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FEDERAL INCOME TAX -- EMERGING ISSUES

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Recorder: VIRGIL D. WAGNER

- o Panelists will discuss and exchange points of view on the following:
  - -- The climate which prevails in Washington with the continual need for "revenue enhancement" as part of budget reconciliation and the potential effect on life insurance as evidenced by recent actions and targeted revenue options, e.g., life insurance reserves, capitalization of expenses, expansion of the alternative minimum tax, etc.
  - -- The issues relative to taxation of "investment oriented" products, e.g., single premium life.
  - -- The issues relative to proper balance in the taxation of mutual and stock life insurance companies (Sec. 809).
- o Any late breaking developments on these or other issues will be included.

MR. DOUGLAS N. HERTZ: Mutuals and stock life insurance companies are both taxed on gain after dividends and before federal income tax, with adjustments made to reflect tax accounting concepts. Mutuals, however, get an addition to income done technically through the mechanism of a dividend disallowance. The addition to income is called the differential earnings amount. It is computed by taking a rate called the differential earnings rate and multiplying it times the mutual life insurance company's mean equity. Equity is an expanded version of surplus. It's meant to be something akin to the working capital of the company. As a practical matter, it tends to come out being about one and a half to two times the company's surplus. It's defined as surplus plus Mandatory Securities Valuation Reserve (MSVR) plus nonadmitted investment assets plus half of the dividend liability plus the excess of statutory over tax reserves. The differential earnings rate, the rate multiplied times equity, is found as the difference between an imputed earnings rate and the overall average mutual earnings rate. Technically, I think the law says it's the excess of the imputed rate over the average mutual rate. That fact may become relevant later on. The rates we're dealing with here are computed by taking statement gain and dividing by mean equity. Statement gain is the annual statement gain from operations after dividends and before federal income tax, adjusted to reflect tax reserves, tax deductible dividends and capital gains. One way to look at the imputed rate

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is it's 16.5% and it's indexed to stock company earnings rates. So it comes out being 16.5% multiplied by a quotient -- the current period stock rate divided by the base period stock rate where these stock earnings rates are numerical averages of the rates of the top 50 stocks over a three-year period. For the current period rate, it's the immediately prior three years, and the base period is 1981-82-83. So the base period rate never changes. It came out when they measured it to be 18.221%.

The average mutual rate in this formulation of taking the imputed rate and subtracting the average mutual rate is a weighted average among all mutuals. You add up total mutual statement gain and divide it by total mutual mean equity, and you get the average mutual earnings rate. Use of a weighted average here gives rise to something known as socialization, the tax shifting that has become so unpopular among the mutuals. The fact is that if one mutual company lowers its earnings and saves taxes, the rest, because the average mutual rate goes down, make up that difference in their add-on tax.

I suppose there are two views that you can take toward this add-on income -- roughly a stock view and a mutual view. The one view is that it is merely a segment balance device. That 16.5% was chosen in this bizarre formula to produce a 1984 tax arbitrarily set in the political process in 1984 at 55% share for the mutuals and 45% for the stocks. A second view would be that this whole formula is an attempt to approximate aggregate mutual income including equity earnings paid out to owners as policyholder dividends or benefits.

We're due to soon see the first result of the Treasury studies of revenue and segment balance that were mandated by the 1984 act. Section 809 with its imputation of income to mutuals was so unusual and controversial that Congress felt that they ought to take a second look at it to see how it works out. It's at least half likely that we will see a preliminary report from Treasury by the end of this month. Unfortunately, that report is likely to contain very little analysis. The man at Treasury primarily responsible for doing this work, Mike Kauffman, is still calling companies and asking them to resolve for him what he feels are apparent inconsistencies or difficulties with the data that was sent in. Companies were requested to mail in data approximately a year ago, and Treasury has been polishing the numbers ever since.

