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FEDERAL INCOME TAX AND PRODUCT DEVELOPMENT

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- o Policyholder implications
- o Company implications
- o Marketing and product impact

MR. STEPHEN W. FICKES: We are here to talk about federal income tax and product development. What we would primarily like to talk about is products from both the company perspective and marketing perspective. Additionally, Mr. Allan Greenberg will briefly discuss the future of taxation and where it could lead with product development.

A few years ago, it was quite easy to get everybody's attention with federal income tax in relation to products because we had such exotic things as 818(c) election, where you could possibly price a product with a $50 premium that had an after-tax profit of $250 in the first year. Now it seems a lot of things have returned to the basics, such as the survival of inside buildup, as opposed to the exotic. If the importance of inside buildup is questioned, I would point to an example that happened in Australia in the late 1970s when the life insurance industry lost virtually all of its tax advantages and, within the matter of a year, the life insurance industry dried up, and virtually had no new business. Later, the industry did emerge again, though as an entirely different industry. Tax advantages were removed, and they reemerged primarily as a benefits industry, again relying upon tax advantages. So, for a life insurance industry, at least as our structure goes, inside buildup and some of the basic issues are very important.

PANEL DISCUSSION

Mr. Greenberg will discuss how the taxation of products could possibly affect the future outcome of the economy and the direction in which the country may go. To cite an example that happened in Germany, the population began to age quite rapidly and the social security system became more and more burdened. What the government began to do was to adopt varied financially feasible fiscal policies for endowment policies, the idea being to allow the country to develop large savings on their own. Then when the population does age, they don't need to rely upon the government as much for support. It's one situation where you have 100% of a population looking to the government for retirement; and it's very difficult to change policy then. If you only have 30-40%, it's much easier to do.

Our first speaker will be is Jim Murphy, who is from Northwestern Mutual where he currently is vice president and chief actuary. He joined Northwestern in 1966 and has been there ever since. He was the project manager for Northwestern Mutual's very successful Update 80 -- "Get More Out of Your Life" project. He is a Fellow of the Society of Actuaries and a member of its Board of Governors. He is also a member of the Planning Committee of the Society of Actuaries, and has served as general chairman of the Education & Examination Committee.

MR. JAMES J. MURPHY: I'll be giving, more or less, an overview of the new tax law's impact on products. I'll be covering two key issues. First, we retained the traditional tax treatment that life insurance has always had. The inside buildup is safe for now. What does that mean for our traditional life products? Second, the policy loan interest deduction is being phased out along with most other consumer interest deductions, at least for personal clients. This will have an impact on marketing based on borrowing. We will look at minimum deposit, access to policy values, and your in-force policies which already have loans. My remarks will be primarily from a mutual company perspective, reflecting my career-long association with Northwestern Mutual. However, some of these remarks will also apply to the context of a stock company and even some, perhaps, to nontraditional products.

Retention of the inside buildup provides us all with a great opportunity. At first glance, some said, "All is well. We won the war." Well maybe, as the smoke clears, we're beginning to see that we really only won a major battle --

Congress and the Treasury are clearly still at war. For now, we are virtually the last tax shelter, as many tax-favored investments were lost or severely curtailed by the new tax law. The marketing opportunity for our products is there if we use it wisely. From a product perspective, our current products are even more attractive just as they are. However, we can consider some new directions as well. The focus should be on broadening the savings and accumulation options. We have had variable life insurance products for some time now, with varying degrees of success. These should receive more attention given the new tax law. Perhaps they can be made even more attractive, particularly if we provide more investment choices for our client's life insurance accumulation dollars.

Then there is market-value-adjusted life -- something we haven't really fully defined yet, but which is being looked at by product designers and regulators alike, trying to find a way to provide traditional, long-term life insurance value without the company carrying the market value risk for early terminating policies. This might be a very attractive vehicle in the future if the inside buildup remains, and the regulators and designers can find the optimal way to deal with this new concept.

As previously mentioned, we have only won a battle and the war on inside buildup is not over. We must be careful. Congress and the Treasury still have us on their list and continue to watch our actions closely. Will we use our recent victory wisely? A few slips, and we will see them on our backs again. It may already be too late. Consider the promotion some in our industry are giving single premium life. The emphasis is entirely on the investment element with the death benefit virtually ignored. Some companies are stretching the definition of life insurance well beyond it's intended limits. So-called wash loans clearly have drawn the attention of Congress. Single premium life is the next battlefront. I urge you to be careful in this and other areas, or we will soon see other battlefronts open, and sooner than we would like.

