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IMPACT OF FEDERAL TAX LAW

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- Impact of the Tax Equity and Fiscal Responsibility Act (TEFRA), the Deficit Reduction Act (DEFRA), and any new enacted or proposed revisions in the Internal Revenue Code on:
  - Insurance company taxes
  - Employee benefits
  - Insurance products

MR. ALLAN D. GREENBERG: I'm Vice President and Chief Actuary of Geneve Capital Group, which is a relatively small, diversified financial service holding company, and we own a few small to medium size insurance companies. We are, of course, very interested in the tax environment. Before the panelists start, I'm going to give some remarks on things that may be happening in Washington today, since the presentations by the speakers will be fairly brief. We hope to leave half the time of the session open for questions.

The first speaker is Diane Wallace from Atrium Corporation. I have known Diane for about 7 or 8 years now. She began her career with Travelers in Hartford, spent some time at General Reinsurance working in specialty reinsurance, and spent the short time thereafter in a former actuarial consulting firm you may have heard of, Tillinghast. It has recently been part of the largest actuarial merger ever. Diane has substantial experience in reinsurance, particularly in matters involving federal taxation of insurance

companies. I've had the privilege of working with her in a few situations, and I'm anxious to hear her insights. I've always found her extremely bright and creative, and I'm sure all of you will find what she says informative. Our next speaker will be Thomas Cerneka, who is a Vice President of Tillinghast, which is now merged with TPF&C. Tom has headed the benefits consulting operation of Tillinghast for a few years and I'm sure will be one of the outstanding people in the benefits area of TPF&C. Tom is from St. Louis and has lived there for several years. Tom also started with Travelers Insurance Company, maybe a year or two before Diane. Our final speaker will be Gary Muller. I came to know Gary back in the days of Stark-Moore when we thought things were terrible. We may begin to look on those days as the good old days. Gary was very much involved with the industry efforts to try to make certain things in Stark-Moore livable for the insurance industry. Gary will be talking primarily about the impact of current law and proposed legislation on the product area.

As most or all of you are probably aware, the Senate Finance Committee recently put out a bill which the entire Senate could possibly pass without amendment. It's hard to say what is going to happen over the next couple of days, but many Senators are committed to sending the bill unchanged and unamended to the Conference. The major new area in this new bill for the insurance industry is the beginning of the taxation of some life insurance companies on some basis relating to GAAP Accounting. The insurance industry was certainly not the reason for putting this into the proposed tax bill, but nonetheless, insurance companies are going to be in a very strange position if they are taxed on a basis that on the surface doesn't really exist for a very large segment of the industry. Definitions are abounding now as to what is GAAP for those many insurance companies that don't have it and that may be the area for a lot of interesting struggles in the insurance industry. I do have fears whenever we have those fights because we tend to get the worst of both worlds. Finally, from my years of experience in public practice, I have found that as far as GAAP and actual earnings go, any smaller company that's public and publishes GAAP earnings will be the most severely hit by this bill. This is because any dramatic increase in sales often results in very, very low taxable income, possibly negative, and correspondingly higher than normal GAAP income.

MS. DIANE WALLACE: The program for our session says that we're going to tell you all about TEFRA and DEFRA, but I think that would not be appropriate since, as you all know, it now appears virtually certain we'll have a new tax bill this year. You all know that the House passed HR 3838 in December 1985 and the House bill has much lower rates than current rates, but it still retains many of the deductions that we had previously. In May 1986 the Senate Finance Committee passed another bill (I might add very dramatically) with big last minute changes. It eliminated most deductions and preferences that we now know and helped substantially to lower tax rates. It is clear now that the bill, probably unchanged, will pass the full Senate this week. Senator Dole is pushing strongly for this, as is President Reagan. The one amendment that appeared to have any chance at all was defeated in the Senate yesterday. Most followers of the new legislation predict that we will have the new law by Fall of 1986 and that it will be very close to the current Senate Finance Committee version. I'd like to tell you a little bit about the law and how it effects general corporations and, therefore, insurance companies, as well as some of the specific provisions relating to insurance companies.

Most of the things in a Senate Finance Committee bill that affect insurance companies are really general corporate provisions. There are actually very few items that are specific to insurance companies. The most important thing, of course, is the actual tax rate on businesses. Currently life insurance companies are taxed at a rate of 36.8%, which is the general corporate rate of 46% less the 20% Taxable Income Adjustment (TIA). The House bill had a rate of 36% on corporate income, and the Senate bill, as it's currently written, has a 33% rate on corporate taxable income. Because of the reduction in the general tax rate, the TIA (20% preference for insurance companies) has been eliminated. It now appears likely that the rate will be somewhere between the Senate and the House rate, somewhere between 33% and 36%. The increase over the current Senate rate may be required in order to pay for any changes that might come up in the IRA provisions. By restoring some of the IRA deductions, the Conference may have to increase the 33% rate. This is a decrease or at worst an equal tax rate to what we currently have. There is likely to be a temporary tax increase in 1987, because most of the changes in the deductions will be effective January 1, 1987 and the changes in the tax rates will occur July 1, 1987. Therefore, for the first half of 1987 we may be subject to a 46% tax rate

because the TIA will be eliminated January 1, and for the second half of 1987, we would go to the 33% or whatever the ultimate rate is. Thus, we may be faced with a tax increase in 1987.