It isn't clear, incidentally, just what numbers they'll present or stress. They have an incredible amount of data. One question that they're going to have to address in some fashion when they decide what numbers to present, for example, will be whether to look at incurred tax or cash actually received in the till at the IRS. The naive answer perhaps is that you should look at cash that was received. On the other hand, the revenue targets set in the process of enactment of the 1984 act were all on an incurred basis. It isn't clear what role Treasury will give to such things as pre-1984 net operating losses, which were carried forward to offset income in 1984-85. Somehow these operating losses seem a bit irrelevant to the operations of the 1984 Act. Similarly, it isn't clear what role Treasury will assign in looking at the data to the role of credits and preferences, many of which were later eliminated by the 1986 act and hence seem irrelevant. The role of consolidation in the segment balance question is another item that Treasury may or may not come forth with an opinion on. I should say that the opinions that I am giving here are mine. I'm not here as a spokesman for the mutuals. It is all personal, and many mutual representatives would disagree with at least part of what I have to say. My own feeling is that the consolidation itself is proper tax policy, and there's no quarrel with the fact of

consolidation. It's the interaction of consolidation with segment balance that is somewhat controversial. One way of putting it is to say that it seems inappropriate to ask mutuals to send the Treasury 55/45ths of amounts that stock companies are giving to their affiliates.

Among other things the Treasury may or may not choose to comment on at this time would be measures of segment balance. Does Treasury think that there is any measure that gives credible results? We'll have to wait and see on some of that. On segment balance, when the 1984 act was under consideration, Pete Stark described the bill that was finally enacted as a black box with two knobs on it. There was a revenue knob -- the late lamented taxable income adjustment that gave our industry a rate adjustment. And then there was the segment balance knob -- the imputed earnings rate, the 16.5% in the formula I described. The balance issue really concerns the propriety of setting arbitrary targets for segment shares of tax revenue and then rigging definitions of income so as to produce those results. As a first reaction, it seems clearly dumb. What should be done is to define income, and tax it where you find it. The balance scheme doesn't seem to make much more sense than allocating revenue shares for the auto industry among Ford, GM and Chrysler, something that I have not yet heard proposed.

The desire to do segment balancing seems to come out of a feeling that mutuals have large amounts of unreported and, in fact, unidentifiable income. I personally reject the model on which present law seems to be built. That model is that mutual company policyholders contribute capital to the company in the form of so-called redundant premiums and seek equity returns on this investment just as shareholders will. This is a view of policyholders as owners of a mutual company. In some measure this seems kind of silly on the face of it. You have to ask yourself why a mutual company would extract equity returns from its policyholders just in order to turn around and return them to the policyholders in proportion to the way it was contributed. Mutuals basically just are not organized to generate equity profits. Another way of looking at it is that I do not hold a second job. Nobody has ever proposed taxing me on the income that I thereby choose not to earn. It isn't clear to me why mutuals should be taxed on income that they do not earn. In this connection I would note that in 1985 the Supreme Court took a look at the ownership status of a mutual entity, in the instant case it was a bank, and decided that mutual members are not owners of the organization in anything other than a nominal fashion in an ongoing mutual. That was the Paulsen case, 1985, if you care to look it up and see how the Supreme Court came to its conclusions.

But, even if you accept the equity model of mutuality, the resort to segment balance is needed only if the economic income of a mutual cannot be measured. This was wrongly assumed in 1984 to be the case. There is a way of looking at these things, now called the prepayment analysis, which clarifies the situation somewhat. This is the arrival of the time value of money in the field of taxation. The argument made is that there are two differences in stock and mutual taxation in a gain-based tax, only one of which was recognized by the 1984 act. First, if you have a gain-based tax, by which I mean tax on gain after full deduction of policyholder dividends, mutuals would deduct any existing ownership distributions while stock companies cannot. That difference was recognized in the 1984 act in section 809. The second difference is that, in a gain-based tax, stocks would receive capital contributions tax free while mutuals would receive capital as taxable premium income. Taking the time value of money into account, a gain-based tax imposes equivalent burdens on stocks and mutuals.

The way to look at this to see that it, in fact, works out is to observe that stocks are allowed to retain and invest all of the capital deposited with them, and they pay out 34% of their earnings to the Internal Revenue Service. Mutuals pay over to the IRS 34% of their capital and then pay no tax on distributed earnings. Either way there is a 34% hit in tax or in lost earnings.

Finally, on the general subject of segment balancing, I'd like to observe that surrogate measures don't seem to work well at all. The pretense that we can somehow track income by using something like assets or equity is a pure sham. Some evidence for this can be seen by looking at figures for equity which should be one of the better surrogates for income. After all, in equilibrium conditions you might expect that there would arise a uniform rate of return to equity. Looking at stock company Form 8390 data for 1985 we can see rates for the 33 companies for which rates were released by Treasury that range from minus 12% to a positive 58%, a 70% spread in rates of return to equity. Earnings simply do not track surrogate indicators well.

