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IMPACT OF FEDERAL INCOME TAXES ON PRODUCT DESIGN

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- o Definition of life insurance
- o Exchanges
- o Policy loans
- o Single premium life products
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MR. DAVID J. BOHL: Under the Consumer Loan Interest Rule of the Tax Reform Act (TRA) of 1986, all interest is now classified into one of five categories: trade or business interest; investment interest; passive or active loan interest; home mortgage interest; and consumer loan interest.

The first four are generally deductible. There are special rules for passive losses, investment interest and the like, but they are generally deductible. For consumer loan interest, deductibility is being phased out. This year we can deduct 40% of the interest that is considered consumer loan interest. In 1989 it is 20%, in 1990 we get down to 10%, and by 1991, it is eliminated. You don't get any tax deduction if it is considered consumer loan interest.

However, we have borrowing which is done simply to finance premium payments. There is an argument that it's investment interest, but it's generally not a strong argument. So those are the individual roles.

Now let's move over to the corporate side and quickly review those rules. First of all, once again, for single premium contracts, the interest is not deductible. We still have to cope with the four-out-of-seven rule, TRA 1986 introduced another new rule there also.

Deductions for borrowing from corporate policies are limited to the first $50,000 of borrowing per insured executive, unless we have a grandfathered contract. The general conclusion that you reach after reviewing those rules, and particularly the impact of the TRA 1986 provisions, is that borrowing from life insurance contracts is often going to be less economically attractive for the individuals who are subject to the consumer loan interest rules. For corporations, there is the $50,000 limit, and we've got reduced tax rates on both sides.

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We can quantify that additional borrowing cost. It's very significant to a lot of our clients. If you look at a contract with an 8% borrowing provision, that seems like a good deal. If that 8% is now nondeductible, and you have to compare that with the deductible borrowing rate, that 8% becomes a 12%. If we have a direct recognition provision -- for instance a contract that pays 10% on non-borrowed funds and 7% on borrowed funds -- in a 33% tax bracket, that 8% borrowing cost is really 16.5% when you compare it to a deductible one -- 8 plus 3 divided by your .67 tax rate.

Before you're going to borrow from that contract at 8%, you're going to go to any deductible source at 16.5% or less. And that is something that a lot of our clients lose focus of.

Let's talk now about the like kind exchange rule -- 1035. For a like kind exchange without incurring tax, you can generally exchange a life contract for a life contract or an annuity contract for a life contract. You can give away your life contract and get an annuity. Those are all generally available. You cannot generally give away an annuity and get a life contract. If you could do that, it would be a terrific death bed transaction. You'd make all the potential tax on the annuity go away.

The first requirement is that you have two qualifying contracts to do a tax free exchange. But, you're not done yet. You can have something called "boot," which is the short term for either cash or debt relief that you are getting as a part of an exchange transaction. "Boot" is not good. Even if you have an otherwise tax free exchange, if you have "boot" you have to recognize taxable gain. That gain is the lesser of the "boot" and the gain realized in the contract.

Let's look at a quick example. Say you have a contract that has $10,000 of cash surrender value, a $9,000 loan, and $6,000 of basis. We exchange that for another contract which just has $1,000 of cash surrender value and no loan. What does the rule say? We've got a life for a life contract, which we're generally going to have, so we're OK. Do we have "boot?" Yes, the $9,000 loan went away. Do we have to recognize $9,000 of gain? No, it's the lesser of that "boot" or the gain realized; the gain realized is the $10,000 cash surrender less the $6,000 that we invested, so we've got a taxable gain of $4,000.

Those are the life kind of exchange rules.

The last set of basic rules that I'd like to go over are the rules for withdrawals and partial surrenders. The general rule is that the principal comes off first, your investment comes off first. The force-out rules under section 7702 may cause some income-first distributions during the first 15 years of a contract. I believe for the traditional whole life contract, it's typically a problem in the first five years more so than in the later ten.

With those basic rules as the groundwork, let's talk about the TRA 1986 and what it did to us. There are two preliminary conclusions that you come to when you review those rules. The first one, I've already mentioned -- borrowing is going to be a lot more expensive, generally. So, it will be less attractive.

The second preliminary conclusion is there are a lot of highly leveraged contracts, particularly in the individual market, that are not going to be viable. When I say the individual market, I'm also including leveraged life insurance

trusts. So, there are some minimum deposit contracts out there that are going to be in some trouble. Bottom line, there are going to be a lot of policyholders looking to reduce the amount of those loans or to eliminate them. Fine, how do we do that?

Two basic methods that we can start thinking about: the first, I'll call refinancing; the second, I'll call restructuring of policy.

Refinancing the loan is first. If the policy is no longer a cost effective source of funds, you have a couple of alternatives. One is to liquidate some low or lower yielding investment and use the proceeds from that to pay off the loan. That is something that a lot of clients, both corporate and individual, miss. They've got money in a money market that is earning 6% and they've got a policy loan that is costing them 16.5%. So you can liquidate an investment.

Secondly, if that is not a cost effective source of funds, borrow somewhere else. Right? Borrow from a more cost effective source and pay off the loan. Even if policy borrowing remains cost effective, the policyholder may still want to go through that refinancing transaction. Why? Under the TRA 1986 interest must fall under one of those first four categories to avoid nondeductibility for individuals.

What individuals may want to do, if they don't have all the tracing where that money went, is to liquidate an investment, pay off the loan, reborrow the money, and reinvest it in a way that can be documented it; i.e., go through a series of transactions where they can definitely document the loan. So, that is refinancing.

The other opportunity is restructuring. We reviewed the basic rules before, and it becomes immediately apparent when you go through the restructuring alternatives that two things fall out. There are no easy answers and you certainly have to have some cash in the contract -- substantial cash in the contract. If you are going to have a permanent contract with permanent death benefits, there has got to be some money in there.

There are basic approaches when you want to restructure. First, you could do the withdrawal or the partial surrender transaction. As we talked before in the basic rules, you can withdraw your basis, you can do partial surrender and you can get your basis out and pay off the loan. For example, if we had a contract with a $10,000 cash surrender value, a $6,000 loan, and a $7,000 basis. You can surrender $6,000 of that cash surrender value, -- you can surrender tax free or withdraw tax free because you have a $7,000 basis. When the loan is paid off, a contract with a cash surrender value of $4,000 remains.

Now by necessity, we know that the death benefit is going to come down, so we might look at a term rider. That's typically what most programs are looking at. But, often that is going to require some additional premium payments to replace the lost death benefits, and we also have to consider the section 7702 force out rules. For most of the contracts that we're looking at, since they're older contracts, they may well be grandfathered. So, that's kind of a partial withdrawal-surrender approach to restructuring.

You can look at the exchange opportunities as the second general path that you could follow. We went through those exchange rules before. You can start out with a loan contract and exchange that for another loan contract, but what have

you really achieved unless the new contract is, for some reason, substantially more cost effective. For that to make sense, the new contract has to be more cost effective, otherwise you have just re-incurred some commissions and other acquisition costs and haven't really gotten anywhere.

You can take the loan contract and do an exchange and get back a policy that has no loan, but then what problems do you run into? Those "boot" rules -- if the loan goes away as a part of the exchange, you may have a taxable gain. And secondly, starting with the same contract and the same company, you are just exchanging it for a contract with no loan on it. You can get the same result by doing the surrender-partial withdrawal we talked about before. You get to the same process -- pay down the loan without incurring all those commission costs. There are no easy answers.

Here are a few general conclusions regarding policy design after TRA 1986. We're definitely going to see that a lot of the gains with regard to policy loans are gone. It's going to be pretty much back to basics, and -- sort of an editorial comment -- that's probably positive. I think people are going to be focusing on the values that life insurance can realistically provide. The fact that it's a good investment without all these borrowing schemes that were a lot of times being viewed as abusive by Congress. So it's going to be a lot less focused on loans, clearly a lot more focused on vanishing premium approaches and full pay. People may actually want to pay premiums. We've been saying that for a number of years. For a lot of our clients, when you look at life insurance and how it stacks up as an investment, it makes sense to pay premiums. But, I think because of the way the agent presents it or for whatever reason, it is hard for the client to realize.