The small company deduction was retained by both the House and the Senate. We will get into that in a minute. The effect of the alternative minimum tax may somewhat mitigate the effect of the favorable effect of the small company deduction. As far as capital gains tax is concerned, and this again applies to all corporations, this rate is 28%. The House removed the capital gains preference all together so capital gains would be taxed at the regular House rate of 36% if the House version were to prevail. The Senate Finance Committee also removed the preference, but instead of setting the capital gains at the regular income rate, they set it at 28%, the current rate. This capital gains treatment, I suspect, will receive considerable attention in Conference, so that is one area where I wouldn't want to predict the outcome.

There is a major new provision in the alternative minimum tax and how it affects all corporations. It is going to be very difficult to predict the impact of the alternative minimum tax because it involves substantial changes, and it is hard to say how businesses will change their behavior as a result of the alternative minimum tax, and therefore, it is difficult to predict how revenues will change. I think it is very clear that it will instigate many changes in business behavior, and we really don't know how that will come out. Just to give you a description of how the alternative minimum tax works, start with regular taxable income, calculate the tax at the current corporate rate of 33% and see what tax results. Then make a second calculation starting with regular taxable income, add back certain preferences like accelerated depreciation and others and with this new higher taxable income calculate the tax at a 20% rate. If this number comes out higher than the regular tax, pay the higher number. The most controversial portion of the Senate bill right now relates to part of the alternative minimum tax calculation called the BURP (Business Untaxed Reported Profit) provision. BURP takes one half the excess of a company's reported profits over its taxable income and adds that to regular taxable income as a preference item under the alternative minimum tax computation. It is really not clear what reported profits are. The motivation behind this provision is an attempt by the Senate to penalize companies which are

reporting big profits to their shareholders and actually paying no taxes. The Senate would like to use the GAAP statement required to be filed by public companies with the SEC as the source for the reported profits. If those are unavailable, the IRS would look to the books and statements provided to creditors that are audited statements. If those are unavailable, the bill specifies that other statements would be used. The IRS is trying to get at any public information that reports profits higher than taxable income. What this would do for insurance companies is tax income that is not currently taxed, such as tax-exempt investment income. The 85% dividend received exclusion income would get added back because that is in the annual reported statement. The biggest concern to many stock insurance companies is the capitalized acquisition expense, the DAC (Deferred Acquisition Cost), which would be in your annual statement. That income would then be taxed under the alternative minimum calculation. Some of the problems that companies see with this are obvious: the AICPA (American Institute of Certified Public Accountants) is objecting because it is going to effectively be setting tax policy through its accounting requirements. For the insurance industry it is very inequitable. That's a value judgment but I guess I'll say it because many companies do not prepare GAAP financials, mutual companies for example. There will be a difference between public and privately held companies. The provision is subject to manipulation; GAAP statements and other statements are subjective in their accounting treatments in many cases. Finally, the small companies are having a big problem with this alternative minimum because it effectively reduces the impact of the small company deduction.

Let's say a small company has $3 million of taxable income. Under the regular tax calculation the company would take a deduction of 60%, or $1.8 million, leaving $1.2 million in taxable income. Under the regular tax calculation, 33% of that would give $400,000 of tax. Now step over into the alternative minimum tax calculation. As I have read it, and not everyone agrees with me, you'd start with taxable income, $1.2 million, add back (let's say the company's statutory statement is the basis here and that statutory income is the same as taxable income, $3 million) 1/2 of the excess of $3 million over $1.2 million (i.e., 1/2 of the excess of your reported income over taxable income), which would add back $900,000 giving $2.1 million of taxable income under the alternative calculation. Hitting that with 20% results in $420,000 of tax. So

taxes increased under the alternative minimum calculation to $420,000 compared to $400,000. Of course, if you are reporting GAAP income and have increases over statutory income as a result of GAAP adjustments, 1/2 of that excess would be added back as well.

The NALC (National Association of Life Companies) is very concerned about the impact on small companies and, as I understand it, is lobbying at the NAIC meeting in Boston to have the NAIC pass a resolution calling on Congress to state that the statutory blank should be used rather than GAAP statements. That would create a uniform environment for all insurance companies; all would have their reported profits based on their statutory blank rather than a variety of statements depending on an individual company's situation. Also, I understand there is a coalition of rapidly growing stock companies that are lobbying against this provision. Most large stable companies, whether stock or mutual, think that their regular tax would exceed their alternative minimum tax, and therefore, there is not a great push among large companies to make any changes to this provision. Those companies that are growing quickly and also publish GAAP statements feel that they are going to get really hurt by this provision because they have lots of unamortized acquisition expense in their GAAP statements, and therefore, their reported income is much higher than their taxable income. It will be interesting to see how that comes out. It is really a new concept to start using books that are not defined in tax calculations. Incidentally, there is a difference between the House and Senate bill. The Senate bill is the only one that has the BURP provision. The House bill has something different, also considered a problem, and that is in the alternative minimum tax calculation. The House bill adds back, specifically as a preference, tax exempt income from municipal bonds. The Senate bill does not do that. It only catches the tax exempt income through this untaxed profit provision.