Having said that, we might take a look at some of these segment balance measures, these surrogate measures of ability to pay taxes. The measures that were looked at back in 1983-84 as discussed in the Committee reports to the 1984 act, were first, historical tax shares. I may yet become a proponent of historical tax shares as a measure of ability to pay if some of the stock company allegations about mutual company taxes turn out to be true. The proponents have some argument. They will argue that this produces stability and doesn't rock the competitive boat. I think the better view of historical shares of tax is that it is a measure that seems to be most designed to perpetuate historical inequities. The second measure that was looked to apparently in the 1984 act process was assets. Proponents here argue that earnings are generated by a rate spread between interest earnings and interest credited, and so assets should measure capacity to pay fairly well. Personally, I doubt it. The spread is just too uneven. Some assets such as policy loans may, in fact, generate only losses. Others such as deferred or uncollected premium are simply fictitious. And, opinion is all over the map on the question of whether, say, group pension assets are as profitable as ordinary life assets. As a final observation on assets, I'll note that an asset measure tends to ignore group life and health. Mutuals today probably have about 50% of industry assets, and that share seems to be systematically declining.

Other measures may do a better job. One measure that certainly deserves consideration would be gain before federal income tax. If you believe in the equity model of how a mutual operates, you might want to do something to make that measure more comparable between mutuals and stocks. That can be done by restating stock gain, deducting shareholder dividends and including capital contributions in income. If you do this, it turns out that mutuals have about 35% of this indicator. Equity seems to be the principal tax allocator among mutuals under the 1984 act. I've already indicated it doesn't do a very good job. Mutuals have roughly 40% of industry equity.

Some final comments. Our view of segment balance may be somewhat unduly restricted. Today's reality seems to be that most stock companies and some mutuals are included in affiliated groups with substantial noninsurance or property and casualty components. A narrow stock versus mutual life insurance view misses the reality of the situation. If you are going to go about measuring relative tax shares, you should do it by looking at least at the entire insurance industry. If competition is between financial conglomerates, you should look, if

at all, at the conglomerates and not at specialized pieces or allocations of them. In the end my own view is we shouldn't be looking. We should be identifying income and taxing it where it's found. The prepayment analysis indicates we know how to define mutual income. It's gain after dividends, and that would make a sensible tax base. John, I suspect you have some other view.

MR. JOHN J. PALMER: Doug has given you his view. I will try to describe the handsome head, trunk and tusks of the elephant. Doug has described the other portions. Let me start with his sort of caveat; that is, that the remarks I am going to make are intended to give you a sense of a compilation of stock company types of views. They are not all necessarily mine, and none of them are all necessarily held by any one person in the change over time. This will perhaps give you some flavor for the items that are in controversy here.

As a preliminary comment, let me just pose one question. Why should stock companies care at all about section 809 since it doesn't impose any tax on them? At worst it imposes an administrative burden of filling out Form 8390. I think there are two reasons. One is a reason of competitive balance. That is, if the mutuals pay substantially less tax, then one would imagine they would have correspondingly lower prices, correspondingly more sales, and all things being unequal in that sense, the mutuals' advantage would work to the detriment of the stock company's marketing disadvantage. This may seem obvious -- if you pay less tax, you can lower your prices -- but some people seriously question whether that effect is really present in our business. Second, there seems to be a tendency on the part of Congress to think that the industry as a whole ought to raise some fixed quantity of taxes. To the extent that's true, then if mutuals don't pay it, the stocks will have to end up paying it. So while these may not be arguably life and death issues, I think they are at least issues of health versus sickness.

Let me go back a little bit to the origin of the present 809 structure and how we got here. This covers a little bit of ground that Doug did, but gives it from a somewhat different perspective. The 1959 Tax Act had a limitation on dividend deductions by way of the now discredited phase system. That was transformed into a fixed percentage deduction with a stock/mutual differential in the brief TEFRA years. When we got to developing DEFRA, once the tax reserve basis question was settled, the only significant remaining question really was what dividend deduction limitation should apply in the new law. This was the key to how much tax the mutuals would pay and hence how much the industry as a whole would pay. This really isn't a new problem.