For both the individual and the corporate market, probably the key factor is going to be earnings available on unborrowed funds. The rate credited on unborrowed funds is going to be the key to competitiveness.

Here are a couple other little ideas after TRA 1986. We believe there is a big niche for life insurance as a life time financial planning tool. I bought policies on my kids with the idea, grandiose idea, who knows if it will ever come true, that I am using it to accumulate funds for their college education. If there is some money left in there at the time they want to buy a house, it will be available for that. They could use it later on if they want to finance a business. During their lifetime, once I'm gone, they can use it to accumulate wealth, continue to pay premiums as they desire and they can build it to the point where at their retirement, it is available to provide retirement income. And during their lifetime, they have gotten a good death benefit. I think we're just starting to see the uses of whole life really focus on that type of a broad lifetime approach.

There clearly is a place in the children's market for heavy premium, level premium contracts to finance college education costs. A lot of our clients are scurrying around now that Clifford trusts are gone, now that a lot of the other income shifting devices are gone. They are looking for places to put money to finance college education costs on a tax effective basis. Good quality, level premium whole life contracts can fill that niche.

The mixed products clearly are going to continue to proliferate. When I say mixed products, something where you can have term, whole life, some dump-in, -- we're going to continue to see that flexibility. As you all know, the big

problem from the clients standpoint is understanding it. It's hard to explain, it's hard for the agent to explain, it's hard for us to explain what was actually bought. So, that is going to be a key factor for us to focus on.

The other major problem that it presents is the ethical dilemma that the agent has when there are various commission rates on the various mix and match products. A real ethical dilemma occurs when he can get to the same end result four different ways and set his compensation accordingly. I don't think that we've found an answer other than good communication with potential buyers to address that.

As far as the individual market, generally, I think our clients, kind of the up-scale group, are definitely waking up to the fact that life insurance is a good solid investment. They are looking for places to put money. All their other tax advantage opportunities are drying up; i.e., qualified plans, discrimination rules, the 415 limits, and the excise on excessive qualified plan benefits. There's a new section 89 provision that is just coming into play, and it is very difficult to put money away in qualified plans. The IRA limits, 401 Keogh limits, -- all that money is going to have to go somewhere. Right now people aren't to excited about it because we have low tax rates. But once they, inevitably, begin increasing, that's something people are going to be stirring around for -- places to invest money on a tax advantage basis. Even municipal bonds, which were kind of the bed rock of the very wealthy individual, present problems because of the alternative minimum tax. So, clearly for the individuals there is a lot of opportunity for products to provide an excellent rate of return on unborrowed funds.

In the corporate market, once again, earnings on unborrowed funds are the key, but I guess there are two other things I'd also mention. Communication in the selling process is going to be very, very important. There is the alternative minimum tax, which can have a lot of effect on a company which owns corporate life insurance. There is something called FASB 96 where a deferred compensation plan financed with life insurance has a dramatic effect on booking of the tax benefits for the deferred compensation. Those are very, very complicated issues that any corporate buyer is going to have to examine.

With those comments, I conclude by saying that we are very optimistic about the industry.

MR. CHRISTIAN J. DESROCHERS: Dave has told you how valuable the tax deferral is to his practice, and as I was listening to him, it occurred to me that it must be valuable -- but look at what we've gone through to get it. At breakfast we were talking about 7702 and John had a great quote. He said, "You have to love it because it's all that is standing between the insurance industry and the inside buildup." As complex as the rules are and as difficult as compliance with 7702 is at times, certainly the alternative is much worse. Congress could simplify our lives with the stroke of a pen by taxing the inside buildup.

The existence of a definition of life insurance makes product design a difficult process. Clearly this section is highly complex. To say that it is little understood by people outside the insurance industry, I think, is an understatement. Additionally, it is a very difficult issue for a company to deal with because the penalties for noncompliance are largely on their clients and yet it is clearly within the responsibilities of the companies to assure that their products do qualify under 7702.

It's also clear that the product development process is often ahead of the legislative and regulatory process, so there are risks in any new product design as to whether or not it will qualify under 7702. At the same time I think in some ways we are regressing and things that two years ago I thought clearly were life insurance may not be. It seems the longer we spend looking at 7702, the more complex the issues get.

What I'd like to do now is to go through two of the aspects of 7702 that have an impact on product design. These are the role of guarantees and the role of the calculation rules. As background, section 7702 creates a series of requirements for an insurance contract to be considered life insurance under the Internal Revenue Code. The basic requirements are twofold.

First, the contract must be considered life insurance under applicable state law. This issue is interesting and it has become more complex as we've seen cases where there are questions as to whether a plan is insurance under state law. Second, to qualify, a contract must meet either a guideline premium and cash value corridor test or the cash value accumulation test.

The consequence of qualifying as life insurance is that the policy is eligible for the favorable tax treatment under Sections 101 and 72 of the Code, which provide a tax free death benefit and a tax deferred build up of policy values. Additionally, the reserves underlying these contracts are considered life insurance reserves for company tax purposes. At the same time, the consequence of not qualifying is that there is taxable income generated on the cash value buildup. This is equal to the interest credited minus expense charges on plans that don't qualify. In the year that disqualification occurs, the entire amount of the buildup would be taxable. The amounts at risk under a nonqualifying contract are still eligible for the favorable tax treatment under Section 101. However, the reserves underlying the contracts are no longer considered life insurance reserves.

Under the guideline test, the premiums paid under the contract cannot exceed the guideline limitation and the corridor relationship between cash value and death benefit must be maintained. The guideline limit is the greater of the guideline single premium or the sum of the guideline level premiums. The guideline premium test is a retrospective test in that a contract is assumed to be in compliance until it fails. Even though it may ultimately fail, it still qualifies as life insurance until the actual failure occurs.

Under the cash value accumulation test, the cash surrender value cannot at any time exceed the net single premium required to fund contract benefits. Unlike the guideline test, the cash value test is a prospective test and must be met at all times by the terms of the contract. Thus, a contract will which will ultimately fail the cash value accumulation test is considered to have failed at issue.

I believe the key to understanding the section 7702 limits is not so much in understanding the tests themselves, but in the restriction that 7702 places on allowable values. Recognizing that the purpose of 7702 is to restrict the tax benefits available to those plans which are considered to be too heavily investment oriented, section 7702 limits the allowable benefit patterns to which favorable tax treatment is granted.

There are three sets of limits which are used to determine values under 7702. Basically, they are the following: first, the contract provisions and guarantees;

second, the limits set within the statute on assumed interest mortality expense; and finally, the section 7702(e) calculation rules. In general, all guarantees under the contract are given effect in determining the guideline single or net single premium values, subject to the statutory minimum requirements on interest rates. Calculations generally follow the structure of the policy to the extent that the structure is not inconsistent with the calculation rule. This applies with respect to such issues as the annual versus monthly calculations or the use of continuous versus curtate reserve values.

The first specific area that I would like to talk about is that of the calculation rules. The calculation rules are found under 7702(e). Along with the contract guarantees and the limits that are placed on them, the calculation rules provide the framework for the determination of the allowable benefit patterns in both the guideline premium and the cash value accumulation tests. As I mentioned, these rules were designed to limit the prefunding of contract designs which were, in the mind of Congress, intended to manipulate benefit patterns and produce contracts with substantial investment elements.

I like to think that the effect of calculation rules is to create what I call a test plan. The test plan is used to determine the guideline premium values and allowable net single premium values under the statute. The rules don't directly limit the actual contract provisions but may limit those values indirectly by limiting the allowable cash surrender values or the gross premiums which can be paid.