Other general corporate provisions that affect both bills eliminate investment tax credits. This is probably less of an impact on insurance companies than other industries, but they still apply. The Senate bill is a little bit more liberal on depreciation and miscellaneous credits then the House bill, but that is still very open. Both bills currently only allow an 80% deduction for entertainment expenses, but I understand that that is also one item that will

be brought up in the Senate debates. There is some movement for restoring the 100% deduction.

Let's move on quickly to some of the provisions that specifically address life insurance company taxation. Luckily, there is no change to the deductibility or the method of calculation of life insurance reserves. There is one change in the property and casualty (P&C) company taxation that would carry over to life companies, and that is in the calculation of loss reserves on A&H (accident and health) business for that A&H business which is not currently subject to life insurance rules. The P&C provision requiring discounting of loss reserves would apply within a life company as well if the company is writing those A&H coverages. One thing that is in the P&C bill that does not apply to life companies is the non-deductibility of 20% of unearned premium reserve. P&C companies now will only be able to deduct 80% of their unearned premium on their premium reserves. As I understand it, A&H business in a life company is not subject to that provision. It is still 100% of the unearned premium reserve that is deductible.

A couple of minor changes appear in the Senate bill that don't apply to very many companies but are important to those affected. One is a provision that says, if a company was insolvent before November 15, 1985, the release of the surplus account that would ordinarily be taxed whether or not there were operating losses, could be offset by operating losses and, therefore, if the losses were sufficient, no tax would be due on that. That only applies if the company was insolvent. Also, there is a provision in the 1984 law that said that certain mutual life companies could treat some life A&H reserves as non-life reserves and, therefore, be taxed as non-life companies, rather than life companies. It said if the mutual company elected that tax treatment, any subsidiaries they had would have to be taxed as stock companies. If that provision is repealed, mutual companies' subsidiaries would no longer have to be taxed as stock companies, they would prefer it, but they won't get it.

There are a couple of additional items in the House bill that were not retained in the Senate bill and probably will not be in the final bill: the House repealed the tax exempt status for Blue Cross/Blue Shield and for TIAA (Teacher's Insurance and Annuity Association). The Senate did not retain that

provision. Also, the House bill had a deduction for 10% of stockholder dividends paid and provided that 80% of the mutual company differential amount would be treated as dividends paid, and therefore, a portion of that would be deductible under the stockholder dividends deduction. I think all of that will be gone although there is a possibility that it would survive the conference. There were also a few technical corrections to the 1984 Act that were contained in the Senate bill. One of them says that when the Secretary of the Treasury computes the differential earnings rate calculation by looking at the earnings of the 50 largest stock companies, the Secretary will have the discretion to throw out those companies that distort the calculation. Also, it clarifies in the technical corrections what a mutual company computes as estimated tax payments. It does not have to know at that time what the differential will be 2 years from now. In other words, the differential is trued up after the fact under the 1984 bill. There was some concern that if that true-up caused tax rates to increase for the prior year for which the true-up was being made, a company would be penalized if its estimated taxes hadn't been enough to take that new differential into account. Obviously, that was impossible to know, so it was clarified in the technical corrections that estimated payments do not have to reflect that true-up that we'll know about 2 years from now.

MR. GREENBERG: Some things have been happening in the insurance industry. We have seen some dramatic changes, both in what's manifested in current recent law, proposed law, and in the attitude of society reflected in Washington regarding employee benefits. We have seen some negative attitudes relative to the insurance industry. We are now seeing this regarding employee benefits. We are very fortunate to have Tom Cerneka with us, and he will update us with some of the things that are happening relative to employee benefits.

MR. THOMAS P. CERNEKA: Legislative history regarding employee benefit plans, according to my staff historian, began in 1921 when investment income on trusts established for stock bonus and profit sharing plans was exempted from current taxation. During the period from 1921 through 1973, by my best count, there were 14 significant pieces of benefit legislation enacted, most of which were reasonably easy to understand and to apply.

This was a period of time during which employers were being encouraged by our federal government to establish employee benefit plans for their employees. History will record that period as the period of encouragement.

Since that time, beginning with the 1974 Employee Retirement Income Security Act and extending through COBRA, Consolidated Omnibus Budget Reduction Act of 1985, there have been 11 significant pieces of legislation -- which, when analyzed in total, will cause this period to be referred to as the period of discouragement and frustration.

While many of the changes resulting from the last 11 years of legislation may be socially appropriate and required to avoid or reduce abuse, the complexity of these new laws and regulations will, in my judgment, very likely drive employer plan sponsors to change the design of their employee benefit programs so as to significantly change the weighting factors between:

1. adequately providing for employee welfare within an employer's budget limitations, and
2. minimizing compliance headaches.

Clearly, the shift towards defined contribution retirement plans results, at least in part, from this change in weighting.