For perspective let me give you a somewhat lengthy quote made by Cordell Hull in 1913 in developing the 1913 Tax Acts. He was at that time the Chairman of the House Ways and Means Committee. He said, "The mutual insurance companies desired to have themselves entirely exempted as to their net earnings from the 1% normal tax imposed upon corporations. Now when this corporation tax law was enacted four years ago, it was expressly provided in that law that insurance companies, mutual or otherwise, should not be permitted in computing their net income to make deductions for dividends paid to policyholders. The word *dividends* was expressly and definitely inserted there upon the broad ground of public policy and of justice, that when insurance companies pay dividends out of accumulations of the character that these companies have, they should pay the tax of 1% imposed on all corporations, but they come in and say that they should be stricken out, that whenever they declare a dividend to the policyholder, it is simply a return of the premium savings and constitutes in no sense earnings in

the way of interest savings or in the way of excess of the mortuary fund or from other sources from which actual accumulations or profits arise. My judgment is that the accumulation of these companies which arise from savings from expenses, savings from mortality, savings from lapses in surrenders and profits from excess interest earnings when considered in the aggregate, are clearly of such a character as to merit payment of the proposed tax. If the companies would keep the question of premium assessments and overcharges strictly within a category to themselves and not mix and confuse them with the profits derived from the sources I have enumerated, I think it would then be possible for the law to deal with one without affecting the other."

All that doesn't prove anything about how taxes ought to go. It simply demonstrates how old the issue is and how long it has been with us -- since the origin of the tax law itself. There still doesn't seem to be any particularly clear internal evidence of the right approach to the dividend limitation, notwithstanding what Doug has said. Instead we have to turn to what Andy Pike calls a more metaphysical approach. There has been much discussion of external indicia of the kind Doug has talked about: proxies for taxable income, the segment balance type of items. Again, these don't seem to produce any particularly clear guidance. Any actuary could probably come up with ten reasons why there is something seriously wrong with any particular measure you pick as a proxy for taxable income. Even aside from that, even if you find the right number in concept, you'd probably have some difficulty getting valid numbers out of industry statistics simply because of the reinsurance effects, stock subs owned by mutual companies and a variety of other difficulties in getting adequate numbers to use as a firm base.

In the early days of developing DEFRA, the stock companies put together a paper trying to approach the quantification of what the mutuals' economic income should be for tax purposes by comparing the mutuals as a group, to the stocks as a group, with respect to their earnings on equity. The basic assumption here (as Doug implied) was that the owners' equity in both halves of the life insurance industry would be reasonably expected to produce the same rate of return. This principle, this return on equity, then was seized upon by the government to develop a tax structure. The stocks put this paper together not as a prescription for a taxation scheme but as a quantification method; that is, to provide a rough idea of what the level of tax ought to be. As I say, this was seized upon by the government and translated into what we now have as section 809.

A lot of details were filled in, such as:

1. A 50-company stock company average return as a yardstick versus, for example, a general corporate return. The argument was that in the same industry the same economics ought to apply.

2. An arithmetic average for the stock companies. Why? To avoid manipulation by the large stock companies who would then be weighted by their assets and have any manipulation weighted.

3. A weighted average for the mutual companies. Why? I think probably to avoid manipulation by the the mutuals, one against the other.

4. The socialization approach that Doug described, using an average mutual earnings rate versus an individual company mutual earnings rate.

5. A recomputation provision: true up and true down provisions to reflect the time lag of data collection versus the tax due date.

6. The equity base definition: adjust the raw equity in the fashion Doug described to try to bring into it other items of "real" economic equity that are available for earnings and, I assume, to head off some of the manipulation possibilities that might otherwise be present.

7. Finally, the massive data collection efforts as reflected in Form 8390, the complex details of which are largely due, I think, to the desire of the mutuals to ferret out, identify and expose to the light of day any possible manipulation that might be occurring in the reporting of these numbers.

Many of these choices in the detailed implementation of the 809 concept were mutual company choices. In fact, some of the more obnoxious features the mutuals complain about most were ones supported by them and insisted upon by them. It reminds you of the legendary case of a man who killed both of his parents and begged the court for mercy on grounds that he was an orphan.

Let me turn to the segment balance issue a little more directly. Segment balance took on a new meaning in starting off section 809 by picking the starting point, the 16.5% imputed earnings rate which, when combined with the 20% Taxable Income Adjustment (TIA) rate that we had enjoyed for that brief period of time, would develop both a fixed amount of dollars of tax from the industry and a prescribed 55%/45% mutual/stock segment balance of the tax burden. The 16.5% was determined as a starting point, and as Doug says, it's indexed to stock changes after 1984. Because it is only indexed and not redetermined from scratch every year, that original fixing point carries on and is perpetuated in the tax law as long as the law stays the same as it is. Here again I think external indicia were looked at to see what the balance point ought to be; that is, whether the number should be 16.5 or 17 or 15. I suspect the end result, 55/45, might have been achieved by taking the mean between what the mutuals insisted was the most it should be and what the stocks insisted was the least it should be, 50/50 versus 60/40.