Now let me turn to the other key 1986 tax law issue, policy loans. With the interest deductions being phased out, minimum deposit is out as a marketing tool, at least for personal sales. There are some marketing alternatives with current products which are in more than ever -- short-pay, quick-pay, or whatever you wish to call it, is in. With these approaches no doubt receiving increased attention, we may want to consider making their use easier for the agents, the policyowners, and the home office. We might also want to consider developing special products for these kinds of sales based somewhat on traditional limited-pay-life designs. We also should be looking at the compensation for agents marketing these plans. If the premium flow anticipated is really as short-term as is shown on many of these illustrations, can that really support the high first-year commission we have traditionally provided? I don't think so. Perhaps we should be looking at level compensation approaches which might be more appropriate. As a minimum, the compensation should reflect the actual payment of cash premiums, not those paid from accumulated policy values. In any event, alternatives to minimum deposit sales will be getting more attention.

Access to policy values via the policy loan has been an important feature of traditional life products. With the new law, will loans be considered less attractive? From the company perspective, the new law is a plus as it should lessen the disintermediation risk allowing for more certain investment planning. For the agent and client, it may be a minus for sales which rely on the use of policy values. This is not just minimum deposit -- there are a number of other uses for policy values such as education. What alternatives do we have? There is the status quo, the loan still provides access, and the deduction of interest may not be all that important. We could return to the 5% rate providing lower apparent cost. But what about direct recognition which many of us believe is so important to maintaining equity? Would we also have to abandon that? We could go to a 0% rate, but then how do we build up our reserves and cash values relative to borrowed funds? Then there is the wash loan approach which I mentioned has been adopted for many single premium life plans. I've already noted that Congress is not happy with this approach.

Finally, we can consider a withdrawal provision. Universal life has it, but is it appropriate for our traditional products? If we went that way, it could have a dramatic effect on the nature of our product and the way we invest to support its values. Whatever we do, keep this in mind -- be careful! Easy access to values will interest Congress and the Treasury. The more we look like investments and savings instead of like life insurance, the greater the danger to our traditional tax position.

Now let's look at policy loans and your in-force, considering a number of situations: first, loans which were taken for emergency use. These policies are probably okay. They can and perhaps should repay the loans now. The deduction was not and probably is not important anyway. Second, we have loans made to meet planned events such as education expenses or a down payment on a home. These too should be okay, particularly if the interest is accumulating. They may want to repay if they can afford to. If, however, the interest deduction was part of their planning we may have a problem here. Third, is arbitrage. The leverage is essentially gone. Repayment should be an attractive alternative in today's market and is probably the best for these policyowners, even though the company may not want large volumes of money in today's market. If they can't or don't want to repay, we may also have a problem. Finally, there is the minimum deposit sales of the past. These are the biggest problem because the direct cost of their insurance has just been increased by the tax law and they probably can't or won't want to repay. Their purpose in the first place was to put the fewest dollars possible into their life insurance policies.

From the company's perspective, the biggest concern is persistency and the replacement risk, probably relative to the last two loan situations which are most at risk. What can we do? Some companies have or are developing special programs for their in-force and, unfortunately, some are designed for their competitors' in-force as well. You can use 1035 exchanges or perhaps find a way to restructure the current policies. The goal is obviously to easily eliminate the loan without a repayment and to maintain at least the net death benefit. But don't act too fast, there are tax implications for the policyowner that must be carefully considered, particularly if policy values already show a gain -- you don't want to create a taxable event for your policyowner.

Finally, let's take a very brief look at how the 1986 tax law will affect corporate-owned life insurance (COLI). The main concern in this area is related again to policy loans and the limit that has been put on corporations' deductibility of interest on such policy loans. This is leading to marketing using more lives and smaller policies so that the leverage approach can be continued. Alternatively, there is also a move to vanish or short-pay approaches without leverage. We also see more and more emphasis on sales approaches involving benefits, rather than the investment rate of return.

The new tax law has also produced areas of great opportunity for the COLI market. With the new limits on qualified plans, nonqualified benefits become a very attractive market for COLI funding. This has a lot of potential, and I know Mr. Ingraham has more to share with you on this.

To summarize my remarks, we won the battle but the war is still on. We should take responsible advantage of our victory, with the key word being *responsible*. Remember your in-force, these are the people we are in business for. If they have a problem, we should try to help them solve it. Last but not least, be careful and be watchful. Congress is still watching us very carefully.

MR. HAROLD G. INGRAHAM, JR.: I'm going to focus my remarks particularly on the implications of the Tax Act on the advanced underwriting and individual policy pension trust market in terms of marketing strategy and product changes.

Let me start with just a few general comments. Although changes in the life company and policyholder tax rules were considered along the way, Congress decided, in view of the major overhaul of the 1959 Tax Act, and the Tax Reform Act of 1984, to leave the basic formula for taxing life companies untouched in 1986. On the company side, Congress repealed the 20% special life insurance company deduction; but with the change in corporate tax rates, life insurance companies will, except this year, enjoy a slight reduction in the tax rate on ordinary income, coupled with a somewhat higher tax rate on long-term capital gains.

Life companies may be, however, significantly impacted by revision of the corporate minimum tax, as well as by dramatic changes in the treatment of the affiliated property and casualty companies. On the policyholder side, the Act retains the current tax status of group life and health insurance and continues the current law treatment of the "inside buildup" on individually-owned life insurance. I think the most significant policyholder changes are the gradual elimination of the policy loan interest deduction, plus taxation of the inside buildup on corporate-owned contracts.