With all of this recent activity and the time limitations on this session, it is impossible to comment more than briefly on the most recent developments. Therefore, we will deem both the 1984 Retirement Equity Act and the Tax Reform Act of 1984 (otherwise known as DEFRA) to be past history and will concentrate on COBRA of 1985 and the potential legislation for 1986, that is, HR 3838 as reported by the Senate Finance Committee.

COBRA

The Consolidated Omnibus Reduction Act of 1985 or COBRA was enacted on April 7, 1986 and includes two major provisions impacting employee benefit plans required continuation of health care benefits and the Single Employer Pension Plan Amendments Act of 1986 which will become known as SEPPA.

HEALTH CONTINUATION

Let's take a quick look at the health care benefit continuation rules, keeping in mind that the number of unanswered questions in the Act is virtually unlimited, and I suspect those questions will remain unanswered for sometime, similar to Top Heavy in 1982's TEFRA. Unfortunately, the provisions of the act are in effect for health care plan years beginning after July 1, 1986. The 10 key provisions are:

1. Employers covered. Essentially all employers are covered but churches, the federal government, small employers (that is, less than 20 employees), and some state and local government employers.

2. Plans covered. All employer sponsored (that means contributed to by employer) health care plans are covered -- that's pretty universal.

3. Given a loss of coverage, when is continuation required? It is when the loss of coverage is caused by the death of an employee, termination of employment, if the employee's hours are reduced, divorce or separation, when the employee becomes eligible for Medicare or when dependents cease to be dependents.

4. What type of coverage must be continued? It's the same coverage as the individual had before the loss, unlike a typical conversion arrangement.

5. What is the length of time for which the extension is required? Generally, this is up to 36 months although if the loss of coverage is a result of employment termination or reduction of hours, the coverage does not have to be extended beyond 18 months.

6. How much can the plan charge (the premium)? The maximum amount is 102% of the standard premium (whatever that is) for the applicable period.

7. What about insurability? That's a non-issue. Insurability cannot be a factor in determining the premium or availability of coverage.

8. What conversion rights does the individual have after the continuation period ends? The individual has the same rights as the individual had at the time the regular coverage was lost.

9. What about required notification of election periods? Of course! The spirit of ERISA rides on.

10. Penalties. If an employer sponsored plan fails, then there is a loss of deduction to the employer for all plans, and highly compensated members of those plans will be subject to income taxation on the cost of benefits.

SEPPA -- THE SINGLE EMPLOYER PENSION PLAN AMENDMENTS ACT OF 1985

SEPPA makes six significant changes to the treatment of single employer defined benefit plans, particularly some related to PBGC:

1. The PBGC premium for plan years beginning after 1985 increases by 327% from $2.60 per participant to $8.50 per participant.

2. There are new PBGC procedures for terminating single employer defined benefit plans. Essentially, these procedures require that all voluntary terminations (meaning those not required or not demanded by PBGC) require an enrolled actuary's certification -- more work for you. A plan may not voluntarily terminate unless it either has a sufficient amount of assets for all benefit commitments or a sufficient amount to cover guaranteed benefits and it meets the distress criteria. If the distress criteria are not met, plans may not be terminated unless one of the criteria for involuntary termination is met.

3. Tax deduction rules are changed with respect to employer contributions made as a result of a plan termination. Under prior law, these contributions were deductible when paid as long as they did not exceed the full funding limitations. Under SEPPA, if the employer is making the contribution in order to move his plan from a distress termination to a standard termination and the contributions cause plan assets to exceed the present value of the guaranteed benefit, the contributions are only deductible if

they satisfy the normal tax deduction rules under §404. The apparent intent behind this provision is to prevent an employer from terminating its plan only to bunch in a single year all of the income tax deductions it would have taken over several years if the plan had not terminated.

4. SEPPA prohibits the amendment of a single employer plan to significantly reduce future benefit accruals unless all participants, beneficiaries, etc. and bargaining representatives are notified in writing of the change, and the notice is given after the amendment is adopted and at least 15 days before it becomes effective, and the notice includes a copy of the amendment. This change effectively bars freezes or curtailments which become effective retroactively or immediately upon execution, and it also gives participants the opportunity to raise any legal issues surrounding the freeze or curtailment before it takes effect.

5. SEPPA authorizes the IRS to require a plan sponsor of the single employer pension plan to post security in order to obtain a funding waiver or extension of an amortization period, if the total outstanding funding deficiencies and waivers are at least $2 million. The intent of this provision is to protect PBGC from the added liability it may incur if a plan terminates while an IRS waiver is in effect and, since the IRS is required to consult with PBGC on any proposed waiver or extension, this provision also gives PBGC more input and control over the process.

6. The plan sponsor may be liable for more funding upon plan termination than under prior rules, which required that an employer be responsible up to 30% of its net worth for unfunded PBGC guaranteed benefits. The SEPPA rules create a three-step process when there is a distress termination, that is -- a shortfall:

   - First, a special trust is set up to receive, hold and distribute the amount of any funding deficiencies or funding waivers.

