as structured settlement companies, or the injured annuitant.

But all of this did not end what Congress was doing with insurance products. I might mention an interesting omission throughout all of this: although there was a lot of talk about dealing with group health benefits, not much was done. There had been talk about capping the tax-free nature of premiums for employee health insurance. A lot of those who want to contain hospital costs say that this must be done. But so far it hasn't been done, and indeed the premium payments by employers are deductible and the employee group health insurance benefits are totally excluded from income. Again, a very favorable arrangement.

What did Congress do to life insurance products in the 1984 law? Well, in DEFRA there was still concern that insurance products, aside from universal life, which was regulated by a definition of life insurance, could be used for investment purposes, not the purposes for which the tax benefits were given under the laws. And the same is true for annuities. There also remained concern about the favorable treatment of group term life insurance. DEFRA provided a comprehensive definition of the term "life insurance contract," expanding on the 101(F) rules to give mathematical tests for all insurance contracts issued after 1984. Section 7702 of the Internal Revenue Code contains that definition. Section 72(s) was added, making Section 72 impressively one of the longest provisions now in the Code dealing with annuities. Section 72(s) required that, in the case of the demise of the owner of a nonqualified deferred annuity contract, whether or not the annuitant was dead, the amounts accumulated under that contract must be distributed. Further, the contract must say they will be distributed in accordance with certain rules.

Section 79(a) of the Code was changed after twenty years to exclude retirees from the taxation on benefits above $50,000 and to do certain things as well, basically, to shore up the nondiscrimination rules enacted earlier. Also, group life contracts for retirees and group health arrangements for retirees were visited with the result being the so-called "zebra" rules, which greatly limited prefunding of benefits under Section 419 of the Code.

In general, the Congress kept looking at insurance products and limiting the reach of the beneficial treatment in accordance with what Congress believed should be the right treatment of these products under the tax law.

The final thing we might mention was that annuities were given, I think, the opportunity for great sales in connection with Individual Retirement Account (IRA) arrangements, beginning with the Employee Retirement Income Security Act (ERISA) back in 1974. Section 408(b) of the Code permits an annuity to be used as a savings vehicle for retirement with deductibility of the premium for the first time. The Revenue Act of 1978 and, more specifically, regulations issued in the early 1980s, also brought us what is known as Section 401(k), which we will be discussing a little later on. These so-called cash or deferred arrangements also provided an opportunity for the sales of insurance products in connection with employee retirement savings arrangements.

MR. ANDREW D. PIKE: Unfortunately, I'm going to have to cover a little bit of the same ground that Mr. Adney covered, but from a slightly different perspective.

I believe that the current attention to the tax treatment of life insurance products is directly traceable to the inflation of the 1970s. It was that inflation that caused the insurance industry, as well as all other financial intermediaries, to change the way they did business. The traditional passbook savings account no longer worked. The traditional 3 percent nonparticipating level premium whole life policy no longer made sense. So the industry had to devise new ways of doing business. This is absolutely sensible, but how does an industry deal with financial markets where inflation rates go from 5 percent to 20 percent and where interest rates vary just as dramatically? It had to design products to separate the interest part from the insurance part, a very positive development for the consumer and, I think, for the industry. We saw all sorts of new products: deferred annuities, variable deferred annuities, excess interest life insurance products, universal life insurance products. But, do these products have any different feature than was always inherent in life insurance, than was always inherent in annuities? To a very large extent, no. The relationship between insurance and investment was always there, and it continues to be there, however, these new products caused concern for the policymakers partly because people became more clever and found ways to squeeze the maximum amount of investment profit out of them. That may have always been done, but for the first time something significant happened. Nonactuaries could understand what was going on, and it was that understanding, more than anything else, that gave rise to the current generation of tax questions.

In addition, there were the abusive products, and what happened in 1982 and 1984 was intended to deal with them.

However, the concern was just as great for the nonabusive products. When tax lawyers who don't specialize in insurance understand what's going on, the consumer can understand what's going on. In fact, I will tell you a true story: Staff members at the Treasury sit around and say things like: "Why isn't life insurance dominating the financial markets?" When I was there, we speculated that if the life insurance industry ever marketed things the way banks do, life insurance would become a dominant financial force, not just a major one. But be that as it may, the understanding of what life insurance is, of what an annuity is, was the key factor forcing attention on the tax treatment of these products. In addition, high inflation rates and high interest rates caused taxpayers to become more sophisticated in evaluating the tax consequences of any course of action. The value of tax deferral always existed, but it's more valuable to a taxpayer when money's worth 15 percent than when it's worth 5 percent. For this reason annuities became more appealing. Life insurance as an investment became more appealing, and certain uses of life insurance, particularly things like minimum deposit arrangements, became much more appealing.