I am now going to focus on the Tax Act's impact on individuals. Lower tax rates are going to produce significantly additional amounts of disposal income for most higher income taxpayers. Life insurance does survive as one of the few remaining tax shelters. If you think of the financial services industry as sort of a horse race, you might say that, since the tax-free inside buildup was retained, the life insurance industry came out well because all the other horses in the race were shot! The Tax Act preserves the stepped-up basis at death, it preserves the inside buildup tax deferral, and it doesn't raise any new life insurance company unresolved tax issues.

IRA deductions aren't available to a person who is an active participant in a qualified plan if the person's adjusted gross income for the year exceeds certain limits -- $50,000 if you are married and filing jointly, $35,000 for single. The maximum elected deferral to a 401(k) plan or a simplified employee pension plan is $7,000. The $7,000 is indexed for inflation in the same manner as are maximum benefits in a defined benefit plan, the CPI adjustment starting in 1988. The $7,000 limit only applies to elected deferrals by an employee, and contributions by an employer can be made to a 401(k) plan subject to the overall Section 415 limits. The limitation on amounts contributed to Section 403(b) tax-sheltered annuities, (TSAs), is the greater of $9,500 or the 401(k) limit. New nondiscrimination requirements have to be satisfied by all 401(k) plans and TSAs.

Highly compensated employees may not defer a percentage of pay greater than either (A) or (B), where (A) is 125% of the average deferral percentage of nonhighly compensated employees, and (B) is 200% of the average deferral percentage of nonhighly compensated employees, but not more than 2% more.

Who is highly compensated? You are deemed highly compensated if you are a 5% owner, or you earn more than $75,000 in annual compensation, or you earn more than $50,000 and were in the top 20%, or you were an officer of the employer and you earn more than $45,000.

Another implication of the 1986 Tax Act was five-year averaging on lump-sum distributions.

Obviously, financed insurance for individuals is considerably less attractive, with the phasing out of the policy loan interest deduction over four years. So what's the defensive strategy?

New insurance programs ought to stress the vanishing premium concept under whole life, and flexible premiums under universal life. This raises the issue of replacements and Section 1035 exchanges. In a recent private letter ruling (PLR86-04033), the IRS didn't find a taxable event in an exchange in which one insurance policy subject to a policy loan was exchanged for another policy subject to the same loan on the same insured. The IRS's reasoning was the original loan wasn't forgiven since the new policy was subject to the same amount of indebtedness. Certain companies are out there promoting external replacements using this private letter ruling as a shield -- it's what I call the rape and pillage strategy.

An interesting colloquy in the September 27, 1986 *Congressional Record* between Senators Dole and Packwood may indicate that these kinds of exchanges in corporate-owned life insurance (COLI) situations will fall under the protection of Section 1035 only if they involve the same insurance company.

Individuals with in-force minimum deposit business shouldn't act rashly. They should be reminded that the maximum marginal rate can be as high as 38.5% this year, and 65% of that interest deduction will be allowed.

For in-force minimum deposit business, there appear to be two tax efficient strategies. First, use existing dividends to pay nondeductible policy loan interest, or have the premiums vanish with the interest on the existing loan being paid.

Lots of older policies have 5% or 6% loan rates and those interest payments aren't really burdensome. The second strategy would be for key people or business owners to collaterally assign their individually-owned policies to their employers using split-dollar. This results in the individual paying low economic benefit cost (the PS58s) for the insurance protection, rather than the nondeductible policy loan interest. Some argue that an individual is better off taking an equity line of credit on their home, on which the interest is deductible, and then paying off the loan against the policy.

Another effect of the loss of the policy loan interest deduction for individuals is that it significantly weakens the effectiveness of rollouts of policies from split-dollar plans and individual policy pension trust plans where such policies have been usually minimum deposited.

Assuming internal replacements, "freezing the loan," were to take place under Section 1035, what should the replacement products look like? One approach is to have a universal life form with annual premiums, rather than single, to avoid characterization of the exchange as abusive by the IRS, with a very low policy loan interest rate for slow accumulation of the loan balance, and with interest credits on the loan such that there would be a "wash loan," or very low net cost, for the loan balance.

For individual minimum deposit business in early policy durations, I think it's obvious that lapses are probably going to increase because here the policyholder has little or no taxable gain on surrender.

True salary reduction deferred compensation arrangements are going to be less attractive to most highly paid executives in the 34% tax bracket situations. There are exceptions, though. One exception is an employee of a nonprofit corporation, a 501(c)3. Another is somebody working for a low-profit corporation, a company that's not making money but wants to. Another is an executive who has exceeded his 401(k) $7,000 limit and wants to elect a deferral with employer matching -- a so-called 401(k) "look-a-like" plan.