There are four calculation rules which are set forth under 7702. The first is that the death benefit is deemed not to increase. The second is that the maturity date is deemed to be no earlier than attained age 95 or no later than the attained age of 100. The third is that the death benefits are deemed to be provided until the maturity date. And the fourth is that the amount of any endowment benefit is deemed not to exceed the least amount payable under the contract.

An exception to the level death benefit rules provided for certain types of increases in benefit plans. An increase in death benefit may be taken into account but only to the extent necessary to prevent a decrease in the net amount at risk. This provision is generally felt to have been put into 7702 to accommodate the so-called universal life option two design which pays the face amount plus cash amount but the rule also accommodates other increasing premium plans. The increasing death benefit rule does not apply in the determination of the guideline single premium, however.

What I'd like to do now is to discuss some examples of how these rules are often unclear in their application and can create some very difficult compliance issues. I'm going to do this by talking about three specific examples. The first of which is the definition of attained age for calculating section 7702 values.

Legislative history tells us that attained age should be within 12 months of the insured's actual age. This provision has a somewhat interesting history and I think has a much clearer explanation in the legislative history for TEFRA than in the subsequent writings. When I refer to legislative history here, I'm talking primarily about the Blue Book which is a pamphlet prepared by the Joint Committee on Taxation after a tax law passes. It contains a sort of after-the-fact legislative history.

The TEFRA Blue Book states that, with respect to section 101(f), attained age can appropriately be read as meaning insurance age determined by reference to contract anniversaries rather than individual's actual birthdays. It goes on to say that so long as the age assumed is within 12 months of the actual age, then it's reasonable to use insuring age as the attained age. Now that seems a fairly clear result, but it was expressed in a more shorthand fashion in the Blue Book for TEFRA which was the bill that enacted 7702. It has a reference to the notion that attained age should be within 12 months of the actual age. This has some interesting implications. First, it is fairly clear that age set-forwards which were a commonly used devise for substandard single premium contracts can create compliance problems. An age set-back which is in theory conservative may be acceptable but clearly set-forwards violate the "within 12 months" restrictions of legislative history.

Another interesting problem occurs in applying section 7702 to joint life plans. One approach which has been used is to define the values in terms of equivalent equal age. Where the equivalent equal ages are not within 12 months of the actual ages, I think some question can be raised as to whether or not this is consistent with the statutory limit.

Similarly, if values under joint life plans are calculated beyond age 100 for any particular insured, one wonders if this does not violate the second calculation rule -- limiting the maturity date. It seems reasonable that an equivalent equal age approach for joint life plan should be permissible, but it's certainly not obvious from a direct reading of 7702 nor is it obvious from its legislative history.

Another interesting interpretation of the calculation rules has to do with the treatment of a contract under which the death benefits decrease on a guaranteed basis subsequent to issue. Remember that the 7702 calculation rule only says that benefits are deemed not to increase. The issue which is raised is whether or not it is necessary to calculate allowable values under 7702 recognizing this decrease in death benefit. A literal reading of the calculation rules would indicate there is no requirement that this be done. At the same time there is a requirement that the 7702 values follow the structure of the policy. So, we have here a fairly significant inconsistency. But, so long as the benefits don't increase and the limits on maturity dates and final endowment are met, then arguably, a contract would qualify by either recognizing the decrease in death benefits at issue or recognizing them as an adjustment when they actually occur. Again, it can be argued that failure to recognize a guaranteed decrease is inconsistent with the notion that the contract structure must be followed in determining 7702 values.

At the same time, if the calculation rules permit the recognition of benefits where the contract provides no death benefits after a certain age, then is it consistent to permit a higher guideline limitation on a contract that has no death benefits past age 65 than on a contract where the benefits merely reduce past age 65? I certainly don't have the answer, but point that out as a sample of some of the inconsistencies that can occur in interpreting 7702.

The third example that I'd like to talk about under the calculation rules is the so-called least endowment rule. This says that the amount of any endowment cannot exceed the least amount payable under the contract.

Where the test plan used to calculate the allowable values runs to the end of the mortality table, the final endowment benefit has no effect on the guideline premium or the net single premium as its present value is zero. Whether that endowment occurs or does not occur or what its value really is has no impact on the calculation of the guideline premium or net single premium.

A literal application of this exception rule for increasing death benefit plans means that any pattern of increasing death benefit is permissible so long as the net amount at risk does not increase over the life of the contract or the life of the insured and the benefits are funded on a level premium basis to the end of the mortality table. This gives a considerably different result for an increasing face amount whole life plan than would result from a similar plan with values based on an endowment one year earlier. The interpretation that the least endowment calculation rule is not applicable to whole life coverage may be a result not anticipated by framers of 7702 and does result in higher guideline premiums and net level reserves than would be permissible if the actual maturity value were required to follow the least endowment rule. While it can be argued that such requirement on actual policy values is inconsistent with the test plan concept which occurs throughout 7702, it does appear to be the intent of Congress that maturity values or the cash values at maturity in excess of the least death benefit are not permitted in determining permissible value. But again, there is a strict reading of the procedures and application of the techniques that would lead to this result.

I have cited these as three reasons that we have some significant inconsistencies in trying to interpret calculation rules, and all these really do translate to is a great deal of uncertainty in product design.

Having addressed some inconsistencies in the calculation rules, I'd like now to address the difficulties created in trying to recognize contract guarantees. A few years ago, after the passage of the 1984 Tax Act of which 7702 is a part, I was at a meeting where John's partner, Bill Harman, was talking about the concept of federal minimum reserves. Bill made a statement to the effect that an assumption was made in enacting that provision that the actuaries, in fact, knew what Commissioners Reserve Valuation Method (CRVM) reserves were. This turned out, in Bill's mind, to be a faulty assumption, and I certainly wouldn't disagree with that statement. A similar statement could be made about contract guarantees. John said in a session yesterday that section 7702 was directed toward unbundled plans where contract guarantees were explicitly stated, and a logical first impression is that it should be a fairly easy process to identify the interest, mortality, and expense guarantee made in a life insurance contract. After considering the issue of guarantees, implied guarantees and secondary guarantees, I'm not sure that one can identify contract guarantees any more readily than one can identify CRVM reserves.

Let me talk for a few minutes about the issue of guarantees. The interest rate assumed in calculations under 7702 is the only contract guarantee to be so limited by the specific terms of the statute. The interest rate is stated as the greater of the rate or rates guaranteed on issue of the contract or the statutory minimum.

Section 7702 provides a limit of 6% to be used to determine the guideline single premium and a limit of 4% to be used in determination of guideline level premium and net single premium values. This reference to the rate or rates guaranteed upon issue of the contract recognizes that the rates used are the guaranteed

minimum or floor rate below which the contractual rates may not fall. This would presumably cover any guarantee made at issue whether it is made inside the contract or as an extracontractual guarantee, so long as it is enforceable by the policyholder.

Were an initial rate guarantee higher than the statutory minimum, however, that higher rate should be used for the period of the initial guarantee. The basis for the guaranteed mortality is the mortality charge specified in the contract or if no charge is specified, that used in determining the statutory reserve.

For accumulation contracts in which the mortality basis is explicitly stated, this rule is fairly clear in its application. However for traditional plans, the mortality rates themselves are not generally specified. The mortality table may be, but the assumed mortality charges are not. This can cause some technical compliance difficulties for certain plans. Let's look, for example, at a unisex product under which the cash values and reserves are not on the same basis. If we follow the NAIC model regulation on unisex plans, then the cash values are blended while reserves are sex distinct. A policy issued to females would not comply with a strict interpretation of the law. If mortality rates were imputed as being equal to the reserve basis, the rates would be female but the cash values would be based on the unisex table.