   - Second, the value of guaranteed benefits is determined, and the excess of that value over the plan assets plus the special trust that was just set up is calculated. If there is an excess (meaning that

there are unfunded guaranteed benefits), the employer must pay to the PBGC the sum of 30% of net worth plus 75% of the amount of excess which remains after substituting the 30% of net worth.

- Third, if all of the assets (which include the actual plan assets, the amounts put into the special trust and the additional amount paid to PBGC) together are less than the value of benefit commitments, then an additional trust must be set up to cover 75% of that differential or 15% of total benefit commitments, if smaller. Benefit commitments mean all vested accrued benefits under the plan whether or not guaranteed by PBGC.

The point of SEPPA is quite clear. It has made a major stride towards reducing or eliminating PBGC responsibilities and at the same time has increased the premium paid to PBGC. It appears that both plans which terminate and plans which do not terminate will be more expensive to employers.

HR 3838

The Senate Finance Committee marked-up version of House Bill 3838 is currently being debated on the floor of the Senate. Upon modification and passage, it will be submitted to a joint House/Senate conference committee and upon agreement, returned to the floors of both Houses. Upon approval, it will be submitted to the President for passage or veto.

Because that bill is still a draft and because very little time has passed since it hit the floor of the Senate and, finally, because of its length, I will not deal with ESOPs or what the bill calls benefit programs which, for all intents and purposes, are welfare plans. Rather, I will concentrate the time I have on IRAs and qualified retirement plans.

The basic changes in IRAs are effective for tax years after 1986 and include, first, that participants in qualified retirement plans may not make pre-tax contributions to IRAs although post-tax contributions are allowable. To be consistent with this rule, QVECs (qualified voluntary employee contributions) would no longer be allowed. Premature withdrawals formerly attracted a 10%

extra income tax -- under the new rules, that goes up to 15%. However, this extra income tax is not applicable to the income earned on post-tax contributions. Spousal IRAs are allowed whether or not the spouse has earned income and deductions for interest on loans to fund IRAs would no longer be permitted.

Before getting into the general topic of qualified plans, a few comments regarding specific issues on 401(k) are appropriate.

401(k)

Most 401(k) changes are effective for tax years beginning after December 31, 1986.

The maximum elective deferral is reduced to $7,000 which is indexed to the Social Security Wage Base. This limit can be increased by as much as $2,500 if the extra amount is invested in employer securities in an ESOP.

Various corrective measures have been codified regarding excess elected deferrals and discriminatory contributions. This codification should remove some of the guessing game.

The deferral discrimination test rules continue, but the split between high and low paid is revised from a 1/3rd-2/3rds to a specific definition of highly compensated. It is interesting to note that this definition is used throughout the Senate bill with respect to not only qualified retirement plans but all other benefit plans as well.

The only premature withdrawals which can avoid the extra 15% income tax measure are hardship withdrawals of elective employee deferrals (those are pre-tax employee contributions). The definition of hardship remains as it was under the current law.

QUALIFIED PLANS

In general, the qualified plan rules do not go into effect until the first plan year after 1988.

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The changes to qualified retirement plans are wide ranging covering almost every aspect which falls under the heading of qualification requirements.

Coverage Rules -- the definitions of highly compensated and excludable employees are revised and codified by this bill, and the tests to satisfy non-discrimination in coverage are amended.

Vesting -- vesting schedules must be at least as generous as either 5% cliff vesting or a graded vesting schedule beginning with 20% at 3 years of service and grading up to 100% at 7 years. In the case of a class year plan, the old rule of full vesting of each class, five years after the class was initiated, still applies; however, the aggregate vested value cannot be any less than it would be under one of the two new vesting schedules.

Integration -- a defined contribution plan satisfies the requirements of the Bill only if the rate of contribution on excess earnings (normally that means over the wage base) is not greater than the smaller of two numbers. The first number is the rate of contribution on earnings below the breakpoint multiplied by 2, and the second is the sum of the rate of contributions below the breakpoint plus the FICA rate for the year -- that's 5.7% in 1986. Therefore, if the rate of contribution below the breakpoint is 5.7% or smaller, the first rule applies (that means 200%), otherwise the second rule applies.

Under defined benefit excess plans, the excess benefit percentage which applies to earnings in excess of the integration level may not be more than 2 times the rate up to that level.

With respect to offset defined benefit plans, a more radical change has been made. First, the amount of offset applicable at any point in time can never be more than a number which is the smaller of a service prorated portion of the maximum offset or 1/2 of the amount of the benefit which would have accrued if there were no offset. In other words, the standard offset can never cause the accrued benefit to be less than half of what it would have been had there been no offset at all.

It is interesting to note that the maximum formula offset is no longer stated in terms of Social Security. Rather, any amount will fly as long as it does not reduce the benefit to below 50% of the percentage of final pay portion of the formula.

There is a second, general rule which allows a plan to include a maximum benefit limitation equal to 100% of the participant's final pay minus the portion of the participant's Social Security benefit earned for service with the plan sponsor.

MONEY PURCHASE FORFEITURES

Under the Bill, it would be permissible to use money purchase plan forfeitures to increase benefits.