Okay, where did this lead to legislation? As has been stated by others, in the year 2000 we will see the headline "Fourteenth Major Re-

vision of Life Insurance Taxation in the Last Twenty Years." Why are we taking so long to get the answers right? Or wrong? Why are we doing it every year, causing you to go back to redesign your products and your computers? Well, there's a little bit of mischief in all of us, but that's not enough to explain it. The Economic Recovery Tax Act of 1981 (ERTA), can be coined the tax give-away act of the century. The goal was to get a bill passed. All sorts of nonsense got included in that bill, but nothing significant in the insurance area. What can you give to a line of products that already has very favorable tax treatment?

1982 marked the start of a period of retrenchment. The goal then was to cut out loopholes and raise some revenue to cut the deficit. That part hasn't worked so well, but what was done on the insurance side? It mostly dealt with deferred annuities. In a sense, Congress took the Treasury at its word when it said: "These deferred annuities are just terrible. People are just using them as savings accounts. Short-term in and out, no long-term savings, no nothing." And Congress said; "Ok, you're concerned about short-term in and out, we'll deal with short-term in and out" and changed the ordering rules putting a penalty on these.

But generally, life insurance products were not on the table. It was a good year for the insurance industry, legislatively. The government was seeking to get the corporate tax treatment fixed up, and fixed up on its terms. What was done? Well, there was a safety net for policyholder dividends, the Menge formula. It was made geometric rather than arithmetic. A few other things were also addressed, but products largely weren't affected, except of course that by application of corporate provisions, companies' aftertax returns were greater than their pretax returns. As a side note when the aftertax return on a product is greater than the pretax return, that means the government is subsidizing the sale of that product. The industry was encouraged to sell those things because they made more money after tax than before. One has to ask: Is that any way to run a tax system in a period of deficits?

But, why did the annuity rules get tightened up? It's simple. The industry wanted something. The Treasury was dead set against annuities and if the industry didn't want something, the annuity rules probably would not have been changed in 1982. What did it want? It wanted to be able to deduct excess interest on annuity policies at the company level. And Treasury was able to say to the Congress; "If you're going to give the insurance industry the favored corporate tax treatment, you've got to make sure these things work the way they're supposed to work." I'm not sure the tax rules do that, but tighteners were put in.

1984 was the Deficit Reduction Act year, another great deficit reduction year. If we have any more deficit reduction years we'll have $6 zillion deficits. But 1984 was also the level playing field tax act. Now, for those of you who are not fluent in tax lingo, level playing field means: give me what my competitor has, but don't take away what I've got that I like. The life insurance industry was desperately concerned about

level playing fields, and stock/mutual was the primary field it was concerned about. The stock companies were saying: "Give me what the mutuals have," the mutuals were saying: "Give me what the stocks have," but there was no discussion of leveling the playing field among financial intermediaries. Again, the focus in 1984 was not on fundamental tax reform. It was on trying to deal with provisions that were producing loopholes. If you could call anything a loophole, you could get rid of it. If you couldn't call it a loophole, but just an age-old provision that may never have made sense but it's always worked as everybody intended, that provision was not being considered for revision. So what happened? A definition of life insurance that is pretty much in accord with prevailing industry practices was enacted. It did not affect the mainstream (that's a very wide stream) of the products being sold.

What happened in 1985? There have been two bills in the tax area because two things happened. First, Ronald Reagan is a President who believes in low tax rates. He is the first President, I think in my lifetime, who's cared about tax reform. He cares about low rates. There is also some concern in Washington about budget deficits. What does that mean? Tax reform can't cost money in terms of revenue. That put pressure on the entire system. No longer was the name of the exercise "Searching for Loopholes," rather, it became a question: "Do the provisions that have been in for a long time still make sense?" Things like state and local taxes and fringe benefits came under scrutiny. Included in that scrutiny were the life insurance products. All of a sudden, tax reformers looked beyond the square corners of Subchapter L72 and 101 and said: "Does this make sense in the context of a system?" They didn't just compare life insurance products offered by different companies. They said: "Are the incentives for savings in life insurance and annuity products sensible compared to what they are with qualified plans?" Qualified plans are the ultimate good guys in the tax system. Nothing should be better, and if something's better there's something wrong. In addition, if something's close, it had better be scrutinized. When one compares life insurance to qualified plans, one starts saying: "Why are these provisions here? Why are unrestricted loans allowed?" In addition, tax reformers started comparing fringe benefits to other forms of compensation and asked: "Is there still a special reason for treating these fringe benefits as nontaxable income? Why is life insurance not taxed when it's provided in amounts under $50,000 when it is taxed in excess of $50,000? Is it hard to value?" No more for small amounts than for big amounts. It doesn't make sense anymore. And when people are looking to make a system make some sense, they are not talking pristine purity, they are talking sense. These things come under intense scrutiny.