Unlike the interest rate, however, section 7702 does not explicitly limit the mortality charges that may be applied. In practice, however, it seems an insurance company does not have absolute freedom in setting the actual mortality guarantees. This concern was addressed in an article that was coauthored by John Adney in which he stated,

> While the statute permits the specification in the use of charges more conservative than those expected to be made at the time the contract is issued, the statute framers expected that market forces would limit the size of the charges so specified and hence, the amount of the increase in the guideline premium attributable to their conservatism.

In reflecting substandard mortality then, it would be reasonable to assume that the underwriting practices underlying the plan and the actual rate of charges should have some consistency, as section 7702 currently provides the Treasury with ample authority to limit the size of charges when they are considered excessive.

The expense charges which can be used in the determination of guideline premium values are not permitted to be recognized in a determination of net single premium values under the cash value test. So, expense charges may be recognized in guideline premium values but not in setting net single premiums. As is the case with mortality charges, the level of expense charges is again not specifically limited in the statute. Arguably, however, the commentary on appropriate levels of mortality charge is equally applicable to expense charges to the extent that the contractual expense charges must bear some relation to the actual economics of the contract and must not be specified simply to increase the allowable values.

An interesting development in this regard is the application of an asset-based expense charge. Although asset-based expense charges in variable life contracts have been applied for sometime, percentage of accumulation value charges have come into some use on fixed contracts as well, particularly single premium plans.

Under the guideline tests, the use of these charges has the effect of reducing the net interest rate at which the guideline premium values are determined. So, a 2% of accumulation value expense charge applied to a 6% guideline single premium would be the equivalent of computing the guideline single premium at an effective rate net of expense charge of 4%.

It would be interesting to see how this plays out through the Congress and the legislative process, but subject to the overall limits, there doesn't seem to be any restriction in 7702 as to the type of the expense charge which can be set forth in the contract with the exception that expense charges cannot be reflected in the determination of net single premium values.

Now that I've covered the straight four guarantees, I'd like to talk about two other types of guarantees which appear in the legislative history for 7702. The first are so-called implied guarantees. A concept developed in the committee reports on 7702 is what can be called the principles of implied guarantees. This was created as a device which limits the permissible level of prefunding by limiting the benefits that can be prefunded under 7702 to level face amount single premium plans. The need to recognize these so-called implied guarantees is based on a statement in the legislative history limiting the interest rate to a rate "assuming the use of the method in the standard nonforfeiture law." This was directed at contracts under which cash values are not determined in the standard sort of way, such as a plan under which guaranteed values are an accumulation of premiums with interest.

In this instance, legislative history says that a company will not be considered to guarantee a lower interest rate by failing to state a mortality charge and it prescribes procedures by which the interest rate is redetermined effectively bringing in the reserve mortality. In these instances the interest rate assumed is increased by the mortality charges which are guaranteed not to be paid. Now, if anyone really understands that, they can see me later and explain it to me. It means that in some cases, the interest rate would need to be increased because a plan is guaranteeing to not charge mortality costs.

There are also things called secondary guarantees, and any secondary guarantees present in a contract should be recognized in determining the appropriate guarantees under 7702. Secondary guarantees typically occur in fixed premium universal life contracts which have cash surrender values based on the greater of an accumulation value less a surrender charge or some type of minimum nonforfeiture value. The principle applied in this instance is that the greater of the accumulation basis or minimum nonforfeiture guarantee should be used to determine the actual value at any given duration. This can create an interesting discontinuation in that the values to be applied are typically different in the accumulation basis as compared to the minimum amount nonforfeiture guarantees.

I'd like to use single premium plans as an example to point out some of these problems in defining contract guarantees. Based on the commentary which I discussed earlier on the limitation guarantees as well as some fairly strong signals from the Congressional staff and Treasury during the current legislative session, we know that if mortality guarantees are too high, they are considered abusive in terms of creating too little insurance per dollar of premium. So, if we set our mortality at too high a substandard level, we can create some compliance problems under 7702. At the same time the limit on implied guarantees makes it equally unacceptable to guarantee nothing, that is to guarantee not to

deduct the cost of insurance charge. Thus, either too high or too low creates problems.

As an aside, I'd like to mention that a fairly large company, having a contract of this type recently announced that death benefits on certain types of these products would be increased and that seems to be the cure prescribed by the IRS -- that is, if you don't qualify, you would have to increase the death benefit under the contract with no additional charge to the insured.

The problem with guaranteeing not to deduct the cost of insurance is that it effectively allows the prefunding of an increase in death benefit in a single premium plan on a guaranteed basis. One of the fundamental assumptions in enacting 7702 was that this type of product is by its definition abusive and so would not be allowed.

Taken together, these two create a sort of interesting irony. If your mortality charges are too high, they are abusive as they allow the cash value to be too high with respect to the face amount. At the same time, if they are too low, that is also abusive as they can be used as a device to fund an increase in death benefit in a single premium plan. Thus, while we say in theory there are no limitations stated with respect to mortality charges, there are practical limits already present which restrict them from being either too high or too low. So, I would suggest that you can pick a number between zero and one for your mortality assumption. Since we know it can't be zero and we know it can't be one, it has to be somewhere in between.

The recent studies of universal life competitive trends indicate that illustrated values have been increasing. In a recent article, I saw this principally attributed to the so-called value enhancing techniques rather than any fundamental shift in credit rate levels or mortality charges or expense loads. It further pointed out that value enhancing techniques are principally of two forms, additional interest credits and persistency bonuses. These methods are generally not of a guaranteed nature but are reflected in current costs of insurance rates or current interest. To the extent that any type of bonus is guaranteed in the contract, however, the 7702 implications should be considered. To the extent that the contract structure is followed in determining the 7702 values, then the impact of the guaranteed bonus should presumably be reflected in a determination of applicable values. Obviously, however, if it's not guaranteed then it can be treated as any other nonguaranteed element.

I'd like to now offer a case study that I recently participated in to illustrate the impact of 7702 on product design. I've chosen this plan because it raises some interesting issues and it is not in the main stream of products offered by most companies. The product design that we are considering is as follows:

The plan is sold as a single premium or a limited pay plan and sold generally at small face amounts at older ages and usually on a guaranteed or simplified issue basis to fund the prepayment of funeral costs. Typically, the increases in benefits are on a simple rather than a compound basis and the gross premiums are often close to or in excess of the initial benefit.

Assuming that you've been asked to develop one of these plans and have some familiarity with section 7702, the first assumption that one makes is that it would be very difficult for a plan of this type to qualify as it seems abusive on its face because it's a single premium increasing face amount plan. However, there

is a qualification under 7702 which John referred to as the Louisiana exception which does provide for these plans, provided that they meet certain definitional criteria.

The limits in 7702 are as follows:

The increases may be recognized under the cash value test if the initial death benefit is $5,000 or less and the maximum is $25,000, if the plan provides a predetermined annual increase limited to 10% of the initial death benefit or 8% of the prior death benefit, and if the product is purchased to cover burial expenses. So, by designing the product under the cash value test and limiting the increases, one could then conclude that the plan did, in fact, meet the requirements of 7702.

If you're in Connecticut an interesting thing happens, however. Remember that one of the other qualifications under 7702 is that the plan must be life insurance under applicable law, and in Connecticut there is an attorney general's opinion that contracts of this type do not qualify as insurance because the risk element is not significant enough. Now, whether or not one agrees with the attorney general is not the point. Having developed a product which follows exactly the exception in 7702 for these products, if a company were to offer it in Connecticut, the risk would be substantial that the product would still not receive federal income tax treatment as life insurance. Although it meets the technical criteria of the statute, it does not meet the first assumption that a product be considered as life insurance under applicable law.

A similar result may be reached in certain situations with regard to the question of insurable interest. It seems to be an emerging principle of tax policy that if a contract does not meet the state requirements on insurable interest, then again it can have problems of compliance under section 7702 because it does not meet the "applicable law" limitations. This may be a way in which the Treasury is solving a concern that it has on the business use of insurance by attacking it on definitional grounds rather than directly.