TAXATION OF LUMP SUM

Under the present law, lump sum distributions can be taxed either entirely on a 10 year averaging basis or, in part on a capital gains basis and in part on a 10 year averaging basis. The new rules would be quite different. First, the capital gains treatment of pre-1974 accruals would be phased out over a 6 year period. Second, the 10 year forward averaging rule would be replaced by a 5 year forward averaging rule applied only once and only with respect to distributions received after age 59-1/2. Naturally, the Bill also includes some relatively complex grandfather provisions.

MAXIMUM BENEFIT AND CONTRIBUTION LIMITS

First, on the defined benefit side, the normal retirement age used in calculating maximum benefits at various ages would be changed to equal the Social Security normal retirement age. The maximum applicable to any benefit beginning before that age must be actuarially reduced, and the $75,000 age 55 floor disappears. The retirement reduction after age 62 should equal that applicable under the Social Security Act. Before age 62, the actuarial equivalence interest rate may be no less than 5% and after normal retirement age, no greater than 5%.

With respect to defined contribution plans, the maximum dollar limitation is frozen at the $30,000 level until it equals 25% of the maximum dollar limitation for defined benefit plans. In other words, the $30,000 limit will not change until the defined benefit limit passes $120,000.

SECTION 404

Under current law, unused limitations for profit sharing and stock bonus plans (that is, contributions short of the 15% of compensation limit) can be carried forward and used to increase limits in following years as long as the combination does not exceed 25% of compensation. Under the proposed law, future unused limitations may not be carried forward.

Under the current law and under certain conditions where an employer has both a pension plan (either defined contribution money purchase or defined benefit) and a profit sharing plan (either profit sharing or stock bonus), there is a limitation on the total deduction under the combination of those two types of plans. That limitation is the greater of 25% of the compensation of employees covered under both plans and the minimum funding standard requirement for the pension plan. This rule has always been a bit confusing to the general public because it put the money purchase defined contribution arrangement under the pension plan heading rather than under the defined contribution heading with the profit sharing and stock bonus plans. Under the proposed legislation, the money purchase plan changes camps and the distinction becomes defined benefit/defined contribution rather than pension/profit sharing. Therefore, whenever an employer has both a defined benefit plan and a defined contribution plan, the §404 combined plan limitation on maximum employer deductions will be applicable.

REVERSION

Asset reversions under defined benefit pension plans which have terminated are subject to an excise tax. This provision would apply only to plans which terminated or will terminate on or after January 1, 1986. The amount of tax is 10% of the reversion, and it is non-deductible to the recipient. There is one

universal exception -- reversion amounts which are transferred to an ESOP are not subject to the excise tax.

CASH OUTS

The rules for determining the amounts of defined benefit plan lump sum distributions and whether a lump sum distribution can be paid without the consent of an employee and his spouse would change again. The most recent change came about with the proposed and temporary regulations issued not quite 1 year ago. Under the Senate Bill, the steps to take are the following. First, calculate the present value of the total benefit using PBGC immediate and deferred interest rate assumptions for plan terminations on the distribution date. Second, if this amount is less than $3,500, it can be paid without consent and your calculations are finished. Third, if the amount exceeds $3,500, there is an option available to the plan, and that is to split the benefit into two parts. Determine the portion of the accrued benefit which, using the assumptions I just described, produces exactly $3,500 of lump sum. Then, take the remaining portion of the accrued benefit and evaluate it using a set of interest assumptions which may be higher than those used for the first $3,500. The maximum interest rates available for this second portion of the benefit are the PBGC immediate and deferred rates multiplied by 120%.

MR. GREENBERG: I would now like to have Gary Muller, President of Financial Assurance Corp., who has had a lot of experience in the development of previous tax laws give us his impression of the current situation relative to individual insurance products.

MR. GARY L. MULLER: The federal income tax law has always impacted the pricing of life insurance, but since 1980 when mod-co reinsurance became the thing to wear, federal income tax in many respects has been the driving force behind the design and pricing of life insurance products. The impact of federal income taxes, during the last seven years, has been the single largest factor in the pricing of life insurance -- greater impact than expenses, lapse rates, mortality and even interest rates.

IMPACT OF FEDERAL TAX LAW

It's impossible to cover all the provisions of the recent changes to the tax law, but I will attempt to cover the key changes which could have impacted the pricing or design of certain life insurance products.

The life insurance product, which the tax law not only changed but virtually destroyed, was the graded premium whole life plan or annual renewable term insurance disguised as whole life insurance. The key changes to the tax law which affected this product were:

a. 818(c) deduction
b. Nonpar deduction
c. Definition of tax reserves
d. Changes in how reinsurance is treated between unrelated as well as related parties.

Tax was the primary reason the product was designed and why it was at one time priced at premium rates below expected mortality with no margin for expenses.

The 818(c) provision allowed a tax deduction with no cash impact, of $21/$1,000 and the average premium per thousand was not much over $1. The ultimate tax shelter is $21 for every $1 of business -- a shelter far better than oil, real estate, or any other plan.

Even if the company writing the insurance couldn't use the deduction, reinsurance would allow the sale of the loss to another company. At one point in time this tax shelter was selling for $3.50/$1,000 or 3 1/2 times the initial premium.