And finally, with the development of new products, virtually any investment someone wants is available in life insurance, or it soon will be. There are variable annuities, variable universal life, various interest rate guarantees. When compared to identical investments offered outside of life insurance, the question arises: "Does this make sense anymore?" For me personally, it never did. Will it continue? That is a tough question, but from the point of view of the policymakers, the

scrutiny life insurance products are being put under means it's not a sure thing anymore that age-old traditions are going to be maintained.

MR. STEPHEN C. ELDRIDGE: Let's turn to the major concern, the taxation of inside buildup. The President proposed to tax policyholders (with respect to life insurance first), annually, on the excess of the cash surrender value over premiums paid. With respect to variable life insurance the policyholder would be placed in the very same position as if he held the investments himself so that current income would be taxed currently. In the case of long-term capital gains the policyholder would be taxed when and if the stocks were sold by the insurance company. Thank goodness the President's proposal is no longer on the table. It's considered one of the options. The reason I say this is to be careful. Although, on the surface it appears that taxation of inside buildup with respect to life insurance is dead, don't believe it. It's still there and will be there in different forms, and that's my principal message.

MR. DOUGLAS N. HERTZ: My job is to comment on what would happen if some of the tax proposals came into being and what possible industry responses there might be. With regard to the inside buildup, certainly the good news is that the bad news won't happen, at least not yet. We're safe for the moment. The caution Mr. Eldridge gave you boils down to the fact that no really bad idea ever dies in Washington, D.C., it just sits around awaiting resurrection. This is something Mr. Pike once referred to by saying that Washington seems to have no institutional memory. People forget why it was that a bill lost the last time around.

The usual industry reaction to a proposal to tax inside buildup is to say that grass will grow in the streets of Hartford and in large measure, perhaps that's true. Certainly, competition would shift products, probably with term, coupled with various forms of savings plans, coming out as the winner. Within the industry, emphasis for loadings and margins would have to shift toward the risk element. After all, that's where the industry has a monopoly. It's likely we'd see the field forces move toward some sort of fee system for compensation, as premium loadings get more difficult to hide. Financial planning, broadly speaking, would come of age, and out in the field you would find productivity the key to survival in a low-load environment. Companies, in general, might find themselves defensively shifting toward becoming financial supermarkets. The general attitude, as I've heard it expressed, is that if mutual funds are going to be it, how do we go about becoming one? In terms of products for insurance, term insurance seems to be what most people think would be at least one of the waves of the future. This is not necessarily great news; I would remind you that you don't need a huge staff of actuaries to price and maintain a portfolio of yearly renewable term insurance. Another option that's been suggested is no cash value or term to 100 as a product. I believe there are legal problems with regard to the introduction of such a product, and it's market acceptability is perhaps open to some question, but if you're going to tax cash value, certainly somebody's going to try to have a low or no cash value product.

Variable life products, perhaps with funding in a separate account dealing with exempts or with growth stocks, could possibly appear. I would note, however, that there's no particular incentive to buy such investment options inside a life insurance contract. There would be no advantage to having them in an insurance contract as opposed to offering such investments outside an insurance contract with an option of buying simple term insurance separately.

For ordinary life, I think there would still be some markets focusing on either untaxed or low-taxed policyowners. For instance, there might be a tendency to put life insurance into a pension plan and fund the premiums with employee contributions that are not deducted.

The President's proposal, incidentally, had grandfather provisions in it. Contracts issued before the date of committee action would be grandfathered and later contracts would be subject to tax. Increases in grandfather contracts would be okay to the extent that they were forced by the Section 7702 definition of life insurance. This would leave open a question as to what would happen, for instance, to other increases such as the addition of paid-up additions to a traditional life insurance contract that was grandfathered. I can imagine the administrative problems that might be caused by the grandfathering in the form it was originally proposed.

There are alternative proposals. A pamphlet was issued by the Joint Congressional Committee on Taxation back on September 20 that discussed this business of taxing the inside buildup. It proposed alternatives to the taxing of the inside buildup to accomplish a tightening of the definition of life insurance, for specific example, to narrow the corridor in the premium test.