A study will be forthcoming soon giving some information on how much money was raised from whom under this tax act. Basically, the purpose is to determine how effective the 1984 act is in carrying out the intent of Congress and as a second step, how reasonable the segment balance is, the burden of tax imposed upon the two segments of the industry, given new insight into what segment balance ought to be. We have no real numbers yet, but we've done some estimates of stock numbers and I assume that the mutuals have done some estimates too. The original goal in 1984 to be raised from the act was $3.1 billion, divided 55/45 mutual/stock. That would be $1.7 billion mutual and $1.4 billion stock. The stock companies have done some estimates, but they are pretty rough. I haven't got that much faith in their exact accuracy, but our best shot to date gives numbers like $1.4 billion from the stocks and $1.2 billion from the mutuals, after you give effect to net operating loss carry forwards. If you ignore the net operating loss carry forwards, it would be more like $1.7 billion stock and $1.4 billion mutual. This is, of course, the exact reverse of what the target was in terms of the share involved. Even rougher numbers for 1985 are something like $2 billion from the stocks and $1.2 billion from the mutuals with

the effect of Net Operating Losses (NOLs), and $2.2 and $1.3 stock/mutual without NOLs. This makes it more like a 61/39 split, 61 stock, 39 mutual. Needless to say, it will be a source of mild concern to the stock companies if anything remotely approaching this kind of result is, in fact, the case. I have hopes that we will find out for sure what the case is soon.

By contrast, numbers from 1983 would be $700 million stock, $400 million mutual; 1982 would be $800 million from each. These are the TEFRA years. Prior to that we have what we might call the Modified Coinsurance (MODCO) years: $900 million stock, $500 million mutual; $1.1 billion each in 1981, and $1.1 billion from each in 1980. By 1979, we had $1.2 billion stock, $1.8 billion mutual; in 1978 we had $1.1 billion stock, $1.7 billion mutual. Now Doug would probably characterize those last two years as the results of the 1959 act operation at its most distorted point and hence no guide at all for what a tax burden ought to be in the future.

If our estimates of the 1984 result are at all accurate, why would it have varied so much from the original $1.7/$1.4 billion mark? As best we can tell, it looks like a lot of the variance is due not to vast changes in the economic health of both of the segments of the industry, but rather to errors in setting the original 16.5 plug number for the imputed earnings rate. Remember that 16.5 was simply plugged in. It was derived from no particular theoretical source. It was arrived at by something like the following approach: You estimate what the stock taxes would be under DEFRA, giving effect to the new tax reserve rules -- loss of special deductions, etc. -- using the full normal corporate rate, and multiply that amount by 55/45 to get what the mutual tax ought to be. You then have to assume what the mutual equity base will be under the new law, and then solve for the imputed earnings rate which when applied to the mutual equity base would produce the proper 55/45 of the stock tax. Having done all that then you add together the stock and mutual taxes and solve for what the TIA should be, in order to produce the target total tax number for the industry.

Two main sources of error in this estimating process appear to have occurred. One is that the mutual equity base, as redefined and expanded, etc. under the 1984 act, was taken to be something like $37.4 billion in the estimate calculation. In fact, it looks to us as if it is closer to $33 billion. Another source of error was an assumption that the stocks would have net operating loss carry forwards of $400 million, and that the mutuals would have none. I think I agree with Doug (but I'd better recheck my position) that NOLs ought to be left out of account since they are temporary aberrations. If you remember, TEFRA generated quite a lot of NOL carry forwards, and, because the NOLs are largely TEFRA creatures, they are therefore temporary aberrations and ought not to be taken into account in setting a parameter in a permanent tax law. So the better approach would be to ignore NOLs entirely for this purpose, and if you want to get the total tax to a right number, impose some temporary surtax while the effect of NOLs wears off. Another way might be to take into account the actual mutual NOLs and solve again.