The nonpar deduction and the ability to set reserves at a very low interest rate, though small in comparison to the 818(c) deduction, just increased the magnitude of the shelter.

The tax benefits were so great some companies considered giving the insurance away, in the first year, to obtain the tax benefit.

The elimination of 818(c), nonpar deduction and the more restrictive definition of acceptable tax reserves have virtually eliminated this product.

Universal life was also significantly affected by the changes to the tax law.

The definition of life insurance for the first time cleared the universal life product to be taxed as a life insurance product rather than as an annuity, an investment, or a combined annuity and term plan. An adverse definition of universal life as a life insurance contract would have destroyed universal life as we know it today. The key tax benefit of life insurance is the tax free inside build up of cash values.

The elimination of the 818(c), nonpar deduction, and the more restrictive definition of acceptable life reserves adversely affected the pricing of the universal plan.

These noncash tax deductions of 818(c) and the nonpar deduction allowed this product and all life insurance products to be priced at a lower premium because of these special benefits.

The universal life product as well as all life insurance products must stand on their own without special tax benefits.

All nonparticipating life insurance products were adversely affected by the elimination of the 818(c) deduction, the nonpar deduction, and the more restrictive definition of acceptable life insurance reserves.

The elimination of these provisions were to be offset by the reduction of the overall tax rate from 46% to 38.6%.

The actual impact on the pricing of any product is almost impossible to determine since the tax status of the company is the key. But the new law only provides a tax benefit if profits exist, whereas the old law provided tax benefits even if profits didn't exist because the noncash tax benefits could be sold through reinsurance. The impact of the changes to the law will probably never totally be known.

How was participating life insurance issued by a mutual company affected by the new law?

Again this question may never be totally answered because the tax status of the company affects the impact of the changes in the law.

Key items affecting participating life insurance are:

- Elimination of 818(c) -- noncash tax deduction.
- More restrictive definition of acceptable tax reserves.
- Tax formula for mutual companies.

If anyone knows the impact of these changes, they are far more knowledgeable than I am.

Single Premium Whole Life (SPWL) or Annuities Disguised as Life Insurance

The definition of life insurance in the current law was developed to eliminate pure or almost pure investment contracts being defined as life insurance.

Life insurance has the tax benefit of interest being tax deferred and interest can be withdrawn as a return of premiums first rather than as interest as required under an annuity or other investments.

The current abuses of SPWL, which are closer to annuities than life insurance, will result in a tighter definition of life insurance and could result in the elimination of the tax free inside build up of life insurance.

Fresh start -- this sounds like a provision given to companies who have been doing things wrong in the past, but are given an opportunity to correct all their past sins on a single date without any adverse tax impact.

Fresh start allowed for the forgiveness of the tax on the special 818(c) deduction which was accumulated plus the forgiveness of the tax on the spread between prior tax reserves and the current more restrictive tax reserves.

Fresh start didn't directly affect pricing of new products, but did impact the replacement of tax motivated products such as the graded premium whole life products. If fresh start didn't exist, companies would take greater steps to save the policies with these special benefits. But now it is more advantageous to replace these plans with products which make more economic sense.

The provision in the new tax law which may have the largest impact on the development of new products is the small company deduction. The small company provision allows companies which have less than $500 million of assets to earn $3 million with an effective tax of less than 15%. But for this provision to have any value the company must make money!

This provision will encourage the formation of new companies and also encourage the design of products which have immediate profits.

Many of the current products have had losses for several years because of high commissions and expenses. I see the formation of life insurance companies by large agencies with the idea of lowering first year commissions to develop profits in the agencies' insurance companies which will be taxed at a very favorable rate.

The net effect of this would be a lowering of the high front end loaded life insurance commission structure.

In summary, I believe the changes to the tax law have had the impact of reducing tax games (you can never eliminate tax games) and have returned our industry back to designing insurance products which make economic sense rather than reduce the tax burden.

MR. GREENBERG: I have a few comments on some of the subjects that did come up in this session. Diane mentioned in her discussion that the special deduction for insurance companies (the 20% special deduction) in the current legislation will be repealed 6 months before the tax rates go down. The interesting effect is that the insurance industry is the only industry which will have a higher marginal rate in 1987 (if the Senate version is passed) than in 1986. I believe the insurance industry stands out as unique in this. It is

sometimes embarrassing to be in the insurance industry. It was tough enough during the Stark-Moore days when many of us were members in the only industry that would ever lobby for a 50 or 60% tax increase. We all have friends in other industries, in their fighting to pay no taxes or get big tax deductions. You indicate a 60% increase is as good as we can expect, and they look at you like you have three heads.

Unfortunately, we on the insurance side do have a problem in Washington. It is that we are avidly disliked by many people in Washington who think of us as fat, dumb, and happy. They want to make us thin, unhappy, but still keep us dumb. I think that when we take a look at current legislation, we recall that we have recently been through a few very major tax revisions. The most recent was supposed to be a comprehensive long term tax revision, and Congress is now talking about making further major changes in taxes for insurance companies. They are talking abut all kinds of various corporate provisions, and yet, they still pick on insurance companies that cannot consolidate with non-life insurance companies. Yet, there is nothing wrong with legislating identical treatment relative to issues like the alternative minimum tax. I don't know what the answer is, but clearly if you take a look at the insurance industry share of corporate tax revenues over the last 25 to 30 years, the growth in that share, while extremely patriotic, is nonetheless somewhat disconcerting.