Another suggestion was a restriction on product flexibility. Suggestions for so-called LIFO treatment of withdrawals I think falls into that category; we will discuss this later. Another idea that would add a certain amount of complexity to the law would be to limit the amount of inside buildup that could be earned tax free. For instance, limit the amount of cash value that could be in a tax free contract or limit the inside buildup over the life of the contract to be no more than the cumulative mortality costs to be extracted over the life of the contract. I think that's all I want to say about it other than to add a side note: There was a comment in that pamphlet relating to so-called qualified-reserve accounts (QRA). I am sure Mr. Pike has a different definition of QRA but, essentially, it is a way of proxy taxing the interest element paid out in benefits by taxing it at the company level. It can be described as a way of allowing reserves to grow without giving deductions and then running them off into income and taxing that income at the time benefits are paid, but I can envision a different description coming from people in other areas. The reason I bring up QRA is that the pamphlet suggests that QRA is an equivalent to the proposal for taxing the inside buildup to the policyholder. It is, except for the fact that the tax might be imposed at the wrong rate, because all the taxing is done at the corporate rate. This seems to be essentially correct, and it is another way of going about taxing the inside buildup that I think the industry has to watch out for.

MR. ELDRIDGE: Let me say that QRA is just one dastardly attack on inside buildup. The first proposal was politically distasteful to Congressmen, they didn't want to say to a policyholder: "You will be taxed each year." So they are now trying to place that tax at the company level. It's a tax on inside buildup by a different name. Not only does this require the insurance industry to make a whole series of different responses, but different policy-design questions come up now. It's easier politically for Congress to tax 2,000 companies than it is to tax 100 million policyholders.

MR. PIKE: QRA is one of the most difficult things I have ever tried to explain. I think it can be viewed as a tax on the policyholder. For other institutions, QRA is the proper measure of the company's income, but I won't spend a lot of time discussing that point. I agree that Congressmen do not want to go after inside buildup. They are not so concerned about policyholders as they are about agents. Many policyholders are not contributors to campaigns, but most agents are. I don't believe that, in the case of the policyholders, Congress has any more inclination to go after the inside buildup indirectly than it does directly. One further comment, Mr. Hertz's notion that ideas don't die, they just get filed away and brought out again later is absolutely correct. I would also agree with Mr. Eldridge's sentiments that the great notions that have been floated this time around will float to the surface again in the future.

MR. ELDRIDGE: I'd like to make a couple of ending comments on QRA without going into the mechanics of what it does. QRA is a method of discounting, if you will, which in substance puts the insurance company on a cash accounting basis. It doesn't look that way on the surface, but if you follow the details through, it becomes apparent that placing the insurance company on a cash accounting basis for tax purposes is what places the proxy tax on the company that would be the policyholder tax otherwise.

MR. PIKE: Mr. Eldridge and I disagree about that.

MR. ELDRIDGE: I'd like to make one other point with respect to inside buildup. Mr. Hertz mentioned grandfathering. Initially, there was to be no grandfathering. It was only after a lot of hue and cry that the Treasury changed its proposals to put in a grandfather clause for old contracts. The reason there originally was no grandfathering provision was that people in the government are very concerned about the life insurance industry's competitive position relative to other financial institutions. The notion that whole life insurance should have no advantage over any other type of investment is what was behind the no grandfathering position and Treasury's continued effort to tax inside buildup.

MR. PIKE: I think that the Treasury is obsessed with competition among financial institutions and that more than anything else is driving the proposed changes to the taxation of life insurance companies. The no grandfathering/grandfathering issue is a political maneuver to defuse opposition to a proposal in which the most intense opposition will come from people who already have a benefit. Members of Congress think

it's unfair to change the rules of game after the fact. For that reason, grandfathering in many areas of tax law is common practice. I don't believe that has anything to do with the question of competition among financial intermediaries.

MR. HERTZ: Moving on to the next point, the President's proposal would have been to tax annually the profit on deferred annuity contracts. Again, the President's proposal also would have treated variable annuities similarly to variable life insurance in that the assets would have been deemed, in effect, to be held by the policyholder. One of the options now on the table would say that investments up to $100,000 by policyowners would continue to receive tax-free inside buildup. Investments in excess of that amount would be taxed currently. In addition, any distribution before age 59½ would be subject to new higher penalties of 15 percent rather than the current 10 percent. Grandfathering associated with this would mean that if you already have more than $100,000 in your annuity, it will remain untaxed, but older amounts and older annuities count against your new $100,000 limit. In other words, if you already filled up your limit, you don't get another $100,000. One observation is that grandfathering should work wonders for the persistency of large contracts. Beyond that, as I see it, the market for very large deferred annuities would dry up. I am sure that is a concern for some particular companies that have specialized in the individual deferred annuity market. I don't know what the $100,000 cap applies against, whether it is cash value, premium in the contract, the net premium in the contract or whatever. The options statement leaves this a little bit vague. The 15 percent penalty I see as being another shot in the war some people keep waging to make annuities come out looking like qualified plans, despite the nondeductibility of the deposits. The final comment I would like to make on the matter is that tax withholding on these contracts would probably be a painful mess all around.