Let me turn now to some of the implications of the tax law on closely held corporations. Lower corporate tax rates are going to give businesses more after-tax dollars to do such things as buy key man insurance, fund supplemental pension programs, or establish split-dollar programs. The lowest corporate tax rate of 15% now applies up to $50,000 of corporate taxable income, and this expands the opportunity to sell key executive or split-dollar insurance to owners falling in the 28% personal tax bracket.

I would like to note that taxes aren't always the primary rationale behind the split-dollar concept. Corporate cultures dictate special benefits aimed at key people. Also, it is easier to use a company check, particularly when a closely held corporation is nothing more than a second hat for the boss and his people. Split-dollar is a very flexible extra fringe benefit to fill in shortages in death benefits and retirement supplements for many companies. It's also used by Fortune 500 companies to insure stock options.

The new Tax Act radically reduces the maximum allowable payout from funded pension plans on early retirement. This is going to further encourage companies, particularly smaller companies, to provide supplemental pensions for select executives and owners with nondeductible life insurance. They will have more after-tax money to use in selected plans, as previously mentioned.

Because the capital gains tax rate differential has been eliminated, the stockholders of closely held corporations ought to replace any buy-sell agreements with cross-purchase agreements, so that the survivor will have a "step-up" in basis after the purchase of a deceased stockholder's interest. Ordinary income tax on the sale of low-cost basis stock during the stockholder's lifetime is tax efficient.

Some say that lower corporate rates will almost certainly reduce the appeal of qualified plans for closely held businesses, thereby diminishing the insured pension trust market. The lack of significantly large deductions, coupled with other qualified plan restrictions, may make qualified plans less attractive as a way to provide benefits primarily for the highly compensated owners. I think thrift plans involving after-tax contributions are essentially dead. I also think there will be fewer defined benefit plans and it is likely we are going to see more target benefit plans, rather than more profit-sharing plans, because target benefit plans provide more of the cost ratios that owner executives are used to in defined benefit plans.

I'd like to now discuss high bracket corporations and the impact of the Tax Act on them. COLI programs, such as insurance funded, nonqualified deferred compensation plans, may actually be more attractive and salable in a relative way, even though those plans are going to be more expensive because some of the leverage has been lost. As you know, policy loan interest on policy loans per person is not deductible by corporate owners for the aggregate amounts of all policies per employee in excess of $50,000. This applies to all COLI policies bought after June 20, 1986.

Why is COLI still viable? Since corporations will be taxed on the inside buildup on annuity contracts, life insurance still may be the most appropriate funding vehicle. Life insurance contracts crediting interest on policy loans nearly equal to loan interest charged will still continue to be attractive.

But what about post-June 20, 1986 insurance policies which will have limited policy loan interest deductibility? Here, in years where the corporate borrowing against policies would go over $50,000 per participant, the corporate controller has some options. He would probably find it more efficient to pay premiums as due and then finance accounts receivable, or buy inventory, or borrow to meet payroll -- all situations where the interest deduction wouldn't be in question.

The same *Congressional Record* I mentioned earlier also had an interesting colloquy between the same two senators which was something like this: Senator Dole: "I am confident that all the sponsors of this provision didn't intend to disallow interest on a taxpayer's normal business indebtedness. I would appreciate, therefore, confirmation that this provision will not disallow interest on indebtedness incurred for a business purpose, merely because the taxpayer has purchased a cash value life insurance policy or has later used the policy as collateral for borrowings other than to carry the policy." Senator Packwood: "The new provision would not disallow interest on indebtedness incurred under the circumstances my distinguished colleague has described."

The colloquy between those two senators indicates that no tracing is required. However, a subsequent statement by Congressman Rostenkowski, Chairman of the House Tax Writing Committee, seems to indicate that that interpretation is not correct. My one comment here is that, if I correctly interpret what the senators said, a corporation could effectively bypass the $50,000 loan cap by simply pledging its COLI policies for collateralized bank loans. I wouldn't bet that's going to stick.

The next category I would like to discuss is deferred annuities. Under prior law for deferred annuities, income credited was not immediately taxed, either to the owner of the contract or the insurance company issuer. Instead, it was taxed on distribution. Under the new law, the exclusion for income credited to a deferred annuity is not now available where the contract is held by a corporation, held by a trust, or held by another taxpayer who is not a "natural person." Instead, the income on the contract is treated as ordinary income received or accrued by the owner during the taxable year; in simple English, loss of inside buildup. For this purpose, income in the contract is the excess of total net surrender value at the end of the taxable year (plus all prior distributions) over the investment of the contract (which is the sum of the net premiums).

In addition, the penalty on premature withdrawals from a deferred annuity contract has been increased from 5% to 10%. Also, the exclusion ratio for amounts received after the annuity starting date by individual annuities had been modified to allow only an amount equal to the investment of the contract to be recovered tax-free.

Under the new tax law, if an employer is the nominal owner of an annuity contract and employees are the beneficial owners, then the contract will be treated as held by the employer to avoid IRS administrative problems.