MR. JOHN T. ADNEY: I'd like to confine my remarks today to two subjects: regulations that are pending affecting life insurance products and legislation that is pending affecting life insurance products, two very narrow subjects. At the moment, in case you haven't noticed, we do not have regulations under section 7702. If we did, Chris' list probably would have been different. It may have been longer, but it certainly would have been different.

The ACLI is in the process of starting talks with the IRS which has agreed to open a regulation writing project under section 7702. The ACLI is undertaking the formidable task of attempting to educate the legislation/regulation staff at IRS who are assigned to this subject. I think all parties expect that this will take a very long time.

Once IRS puts together its idea of how the regulations should look, it will then go to the Treasury Department which will put forth its ideas, and the process will continue back and forth until there is a draft of proposed regulations. That will be some time in coming and I would be surprised if we see it before 1989.

There is, however, another set of regulations which I think will soon be finalized affecting life insurance products and incidentally, life insurance company taxes. Those are the regulations under 817(h) of the code, the so-called

investment diversification regulation for variable contracts. Those regulations were issued in temporary and proposed form, which simply means that they are currently in effect and eventually will be finalized, in September 1986. The hearing was held in mid-1987.

The diversification regulation basically implements section 817(h) in which Congress instructed the Treasury to tell the insurance industry not how to invest for solvency or cash flow reasons, but how to invest separate account assets in such a way that it would not appear that life insurance or annuity policyholders were directly controlling the separate account investment. The concern was that the policyholder should not be able to pick and choose investments as if he had some sort of stock or bond trading account and at the same time enjoy tax deferral or tax exemption which you normally would not get with such a trading account. That was the theory of the diversification regulations.

As they came out, the regulations require that a separate account or a mutual fund in which a separate account invests, assuming there is no public ownership of the mutual fund or portfolio of that mutual fund, has not more than 55% of its assets attributable to any one issuer. The percentages grade up as the issuers multiply to the point where there may be five issuers in an account, and if it is maintained within the appropriate percentages, the account or the portfolio will be considered adequately diversified. There are special rules for real estate separate accounts, separate accounts investing in commodities, start-up periods and close-down periods. The tests occur at the ends of the calendar quarters with an opportunity to bring an account into compliance within 30 days following the close of the quarter.

There is also a special rule, statutorily prescribed, for variable life contracts which, despite the normal diversification requirements are permitted to invest up to 100% of a portfolio or an entire account in US Treasury securities -- not government securities, but specifically US Treasury securities. That rule does not apply to annuity contracts despite numerous efforts of the ACLI.

That's a general outline of the regulations. As a result of the hearing in 1987, it became apparent that while they raised some questions, the number was surprisingly few. They were simple enough that they seemed to be workable. On the other hand there were two principal complaints from the industry. One was the rule within the regulation dealing with the definition of one particular issuer, the United States Government. The other was the absence in the regulations of any provision for inadvertent error.

Let's talk about those two. The regulation, as I said, generally prescribed that an account must have no more than a certain percentage or a combination of percentages of investments from one or more issuers. The regulation reversed a series of IRS private letter rulings which had informally implemented all of this in the past and provided that whenever a security -- by the way, securities include cash -- is issued, guaranteed, or insured by the United States Government or any of its instrumentalities, that security will be considered issued by the United States Government, a single issuer. Therefore, no more than 55% of the account can be attributable to the United States Government as an issuer, save for the Treasury securities exception for variable life.

Now, the industry reaction to all of that was, first of all, that the Treasury overstepped its bounds of authority; that it was wrong, when it reversed IRS ruling policy; that it would obliterate a number of funds which were built around

securities of GNMA and the like, and in any event, the rule simply made no sense.

The Treasury Department responded that it liked the rule. The Treasury, I think, views this area and has viewed it since 1977 when the first of the so-called wraparound annuity rulings were issued, as a question of taxpayer perception. From the standpoint of the policyholder, perhaps as an investor, purchasing a variable life or a variable annuity policy, the concern was whether or not he is picking and choosing his investments. If he can go into a government fund, does it really matter to him which part of the government happens to be issuing, insuring, or backing that particular security?

The Treasury Department decided that it really doesn't matter to the policyholder/investor and all that really matters is that the government is standing behind it. That, apparently, is what gets sold. Accordingly, the Treasury Department is pretty much resolved to stand by this rule. It has announced some extensions of time for the application of this rule. The initial regulation said the rule would not apply immediately and indeed would not apply until July 1, 1987, even though all of the rest of the regulations were applicable immediately. That was extended twice; the current cutoff date is July 1, 1988, when the Treasury expects to have regulations finalized. Now, they have a lot of expectations at the Treasury Department, but I think they will probably come within a season of finalizing as of July 1.

The other principal complaint about the regulation was that it does not provide for relief from error and error can be inadvertent. These are not easy things to police. The Treasury's first reaction to the complaint was that the rule was intended to be tough. That if the rule were not harsh, people would cut things too close to the line, and the Treasury would have a widespread noncompliance problem.

Upon further thought, I think the Treasury has decided they do need to provide some mechanism for relief from error. I believe the final regulation will attempt to address this.

As I said, the regulation will be finalized soon, but that is not the end of this story. The preamble to the temporary and proposed regulation, in its concluding paragraph, has an interesting statement. You may know that the origin of section 817(h) in the 1984 act really did not originate there. It has its roots, I suppose, in revenue rulings that the Service issued as early as 1977 and came out again in 1980, 1981, and 1982, and in a series of private letter rulings. Those rulings, the so-called wraparound annuity rulings which were applied also to life insurance with private letter rulings, basically had the same thesis as the diversification regulation.

If the investments underlying a variable contract were structured so that the policyholder could have the appearance of investing on a tax-deferred or tax-exempt basis, whereas if he was operating in a normal trading account, it would all be fully taxable, those rulings, it was thought, perhaps had been supplanted by the enactment of section 817(h) and the promulgation of this regulation. I think the theory was that the regulations would be adequate to address all of the concerns about separating the policyholder from control of the underlying investments. But, I don't think that has been realized, and I do believe that the view of the executive branch of the government, at least, is that the wraparound rulings continue to have vitality.

Indeed, the preamble to the section 817(h) temporary regulation said:

> The temporary regulations do not address any issues other than diversification standards. In particular, they do not provide guidance concerning circumstances in which investor control of the investments of a segregated asset account may cause the investor rather than the insurance company to be treated as the owner of the assets in the account.

Thus, they would be taxed currently on the income from those assets. For example, the temporary regulations provide that in appropriate cases, a segregated asset account may include multiple subaccounts but they do not specify the extent to which policyholders may direct their investments to particular subaccounts without being treated as owners of the underlying assets. It then went on to promise further guidance in revenue rulings and regulations which have yet to materialize.

What does all that mean? I think it means that the Treasury and the IRS will continue to be on the lookout for instances in which, despite compliance with the diversification requirements, there is an appearance, -- I emphasize, appearance, -- of policyholder control over separate account investment. For example, suppose we have variable annuity contracts with 30 funds. The policyholder has the right to move money among any of the funds, in any percentage the policyholder wishes, at any time. The funds range from money markets to various classes of bond funds, various classes of stock funds, the steel industry fund, the auto industry fund, farms in northeastern Arizona, and various other things in smaller and smaller categories. Now, is that investor controlled? I submit to you, the IRS would have a lot of trouble saying that was not investor controlled, even though it may very well be able to comply with the diversification regulation. I think that is an extreme case and I don't think it resembles yet any contract that is out in the market, but it is just a question of time before the contracts get there.

I would caution everybody to think about the investor control issue and perhaps to apply to the Service for a private letter ruling before crawling too far out on the limb on this subject. The Service will take rulings on the subject. That is all I want to say about regulation. Legislation is a different story.