MR. ELDRIDGE: It was mentioned that the 15 percent is the new penalty that would be applied in all circumstances, not just to this one. It replaces the current 10 percent for all types of plans.

MR. ADNEY: Mr. Eldridge, I would like to comment on the reason you see the rules going in this direction in the recommendations to the Congressional Ways and Means Committee. Again I stress that this committee has not yet done anything about this. These ideas are merely in proposed form, but they have a lot of backing. The proposed conformance with the penalty rules are the result of efforts over the years to protect the inside buildup of deferred annuities against current taxation by having them classified in the tax policy as retirement instruments, rather than as savings instruments. As Mr Pike indicated, I think there is a generally held view among a lot of tax policy people in Washington that the deferred annuity, during the deferral period, is not really distinguishable from any other savings account that is subject to current tax. Now I think one can dispute that on a variety of bases, but the fact is that that is the perception. This shift in emphasis is evident in the attempt to place the annuity more in the category of the qualified plan.

MR. ELDRIDGE: But why raise the penalty? Was there evidence that people were still withdrawing from these annuities, notwithstanding the 10 percent penalty?

MR. PIKE: Not that we saw.

MR. HERTZ: The President proposed it go up to 20 percent. The options are now down to 15 percent.

MR. PIKE: There was evidence, I think substantial evidence, that IRAs were being used as educational savings accounts, savings accounts for home purchases and so on, because even with a 10 percent penalty, one is ahead of the game. The interest rate is high enough that one comes out ahead of a non-tax-favored savings vehicle after just a handful of years. One has more cash, even after paying that penalty, just from the value of deferral. The reason the annuities are brought along on this is that, as Mr. Adney correctly pointed out, they are viewed as a retirement income supplement and should be treated analgously, no more favorably in any significant aspect than other retirement income provisions. A lower penalty is inconsistent with that.

MR. ELDRIDGE: There may be one thing to watch out for, assuming a lot of this goes through, and that is that efforts have not been suspended to try to get that penalty cut. If not back to 5 percent, then back to something below what the IRA and qualified plan penalty generally is. I don't know how successful these efforts will be, but they are being made, premised on the notion that the industry does have aftertax dollars going into these nonqualified deferred annuities which distinguishes them from the qualified situations.

MR. PIKE: I would like to make one more comment about the $100,000 cap. That figure was pulled out of the air. In pulling it, I think the policymakers had taken the industry's word that "big hitters" were not using annuities as regular savings accounts. The annuity industry had said: "It is just Ma and Pa putting a few thousand bucks aside. This isn't big bucks." Okay, if it's not big bucks, $100,000 sounds like a generous figure.

MR. ELDRIDGE: The inside buildup is apparently off the table for now, but not policyholder loans. Under current law, policyholder loans are not treated as distributions and, with a few exceptions, interest on policy loans is tax deductible. The President's proposal didn't include very much about policy loans, only some general provisions limiting the deductions for interest expense. Now though, the options being considered by the House would treat certain loans as distributions of previously untaxed inside buildup. Thus, the inside buildup won't be taxed unless the policyholder withdraws it from the policy, with some decent exceptions. A policyholder would be permitted a loan of $50,000, minus amounts that have been withdrawn as policy loans before the date of the act. One cannot have present existing loans plus another $50,000 after the date of this act. The other part of this exception is that the loan of $50,000 would be permitted if it would be paid back over a period of five years. To the extent that there is a policyholder loan,

it is treated as a distribution of income first, not as a tax-free distribution of premiums. The important and interesting concept here is that any interest paid on policy loans would be treated as nondeductible. It would be treated as a premium payment back to the insurance company. Another interesting thing about these proposals is that they also deal with partial withdrawals, but nothing is said about the options for partial withdrawals. One would presume that this means that partial withdrawals would be treated as distributions of income first, rather than as distributions of tax-free premiums paid in prior years. Mr. Hertz, would you like to comment on these provisions?