This change in annuity tax treatment seems to impact its use in the COLI market, although there are plenty of exceptions. For example, it doesn't apply to annuities held under pension plans, IRAs, TSAs, close-out annuity situations, structured settlements, or situations where the contract is within one year of its distribution date.

The 34% corporate tax bracket on earnings above $75,000 is going to encourage companies to consider executive bonus (i.e., "whole dollar" or Section 162 premium bonus) plans for individuals who are only in the top 28% bracket -- unless the company wants to put "golden handcuffs" on the nonowner key people. Reduced individual tax rates will result in lower cost of the employee insured. On the other hand, such plans may have a higher after-tax cost to corporate employers due to a lower tax deduction (the 34% bracket versus the old 46%).

Because of the tax rate difference here, the individually-owned policies are going to be more attractive to the closely held corporation than corporate-owned policies. Why? Because if the premium is bonused by the corporation to the employee, then the corporation gets a 34% deduction from income.

Traditional split-dollar has been viable for over twenty years and, simply put, it allows two parties to split the premiums, the cash values, and the death benefits on permanent insurance. Reverse split-dollar does the same -- but reverses the two parties to the agreement. The employee applies for his personal insurance, owns the entire cash value, and endorses the policy so that the employer has the right to name the beneficiary for the portion of the death benefit desired. The insured contributes the cash value portion of the premium and the business entity pays the protection part of the premium. The corporation has the option of either paying the insurance company's lowest rate for the protection or the PS58 rates, which will invariably be higher. Use of the higher rates produces a premium offset plan for the insured key person when the PS58 contribution exceeds the policy premium.

If and when a reverse split-dollar agreement is terminated, the employee gains control of the entire death benefit. Since the corporation receives nothing on the termination of the arrangement, reverse split-dollar will have more appeal when a corporation isn't interested in getting its money back. An example could be a professional corporation with the sole stockholder as the insured employee.

The new Tax Act increases the attractiveness of reverse split-dollar arrangements where the insured executive owns the cash value, particularly if variable life or variable universal life is used as a funding vehicle. Now that the capital gains rate differential has been eliminated, the marketability of this product would appear to be significantly enhanced in business insurance situations.

Commenting on some other markets, salary savings is probably a little better market now. Products sold here retain their inside buildup or tax-deferral status and, since the other investment products have been hobbled by the new Tax Act, life insurance ought to capture more of this savings market -- particularly for the over 500 employee cases where I see group universal life making substantial inroads.

With respect to group universal life, a recent LIMRA survey indicated that it will be offered by the top 25 group carriers by 1990, but the most successful carriers will be those offering both group term life plus a side fund, and a universal life type product with level planned premiums and targeted cash values. A successful carrier would offer multiple accounts including declared rate accounts, common stock, bond and real estate funds. Some, but not most, group universal life programs would result in wholesale replacement of existing group term life coverage. The most successful carriers will market group universal life through direct mail and employee meetings led by the carriers, salaried enrollers. Group universal life commissions will be significantly higher (like double or triple) than those of typical group life. Also, group universal life will produce modest but increasing mortality and interest profits.

Accident and health is probably a better market. There is now a higher threshold on an individual's personal tax return for deducting medical costs and a lower individual tax rate. This means that the government is paying less of these medical costs through tax deductions.

Group term replacements, carve-outs, are affected by a number of factors that are causing this particular market to open up. One is the demise of retired life reserves (RLR). Second, is the expense of Table I tax rates for group term in excess of $50,000, even at lower personal income tax brackets. Third, is the cost to employers when retirees convert their group term coverage. Fourth, is the fact that deductible group term premiums are less attractive in the 34% (versus 46%) corporate tax bracket. Now about two-thirds of that cost will be borne by the stockholders. The fifth point is that the nondeductible portion of split-dollar plans is less costly to a corporation in the lower tax bracket. Incidentally, under the split-dollar plan alternative, the "rollout" of a paid-up policy at the insured's retirement is tax-efficient to the corporation if the split-dollar plan is structured on a collateral assignment basis. The corporate interest in the policy can be recovered at the insured's retirement, or the corporation could split the policy in two and carry one as post-retirement key executive coverage to recover the premiums plus the cost of the use of money.

I have one more comment on pension trust. The immediate future of the individual policy pension trust market will hinge to a large extent on the feelings of small business owners as to whether taxes really will stay down or not. Pension trust plans will continue to be written if the prevailing feeling is that they will go back up.

On 401(k), the reduction or the elimination of deductible contributions on IRAs will put more pressure on business owners to establish these plans. On the other hand, participation levels may drop unless employers start matching, or increasing their matching levels. The $7,000 contribution limit probably won't cut life insurance allocations too much, but the new discrimination tests and actual deferral percentage (ADP) rules are going to be much harder for plans to comply with.

The use of COLI as a funding vehicle for postretirement life and health liabilities has become a hot topic of current interest to insurance companies, producers, and the corporate producers of this insurance. The new Tax Act has fanned this interest.