The TRA 1986 has had a variety of explanations. We've seen recently from Don Regan's book that there may even be an astrological explanation for the Act. That might actually be the one that really unravels its mysteries for us. Following TRA, as everyone knows, many of the tax sheltering opportunities that were out in the world were closed down, and the insurance industry wasted little time shooting itself in the foot by marching out to the fore with full page advertisements in the Wall Street Journal and elsewhere touting the fact that it had the last great tax shelter. That was identified as single premium life insurance under which the policyholder could borrow free of tax and could take those borrowed funds, which were really the inside buildup of the contract as it was deferred or tax exempt, and go out and buy yachts and toys and things like that. So said the advertisement.

Whether any of that purports in the least with reality, it had an impact, and I think all of you are well aware of that impact. This was a case of extraordinary bad judgement. I doubt that many sales were produced by such advertising.

I'm sure many egos were gratified, at least until Congress began looking seriously at the claims that were made by those advertisements.

Congress did indeed begin looking seriously at them as soon as they began appearing in the newspapers. What Congress and Congressional staffs determined after their study of the matter was that in their view the tax policy challenge or problem that the advertisements called to Congress' attention hadn't very much to do with the inside build up of life insurance or the single premium form of life insurance, in particular. But, it had a lot to do with the current use of money on a tax free basis even as that money was building up inside that policy tax deferred. It was not lost on the staff that this same issue had been addressed in 1981 and 1982 for deferred annuity contracts. The answer to such problems for annuity contracts was to tax withdrawals on a gain out first basis, the so-called LIFO rules that exist for annuities in section 72(e) of the Code, to treat policy loans as distributions subject to those LIFO rules and to apply penalty taxes on top of those distributions. The purpose of the tax on those distributions was to compensate the government for the time value of its money, the tax money that it had foregone by granting the deferral.

So, when the staff looked at the matter for life insurance, I don't think it's at all surprising that it came up with exactly the same set of solutions. The appropriate cure for the problem posed by the advertisements, the tax sheltering that was touted there, was to tax distributions on a LIFO basis with a penalty tax and treat loans as distributions. That is indeed the solution that is presented in HR 3441 introduced by Congressmen Stark and Gradison on October 7, 1987, applicable to all life insurance contracts. There was limited grandfathering in the bill for contracts that existed on October 7, 1987. As to those contracts, only new premiums after that date would pick up the new rules and one could recover one's investment in the contract up through that date by loan or otherwise under the rules of the old law.

This obviously created a great deal of consternation within the insurance industry which was not quite sure what to do. The first out of the barn, as a reaction to all of this, was the agents association, the National Association of Life Underwriters (NALU), joined as well by the Association of Advanced Life Underwriting (AALU), and their counter to the Stark-Gradison bill was to change the definition of life insurance, to treat single premium policies and near single premium policies, really up to five-pay policies, as not being life insurance. They carved them out of the definition, to subject their inside buildup to tax, and generally to wipe them off the face of the earth.

Some people thought this was a bit extreme and the Hill staff looked at it and concluded it was totally unresponsive to the problem. The company association, ACLI, studied the matter and decided to keep on studying the matter for some time. An ad hoc coalition of single premium writers and other companies formed the Committee of Life Insurers, which took a strong stand in favor of current law and also took the position that the single premium product was a good product and went out to defend it.

Hearings were held in the House and in the Senate in March where all the parties were heard. But, just prior to the hearings, an historic vote occurred in the board of directors of the ACLI. The board members, meeting March 2, 1988, felt that the council's nonreaction to the legislation was not appropriate and they voted 16 to 3 to take the historic step of agreeing that life insurance policy loans should be taxed. They said that they should be taxed for a limited

duration on a limited class of policies. That began to put together the outline of the ACLI proposal and ultimately, an industry compromise proposal.

I won't bore you with all the details in the meantime but simply report that at least when I left Washington last Friday, the NALU, the AALU, and the ACLI all had a common position. That common position was more or less along the lines of what the ACLI board approved in its March 2 vote, and that position was to take contracts which would have been subject to the NALU proposal, the fivepay contracts -- five-pay or fewer premiums -- , and to say that these contracts would have their loans taxed on a LIFO basis, and have their other distributions taxed on a LIFO basis, as well. There would not be a tax on inside buildup, the death benefits would continue to receive full tax exemption, but these contracts, the single pay and near single pay contracts, would begin to get the treatment of the Stark-Gradison bill.

The proposal as agreed to does not give the full Stark-Gradison treatment to these contract distributions. For example, there is no penalty tax in the ACLI, AALU, NALU proposal. Also, the proposal would apply the LIFO treatment and the treatment of loans as distributions only for the first ten years of the policy. Also, it is the common position of all these industry organizations that the bill should be adopted with complete grandfathering of the existing contracts. The rules should be prospective by contract issued after whatever effective date Congress decides. Probably that date would be, at least initially, the date of any Ways and Means Committee action. We'll get to that in a moment.

There is a compromise proposal out there. Thus far, I think, following the discussion of the hearing in the House and the Senate in March, the Hill staff considers this industry proposal to be a good start. It doesn't think it goes far enough; it obviously wants to get closer to Stark-Gradison. The Treasury Department, in its testimony in March, fairly well endorsed this sort of approach, but I think the Treasury would also agree that the industry suggestion doesn't go quite far enough. I think the industry knew that and that is why it put it together the way it did. It expected further compromise in the legislative process.

Does this mean that a change in the definition of life insurance is dead? Well, no it doesn't. In fact, part of the industry proposal is to change the definition of life insurance. The change would be more cosmetic than real, but the nature of the change would be, say, for a contract to be treated as life insurance for federal income taxes purposes; 7702A would be written in these terms. A contract would either have to be a life insurance contract under current law and meet the five-pay standards of the proposal or it would have to be modified endowment.

Now, you ask, what is a modified endowment? Well, that is the new term. A modified endowment is any contract that is currently recognized as life insurance but that can't meet the five-pay test, i.e., the single premium contract or a near single premium contract. There would be some change in the definition.

I think it is also conceivable that staff people on the Hill will be looking at other possible changes to the definition. They are concerned about overstated mortality and expense charges; they are concerned still about seeing the advertisements crop back up even after some proposal is enacted. It is possible that you will hear something about that, but I think it's far more probable that what we will see is the proposal coming out of the staff to be presented to Ways and

Means that will be somewhere between the ACLI, NALU, AALU proposal and the Stark-Gradison bill. It will be somewhere on that continuum, focused on distributions and loans and just asking how are we going to tax them and what types of contracts are we going to give this treatment to.

All of this presupposes that there will be a tax bill in 1988, and that is the bigger question. Nobody knows whether there will be a tax bill in 1988. In other years we heard predictions that a tax bill would die but it somehow sustained life and kept on going and ultimately got enacted. This year is a bit different.

The main bill that is on the table is the Technical Corrections Act, technical corrections to the 1986 and 1987 Acts. This bill has a lot of interest among technicians. There are numerous taxpayers who are carping at numerous Congressmen to get this thing enacted so they can get their taxes straightened out. The bill, along with a few add-ons, has one little problem. It loses a lot of money. It loses $3-$4 billion in the few years, and the question is, where is the Congress going to raise the money to make up for that. The bill, in order to be enacted, must be revenue neutral.

The single premium life insurance issue, as it has been described, can raise some money, and that's the reason why, if there is a markup of the Technical Corrections Act, it will get on there. It's a revenue raiser. The staff expects it can get $300 to $400 million revenue estimates out of it. That's different than $300 to $400 million in actual taxes, those are revenue estimates. Revenue estimates are whatever the Joint Committee staff say they are. But, the bill is worth something.

The real problem facing Ways and Means is it doesn't have much else to put into the bill. And, I don't think it thinks it would be worth the political pain of redoing a lot of other tax rules in order to make up the difference. It is quite possible that Ways and Means will begin a markup sometime after June 6, and that markup will get under way and take in technical corrections and other odds and ends that members want. Transitional rules, of sorts, to the 1986 and 1987 acts, will bring in the single premium issue, and then the whole machine will stall for want of the rest of the revenue and the votes to bring it in. I think the Ways and Means fully expects that if it cannot conclude a markup before the convention season starts which will be late July, it is really not going to be able to get a bill to the House floor at all.