MR HERTZ: Yes. Here we have a clear set of proposals to tamper with tax laws, which would have an immediate effect in the marketplace. Some companies I am familiar with are getting calls from their field forces asking: "What do I do now, what do I tell potential clients about their access to cash values on contracts I am trying to sell?" Different companies and different agents, of course, are going to have different levels of concern with this. But I think everybody's got some concern with this and with the question: "Will people put money into contracts with restricted access to the cash value?" Some people certainly go as far as to say that LIFO taxation of loans and withdrawals is just about as bad as a direct tax on inside build-up. Others take a more moderate view of the situation. As regards a product or marketing response to this, I think companies would have to give some consideration to the use of low loan rates and dual dividend patterns. The $50,000 exception mentioned by Mr. Eldridge is of limited utility. I am not a lawyer, but I have some doubt that this cap is useful because of the requirement that the loan be repayed within five years. It appears to me that what's happened is that somebody took a tax rule that applies in the qualified plan area and dragged it over to policy loans. I don't know if that person had any knowledge that it might be impossible to satisfy a five-year restriction in a life insurance contract. Mr. Pike, do you know anything about that?

MR. PIKE: A little bit. Some government people working on life insurance issues have an absolute obsession about policy loans and inside buildup working in conjunction with each other. That the pension rules were pulled in and made applicable was done, I think in part, to put the burden on the industry to come forward and show that these rules are not reasonable. There is some room to modify the rules to reflect realities of the industry, but there is a real sense that the burden should be on the industry to make suggestions as to how those rules will work. I don't believe there is enough knowledge about the intricacies of restrictions on loans.

MR. ELDRIGE: With respect to the government staff attitude toward the present policy loan provisions, I'll say that one prominent Washington figure once commented to me that if there was a choice between peace in our time or cleaning up the policy loan provisions, probably peace in our times would be higher on the list of priorities, but he really had to stop and think about it.

MR. HERTZ: As recently as DEFRA, there were provisions in the House bill that were eventually dropped, but it wouldn't surprise me to

see those coming back as a proposed compromise on what might be done with policy loans. There is still an opportunity to lose interest deductibility on a much more broader playing field; that is the general provision on nonbusiness interest. I believe it was the President who proposed that the limitation on nonbusiness interest deductions be equal to investment income plus principal residence mortgage and an additional $5,000. I believe limitation is now recommended to be equal to investment income plus the greater of $20,000 or mortgage on one's principal residence. Either way, new treatment of policyholder loans could come about through a much more general provision. As Mr. Eldridge notes, the heading of the provision discusses policy loans and partial withdrawals or partial surrenders. It's not clear however, that there is a proposed distribution rule, because the option discussion mentions only policy loans. There is at least one person currently at Treasury who called the ACLI and commented that any rational person reading the provision would understand that the intent is for partial distributions to also be subject to the LIFO pattern of taxation. One comment I would like to make, and maybe invite Mr. Pike to comment on also, is that the industry has recently gone through a rather large-scale fight over the provisions of Section 7702(f)(7)(b), the so-called changes treated as exchanges rule. That is now in a technical corrections portion of the bill the House is putting together, together with a proposal on the table for LIFO taxation of all amounts coming out of a life insurance contract, so that all of the fuss might have been over just one year of insurance policy issues. But it was an interesting fuss, and I'd like to hear Mr. Pike's views of what the Treasury was trying to do and how it all came out.

MR. PIKE: Section 7702(f)(b) is one that not too many people focused on. Treasury thought there were some ambiguities about what happens when a policyholder changes from what was called an option 1 to an option 2, or an option 2 to an option 1, universal life policy. Was that to be treated as just a little change in the terms of a single contract or would that be viewed constructively as an exchange of one contract for another? If the latter, was it an exchange of policy resulting in a policyholder getting cash in hand? If so, under Section 1035 of the Internal Revenue Code, the taxpayer would be taxed on that cash to the extent there is gain in the contract.

Section 7702, (f)(7)(b) was not an attempt to codify that interpretation. It was very difficult to draft it in a way that it would do what it was intended to do. And although the world became much more complicated, any single policy would enable the policyholder to do all sorts of things that theretofore required changes in paper. Well, some people started looking at this provision. They said: "Well, we think it is a little bit overboard." Later, agreement was reached to try to come up with a Section (f)(7)(b) that kept something of its original flavor, but did not hit hard on much that was of interest. The revised provision represented a compromise between the stock and mutual companies. Since both had an interest in gutting Section (f)(7)(b), the compromise, to use a favored expression of government, barely has gums much less teeth. But, the sentiment was to try to defuse the political opposition to what was done in the old Section (f)(7)(b).