MR. JOSEPH L. TUPPER III: I have two questions. One of them is sort of a deep rooted fear, which is the taking away of the tax deferral to the inside cash value buildup. The question I have is, what kinds of practices may insurance companies have now or might have in the future that would tend to make that more likely? The 818(c) election is an example of something that might have been taken away in part because of things viewed as abuses. The other question I have is what are the possible things the industry could do to fix the current taxation of back-end load universal life products? If anyone would like me to say more about what I mean by that I'm happy to, but I think most people here know more than I do, on how damaging that taxation can be to current cash flow.

MR. MULLER: What I see as having the biggest impact potential to eliminate the inside buildup are the designs of some of the single premium whole life

plans. There are plans out there in the street, that, if you did not know they were life insurance, you'd think they were annuities. There are no charges for expenses, they are built into a spread between the current earned interest rate and the rate credited to the policies. I think as long as we as an industry profess to the public that we are an investment industry rather than a life insurance industry, we have the potential to lose some of the benefits that exist for life insurance products and companies. The inside buildup is designed as a benefit for life insurance, not for investments, and as long as the industry wants to profess that it is an investment industry rather than an insurance industry, it has that potential exposure of losing some of the benefits that go with it.

MR. GREENBERG: I think it is ironic that with respect to 818(c) everyone perceived this as an extremely inappropriate item for tax deferrals, so Congress wisely made it a permanent tax benefit. Those companies never using 818(c) got nothing, and those companies using 818(c) extensively got tremendous additional windfall benefits.

Just as an aside, not really relative to tax legislation but rather to IRS enforcement of prior tax law, much of the abuse (and I don't know whether that is a correct term but what has been perceived as an abuse as Gary has described during his remarks) is the use of 818(c) in leveraging "graded premium whole life," and the IRS agents are now attacking this. They have been attacking this for a long time, but they are now attacking these products with knowledge. One of our counterparts has obviously gone to them and explained what preliminary term reserves really are, what 818(c) really is, and they are now attacking graded premium whole life on a sound actuarial basis.

We had some lively remarks last night back and forth among the panel members as to the industry's chances on this issue. I was more optimistic than most people in the industry, until a few weeks ago, that the industry did have some chance to win at least compromise tax benefits relative to 818(c) on the so-called abuse areas. I now think that the chances are substantially diminished, and I may now be more pessimistic than the average person in the insurance industry.

MR. THOMAS E. SKILLMAN: I have a question in respect to Phase III tax under the Senate bill. It looks to me that if you are in the alternative minimum tax situation, you may be able to turn to Phase III and get by with a 10% effective tax on it. Is that right or wrong?

MR. GREENBERG: I think that is the way it reads. I look at it the same way, but the issue and the reason many people won't like it, is that most companies with a handful of exceptions, otherwise would never have to pay a Phase III tax. Why would you want to distribute it and pay a tax on it, other than if you had the alternative minimum tax? But the second thing is that it appears that every element of the alternative minimum tax seems to be a timing difference. The alternative minimum tax in almost every aspect is a prepayment of future taxes. You have an infinite carry forward of a tax credit to your regular tax and this is not just with respect to deferral items such as commissions and similar items. Specific reference is even made, in the Committee report, to things like tax exempt interest. There essentially are taxes that you pay because your book income is higher because, for example, you have tax exempts.

I think that for a few companies that have problems similar to credit insurance companies with very high policyholder surplus accounts with potential Phase III tax, this may be a very unexpected side benefit. Certainly for most of us this sudden additional tax one or two years after major tax reform is very nerve wracking. Even though this tax represents a so-called timing difference, for some of the smaller growing companies, this timing difference is so long as to almost be worth a permanent tax.

MS. WALLACE: Al, I think you're right. I think it is important to remember that any deduction against future taxes would only apply if you got to the point that you were taxed on a regular tax base again. It is not a deduction against future alternative minimum tax. It could be very, very long term deferral; therefore, almost valueless.

I have a question that maybe someone in the audience could help us with. My first reaction, and maybe this was naive, to the elimination of the IRA deduction was that it would be bad for the insurance industry. There is,

however, a possibility that it might help us in attracting money that is now otherwise going to the banks. A larger proportion of IRAs are sold by banks than insurance companies and if they become less attractive, then insurance products, annuities, non-qualified annuities, and life insurance, may become attractive alternatives to money that otherwise might be going into bank IRAs. Does anyone have a comment on that?

MR. CERNEKA: It goes even beyond IRAs. I agree, you take the tax shelter away, those who are seeking tax shelters are going to find another way. The IRAs are not the only tax shelters that are being attacked by the Senate Finance Committee Bill. I would guess the opportunities are even bigger than just IRAs. You have to go somewhere.