Current studies have shown that about 80% of large and medium-sized employers continue some form of postretirement life and health coverage, for former employees and their dependents. But postretirement benefit plans have been primarily funded on a pay-as-you-go basis. They were established this way since there has been no ERISA or GAAP accounting requirement for advanced funding, and since the employers believed that Medicare would cover an increasing percentage of the retirees' medical costs.

However, employers are now experiencing increasing costs, particularly for postretirement health care. That's because of a number of factors. One is an aging population. A second is inflation of medical costs. A third factor is Medicare paying less of the total cost. Also, the downsizing of major industries in recent years has resulted in proportionately more retirees and less future actives to support these costs.

While pension costs have been generally closely monitored and projected over the years, pay-as-you-go financial reporting and funding for postretirement medical plans have virtually been the rule without exception. As a result, financial and benefits executives have been forced to fly blind, as it were, as to the true levels of current and future costs.

Faltering plan sponsors, in their attempts to adjust or cancel retiree medical plans, have met strong resistance from retired employees. Just as importantly, the courts in which the disputes have found themselves have frequently turned a sympathetic ear to these retirees. FASB has begun to study postemployment benefits and is expected to soon require some form of accrual accounting. It's not totally improbable that some form of advanced funding may eventually be mandated by Congress.

All this is background to the fact that COLI appears to be a potentially powerful funding mechanism for postretirement benefits, even under the 1986 Tax Act. This approach would be similar to that used for deferred compensation and supplemental retirement programs. The postretirement benefit funding concept anticipates relatively small policies on all (or at least the majority) of current employees. This is going to require a different approach, as compared with current COLI programs, in a number of areas, such as case quotations, or underwriting, or application taking. There will be a greater use of group contracts and there will be differences in claim processing and administration. In particular, the insurable interest rules of the various states are going to have to be researched.

On minimum taxes, the new Tax Act has amended the corporate minimum tax rules so as to expose the inside buildup and death proceeds of life insurance policies to the minimum tax. This has been done by characterizing these policy amounts as items of tax preference that are included in the minimum tax base.

The minimum tax is calculated on alternative taxable income, which is corporate net taxable income plus certain items designated as preference income. If 20% of this base exceeds the income tax otherwise payable by the corporation, then 20% is the alternative minimum tax.

The Tax Act provides that the alternative minimum taxable income of a corporation would include as preference income, 50% of the amount by which the adjusted net book income of the corporation exceeded its alternative minimum taxable income, not counting this preference item. This adjusted net book income would include, each year, the accrual of cash values in excess of net premium payments -- and, at the time of death, the excess of death benefits payable to the corporation over the policy cash value. This means that the addition to book income attributable to COLI could result in the imposition of an alternative minimum tax on the corporation. One consequence of this is that it's no longer possible to assure all corporate purchasers that life insurance will be certain to generate tax-free income. However, any threat of inside buildup taxation for small closely held corporations is substantially reduced on death because of an exemption. That exemption amount is $40,000, grading off to zero by 25% of the amount by which the alternative minimum taxable income exceeds $150,000, so it grades off completely at the $310,000 level. Incidentally, another attractive feature of reverse split-dollar is that it also serves to remove any possible threat from the inside buildup preference income tax of 10% of corporate-owned cash values.

Needless to say, the calculation of this minimum tax for any corporation involves a myriad of factors, in addition to life insurance figures. Hence, it's going to be difficult to precisely predict the impact on any particular corporation. However, one thing is sure -- it's no longer possible to assure all COLI buyers that life insurance is certain to generate tax-free income.

Some final comments on questions that you might want to ponder. The new Tax Act imposes a further pension plan cost burden that will be particularly onerous on the smaller corporations. It involves matters like coverage and vesting (i.e., 90% of small corporate defined benefit plans now have 10-year cliff vesting). The new Tax Act substantially liberalizes this and comparability testing (i.e., the ratios of "highly paid" to other employees).

If employers, acutely feeling a benefits squeeze, do increasingly terminate their qualified plans in favor of nonqualified plans, then how will Congress respond? I believe that inevitably Congress would impose ERISA-style regulations on nonqualified plans in such a scenario.

In the final analysis, the ultimate challenge might be: how should government provide sufficient incentives to increase the level of employee benefit plan coverage, particularly in the smaller case market?

My final point relates to the inside buildup issue. With the new restrictions on passive losses from tax shelters, emphasis has started to shift to life insurance (and home ownership) as among the few remaining tax shelters left. Congress could, and likely will, revisit the taxation of the inside buildup to meet future revenue or tax equity needs. If Congress does revisit life insurance, the treatment of single premium life insurance now being marketed principally by stockholders to relatively more affluent policyholders will certainly be more vulnerable to attack than traditional annual premium-paying policies. Such a scrutiny of single premium contracts is taking place even as I speak.

MR. FICKES: Our final speaker is Mr. Allan Greenberg. He started with Prudential, spent five years as a tax consultant with two of the Big 8 accounting firms, and currently is vice president and chief actuary with Geneve Capital Group.