Again, we are in a period of scrutiny of rules. The ACLI flooded the market with TV commercials saying: "Tax the inside build-up. That's like taxing me on my home appreciation, that's un-American." The answer is that, traditionally, when you get the cash in your pocket, that's the time to tax any gain, whether you borrow the money or whether you get it out when you change your benefits. That is the appropriate time to tax, and that is the rule virtually every place else in the Code. I think that, because of the popularity of those commercials in Washington along with the anger of just about every policy-maker, these exchange and borrowing questions are not going to die. They are going to come back again and again and again.

MR. ELDRIDGE: I would like to move onto buildup in structured settlements. Under present law (and this can get a bit confusing) neither a casualty company nor a third-party assignee or assignor (who pays out the annuity) is taxed on the investment income as was mentioned previously. In effect, the injured party who receives the annuity over his or her lifetime is able to exclude all of the proceeds. Both of the paying parties, (the life company or the third-party assignor) are able, by different provisions, to exclude the investment income earned on the premium paid by the casualty company from day one. In a bit of a confusing way, the President's proposal, which is the proposal being considered by the House Ways and Means Committee, is to tax that investment income, but not at the annuitant's level (not at the injured party level), because that would be politically unfeasible. Now it's the third-party assignor who will pay the tax on the investment income. The third-party assignor would include in taxable income the amount of the premium received from the casualty company. Then two different options are available. The third-party assignor could, upon purchase of an annuity contract from a life insurance company, take a deduction. The deduction and the income should be the same and the third-party should then be whole. As an alternative to that, the third-party assignor could take deductions as payments are made to the annuitant. Now in that case, an upfront tax must be paid on the premium received from the casualty company. Again, the concept is to incur a tax on the investment income, which previously was not taxed, and to place that tax at the company level. I must say there is something that is confusing in that these provisions, on the surface, apply only to the third-party assignor. Nothing is said about what happens if the casualty company directly buys the annuity from a life company without using a third-party assignor.

MR. HERTZ: I don't have a lot to say about the market consequences of this. I suspect that the market for such things would simply die out. There would be no tax incentive toward extension of payouts, and so I suspect that lump-sum settlements would once again come to dominate. This treatment strikes me as related to what is being proposed with QRA. It is also similar to what happened to the casualty industry in DEFRA on nuclear power plant decommissioning and mining reclamation and with the more general rules on premature accruals. All of these are attempts to get at the time value of money. What happens when a taxpayer takes a deduction today for payments that will not be made in cash until a year from now?

PANEL DISCUSSION

MR. ELDRIDGE: I would like to briefly mention some other items. With respect to IRAs and Keoghs, presently for an IRA, there is a $2,250 limit for an individual and nonworking spouse. The President's proposal would raise that to $2,000 per spouse, including $2,000 for a nonworking spouse.

Presently, the options considered dropping that back to the original limitations of $2,250 with some slight modifications in terms. The more interesting option for life companies is for the Section 401(k) rules. Originally, the Treasury had proposed to limit 401(k) cash and deferred arrangement to no more than $8,000. Under the current options, those have been reduced to $5,000. As a matter of fact, the Treasury had changed it from $8,000 and then eliminated them entirely. Now the options say $5,000. There is one other interesting aspect about 401(k)s and IRAs. Under the present options if one were to make a $2,000 contribution to his 401(k), then he could not contribute to an IRA in the same year. The President's proposal has the integration reversed.

MR. HERTZ: It appears to me that our industry has not had a great deal of success in marketing IRAs. The banks have done a heck of a lot better there. 401(k)s on the other hand, have been something of a hit for our industry. With both group and individual products affected, restricting 401(k)s the way the option suggests could certainly take the bloom off that rose. If you add the fact that tougher nondiscrimination tests and the elimination of hardship withdrawals have also been proposed, the prospects for the 401(k) look even worse. While our industry can probably survive the demise of this market (we got along without it in the past), it is a nice expanding market. From government policymakers' viewpoint, it is one of the few savings incentives in recent memory that appears (on the basis of rather little evidence) to produce genuinely new savings. So it is a little hard to understand just why they would want to cut this experiment off in midstream.

MR ELDRIDGE: The only other thing I would like to mention about 401(k)s is that they will be subject to the new, lower proposed overall limits on pension plans. There are a number of other changes with respect to pension plans that you should study. Changes in discrimination rules, for example, will affect a great deal of what we are talking about. With respect to other fringe benefits, health insurance has gone back and forth from a cap to a floor and now back to a cap. The committee is presently studying an option which would limit the amount which could be provided tax-free to an employee, that being $120 per month for a single employee and $300 for a married employee. The other significant changes would be to eliminate the $50,000 exclusion for group term life insurance. Also the $5,000 death benefit would have to be provided through a commercial insurance company.