So for 1988, the single premium controversy may turn out to have been much ado about nothing. That is too close to call right now, but all of that is a distinct possibility. As the days have worn on there is more and more pessimism from the Ways and Means Committee about its ability to put a bill together.

What does that mean for the insurance industry? That doesn't mean the issue will go away. These issues never go away. In 1989 the Treasury Department is expected to put forward a study, a report to Congress, on how well the 1984 law is doing and how it would change the 1984 law, including the definition of life insurance, the tax treatment of policy loans and other distributions, and on and on. I would expect that if nothing happens this year on life insurance, the Treasury will raise the matter next year. And even if something does happen this year, the Treasury will raise the matter again next year, so I think we are going to see continuing focus on the life insurance product questions. I think later on this year we will also see some focus on the corporate tax questions

affecting life insurance companies. The Treasury has recently said that it expects in the first few weeks of June its long awaited report on revenues from the life insurance industry under the 1984 law for 1984 and 1985. After that happens, the Ways and Means Committee is expected to have a hearing in its select revenue measures subcommittee, not necessarily to do anything in reaction but at least to have an oversight hearing.

Life insurance, I think, will continue to be brought to the fore, and in an age of deficit reduction, that is not good because that usually means that we end up somewhere on the short end of the stick. It will be necessary to remain watchful.

MR. DESROCHERS: As I've been sitting here listening to Dave and John's presentations, it seems to me there are three general things that we can say about relationships to taxes and life insurance. First, life insurance with the deferral of tax on the inside buildup and the tax free death benefit is a very attractive provision for the life industry and it is one that has a great deal of value and should be preserved. Second, the price of maintaining that tax free treatment is that we will be faced with a continual list of technical compliance issues, not only with respect to the definition, but also with respect to investment control, loans and other issues. Third, the outlook for the next several years is that we will be under continual pressure to lessen the attractiveness of tax deferral and that if the advantages are to be maintained, then the industry is going to have to work very hard to maintain those advantages.

MR. MELVIN J. FEINBERG: If some version of the ACLI and AALU proposal is adopted this year, do you think there will be an opportunity to get (f)(7)(B) repealed?

MR. ADNEY: Nobody seems to like (f)(7)(b), you're right. I don't think it will be repealed for contracts upon which the new rules have no effect -- previously issued contracts, assuming we get prospective treatment of the new rules. I do think that if something like the ACLI proposal or somewhere between ACLI and Stark-Gradison gets enacted, then a good case can be made that (f)(7)(B) is dead wood -- it might already be dead wood, but at least to officially confirm that -- and to get it repealed.

That does not appear as an agenda item in the ACLI, AALU, and NALU position paper simply as a matter of simplicity. The decision was made that it could be raised with the staff people later on once we saw the contours of the legislation.

MR. LYNN C. MILLER: What will happen to Stark-Gradison and the effective date of October 7 if there is no action on single premium life this year. Will that just fade away and we won't have to be concerned about the October 7 date?

MR. ADNEY: I think the October 7 date will fade away and probably already has.

What is not going to fade away, unfortunately, is the debate about whether any new rules that come in would apply solely on a prospective basis or would affect existing contracts by having a new money rule. By that I mean, the rules would attach to premiums paid after whatever date is specified in the legislation. That was the approach taken for annuities in 1982 and while it does not work well at all for life insurance policies, I think the Hill staff people are still

enamored of it. It seems to be, at least from their perspective, the ideal antiabuse provision. It isn't the date that would continue to haunt us, but it is the prospect of a form of grandfathering that is not complete enough. From that standpoint, it might even be better for the industry, if the Ways and Means Committee were to get going on this, to put together some sort of single premium proposal to adopt complete grandfathering and then to have the machine stall. That might be the best of all worlds.

MR. MILLER: What's interesting about the provisions of grandfathering of Stark-Gradison is that it really protects single premium policies that were sold prior to the date and disadvantages the policies that are considered nonabusive.

MR. ADNEY: That irony has not been lost on the industry. I don't think that the Hill necessarily perceived it that way, but I think in further discussions the Hill people are being educated. My guess is that, for that very reason, we may very well be able to get complete grandfathering. I think it is high on the members priority list. It's a little lower down on the staff's priority list. The industry may still have to concede certain things in order to complete grandfathering. For example, the Hill people are still quite worried about enacting a new set of rules and giving them prospective treatment by contract and then watching old contracts being used and modified and changed in ways that they become the new wave of single premium contracts. So the ads are no longer, "Buy our single premium policy," it's "Bring in your old policy and let's see what we can do with it."

For that reason, it may be necessary to take a tough rule on material changes, such as what was present in the definition of the life insurance transition rule in 1984. By that I mean to say that while an old contract would be grandfathered, if that contract were materially changed in any way -- the death benefit was changed, whether that was done with or without evidence of insurability -- then that would become a new contract for this purpose. So everybody should be aware that there may be something that may be sitting in the effective date rule which will look a little less like prospectivity than you might desire.

MR. MILLER: One more question regards diversification. You gave the example of 100 different funds. Is this diversification issue that you are talking about more focused around the ability of the policyowner to move money from one fund to another and have multiple choices, or is it the nature of those funds being more and more refined to deal with a specific type of investment, like a sector fund? Or is it both?

MR. ADNEY: I think my concern is with both. I think the two are interrelated and I'll tell you why. First of all, consider a policy with a group of funds under which you had to make a choice of what you were going to invest in when you paid the premium, and could never change it thereafter. I don't know why anybody would buy such a thing, but if that were the design, I'm not sure the government would be terribly concerned about that.

Similarly, if you had a choice of two funds and could move the money back and forth anytime you wanted, I don't think the government would be too concerned about that. But as the funds proliferate and the number of transfers proliferate, I think the government gets concerned that it looks like nothing more than a tax deferred or tax sheltered trading account. I think there is also a concern, though somewhat different, about the scope of the fund. The narrower the fund, then the more it's going to look like the policyholder is picking a

particular investment when he goes into it. I think there is lots of room to argue about whether that is so, but again, what you are dealing with is a question of perception. And if the Treasury Department decides that there is a strong enough perception among potential purchasers of these products that they are really controlling investments, that will be enough, I think, to cause a pulling of the plug, if you will, by a revenue ruling or regulation on this. For that reason, we have advised people to disclose in prospectuses that there is considerable uncertainty here, that there is risk, and that we've also advised people to reserve the right to amend contracts as necessary to comply with any future changes in the tax rules. The last thing I would mention is that, if all of that is not bad enough, Congressman Stark has also gotten wind of this and it wouldn't surprise me at all if by no later than 1989 this became a legislative issue.

MR. MILLER: Did you say that some time this summer we expected some final regulations or rules on this issue?

MR. ADNEY: On the diversification regulations generally, yes. Not on the control issue. I don't think you are going to see anything on that anytime soon. Maybe a private letter ruling within the next year.

MR. ALAN MARK EMMER: Mr. Adney, any ruling on whether a paid up additions rider would be considered single premium or on how it would have to be structured within a contract to not have the single premium rules apply? Particularly if the proceeds were withdrawn just to pay premiums?

MR. ADNEY: Your question is whether it would be viewed as a single contract or as two pieces -- the base contract and the paid up additions rider. Under 7702, generally it doesn't matter that much because it will work out either way. But under the ACLI proposal it could matter very much if that paid up additions rider was treated as a separate contract, because as I understand the way it is structured, it would not be able to meet the five-pay test of the ACLI proposal, which is more or less the same five-pay test that NALU has been working on in different incarnations.

I don't think we've got a clear answer for you right now. It really depends on whether you glue those pieces.