MR. ALLAN D. GREENBERG: What we are here to talk about is the future of insurance taxation -- where it's going and what the implications are for the industry and perhaps, at the risk of being presumptuous, what it means for the country as a whole. First, I'd like to speak a little about the current issue of policy loan interest deductibility being phased out. With 65% deductibility in 1987, I think all of us in this room should not be in a complete panic. I heard and saw things happen in November and December of 1986 that led me to believe that, because of the loss of 35% of the policy loan deduction in 1987, a lot of companies were making moves very quickly, perhaps in response to their marketing forces, that were less than prudent. Nonetheless, clearly within a few more years the deductibility of policy loans will be zero and will be so severely reduced in 1988 as to pose a serious problem for those policyholders who depend on the deduction.

There are two kinds of policyholders that are involved. First, there are those in probably the majority of instances who do have a policy loan, but one of their alternatives that is viable is a simple surrender of the policy. They then can perhaps, under favored treatment by the company, take out a new policy if discrimination considerations are handled carefully. There may be a way to do it avoiding the considerations of Section 1035, perhaps limited underwriting -- something of that nature. The more serious, although less frequent, case is the minimum deposit plan that has been in force for a long time and where the policy value exceeds the basis in the policy. In this situation, only an exchange will work, and even there it must be done judiciously. The comments of Mr. Ingraham regarding exchanges of another company's policies on a Section 1035 basis, although well taken, are, perhaps, too black and white. I think companies should look for opportunities to provide policyholders of other companies with Section 1035 exchanges, particularly if their companies are not responding to the problem.

The next two items are going to relate to where we're heading with respect to taxation, based on where the Administration and the Treasury have been coming from with respect to life insurance. Someone described taxation as an art -- it's an art of plucking the most possible feathers from the goose while causing the least possible amount of squawking. I suggest the possibility that the insurance industry's lack of squawking has left us almost naked and featherless, and they're now going to go after, as quickly as possible, any odd feathers they have left unplucked. There seems to be a misinterpretation in Congress of what life insurance is. Where is it going to lead us? I believe it should be of great concern to all of us. One of the two most devastating recommendations that came out of the Treasury proposal which was later repeated, but at least somewhat modified by the Administration proposal, was the removal of the reserve deduction for insurance policies. Let me say that the Treasury proposal was absolutely unqualified -- it didn't list any exceptions whatsoever and, in doing so, would have totally eliminated any immediate annuity products forever. It requires very little insight into the intricacies of life insurance to see what a lack of a reserve deduction would do for any company offering immediate annuities.

The Administration proposal, the following calendar year, did allow for an exception for annuities without cash values. However, completely left out were any term insurance policies regardless of their length of coverage and, perhaps even more striking, any mention whatsoever of health insurance. I suggest that lack of deductibility of health insurance reserves would deal a body blow to those companies that are offering competitive and attractive products that allow citizens in a free society, if you'll pardon the dramatic flair, to protect themselves in the event of personal catastrophe resulting from accident or illness. Essentially, and let me read from the explanation put out by Treasury staff -- "the reserve deduction thus serves to adjust the company's income to account for its liability to pay . . . in the event of a claim under a policy the face amount of the policy." Given that health insurance wasn't specifically mentioned, it should be called "benefits under the policy." It seems to me that we as actuaries have not done a very good job of explaining what insurance is. Insurance is not a cash flow business. It has, in the distant past, been a cash flow business with the resulting virtual destruction of that particular insurance business. We remember in our younger days studying about assessment companies as part of the syllabus of the Society of Actuaries. What happened to them? These proposals are suggesting that we go back to an assessment company approach.

"The reserve for policy claims will often overstate the company's reserve deduction . . ." The implication is that reserves are not needed! I think we have to do a little bit better job to convince people in Washington, and maybe perhaps convince people throughout the country, what insurance is all about. It represents a moral and legal commitment on the part of an insurance company to pay a benefit when it's due! As a kid, starting out at Prudential, I can remember almost constant reminders that we're in business for only one reason. That is to pay claims! To have the money to pay the beneficiary or to pay the claimant when it's due! As thick as I am, I managed to learn that. But my colleagues and I have not done such a good a job of convincing other people of the necessity and the importance of what insurance offers.

From the point of view of drama and as a popular issue, nothing has been discussed as frequently as the case of the inside buildup. Here it is a little bit more clear to me what the problem is. The previous speakers are two of the more esteemed actuaries in our illustrious society. Both commented how lucky we were that life insurance has been retained as a tax shelter. I think that perhaps it would be better for us if we addressed the issue of so-called inside buildup from the point of view as to whether the country is interested in the destruction of life insurance. Is it the purpose of the government or perhaps the people through their elected government to destroy insurance?