MR. HERTZ: It strikes me that a cap on health insurance at levels of $120 individually or $300 for a family probably is going to catch almost nothing. The hit there would certainly be a relatively mild one. Perhaps plans written in the state of California might wind up with some tax. Many view this more broadly, though, as setting a danger-

ous precedent. If you put fixed caps in, there is always a temptation to lower the cap in the future, or to just let it sit there in an inflationary environment and eventually become a much more serious thing. As far as repealing the exclusion of $50,000 worth of group term life, it is hard to say what effect this would have. Group term life has always had a tax preference. Nobody really knows what happens if you try and market it without that. I think you could expect a lot of individuals to refuse the coverage, particularly the young and healthy, which might lead us to certain antiselection problems as regards mortality experience.

MR. SIDNEY A. LEBLANC: First of all, I would like to thank Mr. Pike for coming here. I think we in the industry spend too much time discussing things with each other and reinforcing our conventional wisdom. We need to talk to someone from outside the industry occasionally, someone who can articulate challenges to those concepts. The question I would like to ask the esteemed panel is this: Would you care to speculate about what will ultimately pass in terms of these policyowner provisions, sometime next year?

MR. PIKE: Congressmen like to do two things in life. One is to raise spending for their constituents, the other is to cut taxes for their constituents. What they are being asked to do now is raise their constituents taxes. They don't like to do that. Logically, tax reform should be dead. And it may be dead, it may be dying a slow death this fall. There is speculation that it is. Even if that happens, and nothing comes out of the current Ways and Means Committee mark-up, that's a pause and not rigor mortis setting in. There is a deficit and people are starting to get quite scared about it, and one way of dealing with the deficit is to raise taxes. Everybody thinks there are going to be tax increases. The drill the Ways and Means Committee has gone through to learn what to do about certain tax loopholes will be useful eventually, even if nothing happens this time. Tax reform is going to be a vital element in that tax raising/reform exercise. There is a possibility of tax reform with increases. My bet is that certain aspects of insurance products (less likely inside buildup, more likely things like policy loans, annuities and fringe benefits) are going to be on the table, and they are going to be tinkered with. My guess is that this will be part of the tax increase next year.

MR. ADNEY: I'll be more short-ranged if I may. I am not sure whether or not we will see a bill that will pass the floor of the House. I think that is still debatable, but still a possibility. The Ways and Means Committee, is under a great deal of pressure to come forward with something so that the House is not branded politically as a roadblock to the President's proposal. That is what's keeping this whole thing alive. And, as much as the committee members don't like the options they see in the daylight, they can't sleep at night thinking that that is what will happen if they don't act. Regarding the insurance provisions, I believe the options we are seeing are not far from those we would wind up with if the committee reports a bill: no tax on inside buildup of life insurance policies, $100,000 or some kind of exemption like that for individuals who buy annuities, an inside build-up tax on corporate owned annuities. Regarding changes in the policy loan and

withdrawal rules, I would rate that a dead heat right now. On one side we have Chairman Rostenkowski and staff wanting this. On the other side we have insurance agents. They have fought before, they are fighting again and I think it is too close to call at the moment.

MR. A.G. HASSELMEIER: I would like to know what you think of the likelihood of the clarification regarding LIFO treatment of partial withdrawal. What do you think the likelihood is of that passing as part of the Technical Corrections Act?

MR. PIKE: If you are asking what the likelihood is that the proposed change to Section (f)(7)(b) would be enacted as part of technical corrections, the likelihood, if and when a technical correction bill is reported out, is very great.

MR. HERTZ: The broader question is when might we get a technical correction bill. There is another question we didn't raise in the more general discussion--in the LIFO provision in the proposed options, what would happen with contracts where a dividend is applied to reduce the premium? Would that be deemed to be a LIFO taxable event? Or, what would happen with the surrender of paid-up additions to pay premiums in a traditional contract? That kind of marketing scheme has become popular in many companies. I don't think we know much about how a LIFO rule on distributions might be applied.

MR. PIKE: Neither do we. People think that individuals in government either know nothing or know everything. The truth is somewhere in between. But there are a lot of things, particularly regarding the technical ways the industry operates, where we need help. You are the people who can help us. Don't think that we do not appreciate sincere offers to put us on the right track on how to create laws that do not injure the way the industry markets their products. That is not what we are trying to do. Your input would be quite welcome.