MR. EMMER: I'm familiar with with the ACLI and NALU discussions and it's clear from the people who met and worked these formulations that the whole life policy and the paid up additions rider would be unitary.

MR. ADNEY: Well, I was a part of those discussions and it is not clear to me. With respect to paid up additions, generally, you are right because we've carved in specific rules on amounts retained in the contract. The problem with the paid up additions rider is that it is arguably a separate contract. I don't think you are going to know the answer, but it could very well go the way you say. If it could be made clear that you glue the pieces together and test it and there is no problem. It is not a modified endowment. But, right now, I would say from what I have seen, based on the rules of 7702, I think it is unclear. I don't know how to call it.

MR. EMMER: You had mentioned before that substandard age rating could be a problem. Since so many companies do it, isn't it possible that that would be considered a guaranteed mortality charge within the contract?

MR. DESROCHERS: It's possible and I've seen some discussion of it. I think it comes down to the interpretation of attained age. Certainly, on its face it can be considered abusive in the sense that it allows you to have higher guidelines or net single premium values than you would otherwise have. So, if you are looking for abuse one could say, well, why couldn't everybody be substandard. Why wouldn't we just apply this to everybody? We've got a guaranteed issue product and therefore we set forward everybody's age. I think that the problem is separating legitimate use from abuse and the tendency is to throw the baby out with the bath water. If it is perceived as abusive, they would just as soon throw it out. I think that in the Blue Book language on attained ages, they may have known what they were talking about, they just didn't say it very well. It causes a number of problems and that is one of them. I would have a great deal of concern about that.

MR. ADNEY: I also might add that there was some correspondence with the Treasury Department. Integrated Resources wrote in through their counsel asking for clarification on the age rating question and the Treasury twice turned them down, informally. Treasury didn't write back to them, but basically concluded that this was not a permissible approach under 7702 and was not something that Treasury wanted to permit by amending 7702.

MR. DAN R. SPAFFORD: In the Blue Book under adjustments there is a paragraph -- I think it applies only to the cash value accumulation test products -- about changes in face amounts or adjustments to the contract you are to assume as a new issue. Is it absolutely clear that you should take into account all the guarantees at that time? Also, what was the point of putting that in since under a cash value accumulation test product, it has to meet the limitation at all times anyway?

MR. DESROCHERS: We were talking about this last night so I know John has a good answer for it. I think that is a very legitimate question and one that is going to cause some interesting compliance problems.

MR. ADNEY: Dan, I think you are on the cutting edge of the question. I don't think there is a very clear answer to any of this. I think the right answer, probably, is that when you have the benefit change under a cash value test product, you do need to adjust the net single premium accordingly. The typical example would be a level face policy on which you added a paid up addition. There you would simply adjust up the net single premium to cover the cash value attributable to the paid up addition.

I think you raise several questions with that. Is that an adjustment, first of all? And secondly, if it is an adjustment, what do you need to do if any outstanding guarantees are in the policy at that time? And I take it in particular, what you are concerned about is a policy which has renewal excess interest guarantees. The question is would you need to go out and determine that net single premium for the policy, not on the basis that you've been using since issuance but reflecting for the period of time it's in effect, the excess interest guarantee, the renewal guarantee. What makes that a little ironic, with all of its complications and problems, is that on the other side of the government, at the Securities and Exchange Commission, you have a safe harbor rule that says if you have an excess interest contract you ought to have at least a year guarantee of excess interest in order to avoid treatment as a security. It is not an absolute rule, this safe harbor; it's before the Supreme Court right now. But, it's there. So how do you mesh all these things together.

My answer is that I think you can ignore the renewal guarantee whether it is an adjustment or not. And I ground that on the notion that it doesn't make any sense to take the renewal guarantee into account. The rule is probably different under the guideline premium test which is operating in a somewhat different world. Under the cash value accumulation test, principally because it assumes you will have a mechanism in the policy to assure compliance in all events from day one, you cannot be held to just assume what future excess interest rates or mortality rates are going to be aside from the permanent guarantees in the contract and any initial guarantees. So, I don't think that you would be held to that standard. I think if you were held to reflecting those guarantees, the cash value test would sort of reduce down to a pile of gibberish with which no one could ever comply. There would be great disparity between cash value and guideline premium, which I don't think anyone would want, including the IRS.

I also don't think it was intended by Congress to work that way. That's true of renewal guarantees and that's my approach to it. As far as whether this is an adjustment, there is certainly a lot of discussion in the legislative history, as you suggest, about the fact that this is an adjustment, but the adjustment rule sort of got ahead of the legislative language. The statute is what controls, not the legislative history, in the event of any conflict between the two. The statute is what is passed by Congress. Section 7702 had an adjustment rule dating back to 101(f) days and that was also true of the cash value accumulation test. All the language you see written in legislative history about adjustments was written in connection with 101(f) and the way adjustments work there.

Subsequent to all that, and I believe it was at some point in late 1983 or 1984, section 7702(b)(2)(c) was added to the statute as a sort of automatic adjuster for the cash value accumulation test. I think that rule could be interpreted to take all changes in that single premium out of the adjustment rule. If so interpreted, you wouldn't worry about renewal guarantees, and then all the discussion in the legislative history becomes gibberish. So, the question is what do you give effect to, the statute or the legislative history. I think it is an interesting debate. Again, I think the bottom line is whether the change under the cash value test is an adjustment or not; you should not have to reflect the renewal guarantee because ultimately that makes no sense.

MR. SPAFFORD: I have another question for you, John. You know the investment timing services and asset allocation services that were seen on variable annuities, how do you think they are going to affect the Treasury's view? Are they a good thing or are they a bad thing in terms of the policyholder controlling the contract?

MR. ADNEY: I'm glad you raised that. First of all I think it will help focus the Treasury's attention further on the product, which is not good. I think the Treasury could ultimately come down to two entirely opposite conclusions. One is that this is prime evidence of policyholder control, and the other is that it is merely a way of reinventing the old style variable annuity with one fund that was fully managed. And, exactly where they'll come out, I don't know. I'm not sure they will ultimately be able to reach any conclusions based on the existence of that service, principally because the Service does push it back toward independent management and away from policyholder control. But what I think it will do is focus the Treasury on the fact that the underlying contract that is using that service is one that may just be admitting that there is a lot of policyholder control, potentially, there.

MR. DONALD A. SKOKAN: There are several companies that have introduced long-term care riders that are being attached to universal life policies. Am I correct in assuming that those would be nonqualified riders or is there some means of considering them as qualified riders to a universal life policy?

MR. DESROCHERS: It raises a couple of interesting questions. Long-term care has the attention of Congress and so it is very likely that in the next Congress the issue of long-term care will be dealt with. I think it is very much in the interest of many of the members to do as much as they can to encourage long-term care. I think we have two situations: what is currently the case, and what may be the case subsequently.

Currently, I think they are and would be considered a nonqualified benefit. To the extent that it was prefunded, it would be offset against the limit. I also think there is an interesting question raised as to the contract during the pay out stage -- if in fact it doesn't change from life insurance to either an annuity type of contract or a health contract. There are certainly some issues raised, not only about the qualification but the taxation of those benefits to the person receiving them. There is a lot of uncertainty right now as to the status of those contracts, but I believe that if Congress acts other than to enact the Kennedy provisions which would take the long-term care out of the universe of private insurance, then I think we will see some action which will make conditions favorable for offering that benefit. It does seem to be their interest to act on long-term care. Although currently there are many questions raised, there is a very good chance to get clarification of that next year or perhaps the year after.

MR. SKOKAN: Do you have any speculation on how the benefit payout might be taxed assuming that there is no subsequent legislation or regulation?

MR. DESROCHERS: I think they will take a favorable view because I think it is looked at as something that is socially desirable. They may try to either treat it as an incidental benefit or treat it as some sort of health benefit which would not be taxed.