Inside buildup to me has only one legitimate analogy -- that is home ownership. I happen to be lucky enough to have moved into Fairfield County in Connecticut a few years ago, just before the recent boom took place there. House prices have virtually doubled in the last two years! There is no question that I have done nothing to merit this tremendous windfall -- I've made more money on the increased value in my house in the last two years than I have made in earned income! Is it fair that I should receive this windfall benefit and not have to pay any taxes on it? There are many people that live in different parts of the country that have had minimal or no appreciation on their homes. Why should I receive these huge six figure numbers as increase in my net worth and get away, at least currently, scot-free and pay no current taxes? The only answer

I can think of is that if I had to pay those taxes, there's only one way I could do it -- I would never have enough money, I would have to sell my house!

If you tax the inside buildup of a life insurance policy, for many people, the only way they could pay the tax is to sell the policy. Does insurance coverage mean anything? Do we care about providing insurance benefits? Or is it sound public policy to eliminate an important element of individual citizens providing for their own welfare and perhaps supplement it with government provided programs? We are currently paying through ourselves and our employers (if we are employees) over 15% of our annual pretax salary to social security. What's going to happen 25 or 30 years from now? Are we going to have to pay over 50%? At what point do we suggest to society in general that it is good for society for individuals to be able to look after themselves as much as possible? I think the way that we should address the tax on inside buildup is whether the government, as public policy, should be interested in destroying the concept of insurance. That's the level at which we should be fighting the issue.

I recognize that perhaps I've been overly dramatic in my discussion of these issues. Over the past 3 or 4 years, I've spent a lot of time in Washington, and experienced much futility, discussing fairness issues in insurance. I have seen the insurance industry receive treatment that could be described as punitive. We've seen a statute on reinsurance that allows the Treasury to tell us what our taxes should be! Treasury will examine arms-length transactions and they will say how much our tax should be and what the transaction really means. We have seen an alternative minimum tax that suggests that 2 or 3 years from now acquisition expenses are going to be part of a list of preference items that will now go into our alternative minimum tax calculation. Perhaps some remember the remarks of Congressman Pete Stark, and other congressmen as well, addressing bodies like this one and the ACLI explaining how it was unfair for insurance companies to have net level reserve deductions since they already are allowed to expense their acquisition costs. It seemed very unfair! Therefore, to correct this situation, we have now moved to preliminary term reserves for tax purposes. It strikes me as somewhat inequitable that we are going to be taxed for deduction purposes on a preliminary term basis but for expenses on a net level basis. Finally, I have yet to be able to discover an industry where dividends received from wholly-owned subsidiaries are going to be an element of preference in calculating alternative minimum tax, yet the industry as a whole cannot consolidate with any of its nonlife insurance affiliates.

In 1987, if there is a long enough chain of life insurance and nonlife insurance companies (and I agree it's a ridiculous example, but the result to me is even more ridiculous), and if a life insurance company at the bottom end of 10 or 11 companies makes a million dollars, pays tax on that, and dividends up from all the subsidiary companies (100% wholly-owned), the after-tax amount of $600,000, that million dollars will generate $1,060,000 tax. The method other corporations have to prevent that is to consolidate, but life insurance companies are not allowed to consolidate with nonlife insurance companies.

I suggest, given all these historical examples of how the life insurance industry has been treated in recent tax legislation, that we must address these issues, both with Congress and the public, on a more aggressive basis than we have in the past.

MR. THOMAS G. KABELE: Mr. Greenberg, could you explain the $1,060,000 and how you got that calculation?

MR. GREENBERG: If a 100% dividend received deduction is made to a non-consolidated group, it is treated as a tax-preference item. Therefore, if a company receives a $600,000 dividend and it's taxable income and book income are zero, the imputed book income will be $600,000 using the alternative minimum tax (AMT) methods. Then, 50% of that will produce $300,000, which at a 20% tax rate produces $60,000. If you do this up throughout the entire stream, at each level, you will be generating $660,000 of tax.

It is a ridiculous example -- I don't intend to suggest that this can happen to too many companies. However, you can see real examples of companies not being able to take dividends because it could definitely generate tax rates in the 50% range. It happens once or twice and you've got a corporate structure that you can't do anything about and you have to pay tax twice on preference items to get the dividends. For companies that have done leveraged buyouts it is potentially disastrous.

MR. JAMES CHARLES HARKENSEE: My question deals with the alternative minimum tax. Is this going to have any effect on companies that are not required to produce GAAP statements like wholly-owned stock companies or mutuals?

MR. GREENBERG: It actually will probably affect them more because the way it is defined right now is that you must capitalize your acquisition expenses with an allowance for amortizing previously capitalized acquisition expenses. It hasn't been clarified yet (with respect to mutual companies) whether in the first year they will have imputed for them the entire amount of acquisition expense to be capitalized as a preference item, as opposed to companies now issuing GAAP statements where there is already an existing structure for amortization of previously capitalized acquisition costs.

MR. PAUL LEFEVRE: Mr. Ingraham, are you aware of any implications to a life insurance company that would issue an annuity with a corporate or trust ownership? I've heard that from the reporting standpoint such an annuity might not be treated as an annuity as far as reserves are concerned. I don't think there are any, but are you aware of any?

MR. INGRAHAM: No, I'm not.