Running through the calculations, correcting the calculations in those two respects (the equity base and the NOL treatment): (1) if you just correct the equity base, you get a number like 20.4 instead of 16.5 for the imputed earnings rate; (2) if you use the right equity base and actual NOLs, you get something like 19.9 instead of 16.5; and (3) if you use the right equity base and no NOLs, you get something like 22.6. These are all, of course, rough estimates, but I

think the direction of the change is fairly clear even if the magnitude may be subject to doubt.

Where do we go from here? There are two general kinds of approaches one can take. One can assume that the basic 809 concept is valid, or at least the best we have, and try to tidy it up in various respects. The stocks, of course, have a short list of ways in which it might be tidied up. First of all, I remind you that under this approach you have to assume that the premises underlying 809 are still valid. That is, that the mutual policyholder is indeed an owner or an owner-like person for this purpose. (If they aren't, one would wonder who is the owner of a mutual company? Is it management? Is it some departed generation of policyholders? It's hard to imagine who would be if it were not the current policyholders.) The second assumption is that mutuals and stocks are in the same business, and since they are in the same business, pretty much selling the same products in the same markets with roughly the same pricing, it's reasonable to expect that in the aggregate, over time, the same kinds of returns would be achieved on the entity's equity. Doug wonders why you would extract a price to get an equity-type return in order to just turn around and give it back. Well, in fact, the mutuals engage in a lot of forms of enterprises that are not just dealing with those policyholders. They have stock brokerage firms, P&C companies, and a whole stable of other operations which are generating returns out of that same equity.

Turning to the list of not-so-quick fixes to 809, one would be to delete the mutual socialization effect; that is, return to the original Stark-Moore proposal under which the differential earnings rate (hence the limitation on dividend deduction) is obtained by comparing individual mutual company earnings rates to the imputed earnings rate rather than using an average industrywide mutual earnings rate. The result then would be that other mutual companies' activities would not affect your own company's tax. The downside, or a kind of a corresponding consequence, is that the mutual company's tax on normal income and deduction items would not affect the tax at the margin as the general proposition. In this case it would be particularly important to clarify that the differential earnings rate could not be less than zero.

A second kind of fix would be to redefine the imputed earnings rate. Use the three-year weighted average of the stock companies directly, not merely as an adjustment to an original plug number. This would remove the allegedly arbitrary segment balance from the calculation, since it wouldn't be a predetermined artificially set number. You would simply use the raw stock rate or average stock rate as it came out.

Another kind of a fix is to impose some kind of spreading mechanism for capital gains and losses. One of the reasons for the volatility in the earnings rates which Doug cited is the undiluted inclusion of realized capital gains and losses. They have varied quite a lot over the last several years. They can, I suppose, be expected to vary quite a lot from year to year in the future. The negative differential earnings rate we have now, even using three-year averages, is due to a combination of the volatility of the capital gains and losses and a mismatch of timing between using a three-year average for the stock rate and a one-year average for the mutual rate. There was an interesting recent article in *Forbes* which you've probably seen, on the negative differential earnings rate question. (It also gives a quick and pretty accurate synopsis of how this section 809 works.)

Another kind of a change which would seem fairly attractive would be to delete the true-up mechanism, primarily on grounds of simplicity. This would obviously require some sort of a transition rule, and it places some burden on an assumption of stability of tax rates from year to year. That's an assumption that hasn't been particularly valid recently, but it may be close enough to valid to warrant making for the sake of simplicity.

Another change needed is to clarify the equity base definition; specifically, to tighten the definition of voluntary reserves or nonvoluntary reserves. Current law allows a deduction from the equity base of something called nonvoluntary reserves, meaning reserve items that aren't tax reserves but aren't voluntary. The class is currently pretty ill defined. A simple and clear definition that appeals to stock companies is to require the normal tax accrual rules; that is, the reserve would have to meet an all-events test -- all events determining the liability would have to have occurred, the amount would have to be determinable, and economic performance with respect to the liability would have to have occurred. Currently, such nontax reserves as deficiency reserves and other excesses of statutory over tax reserves are included in the equity base. It's hard to see why reserves of some lesser statutory status should be excluded. As a practical matter, I think there is very little in the way of nonvoluntary reserves currently included in the equity base, so a change like this would be primarily in the nature of heading off future manipulative possibilities rather than removing some present advantage.

Another suggestion is to adjust explicitly for the different tax treatment in the hands of recipients of stockholder dividends (generally currently taxed) and the portion of policyholder dividends that represent owners' earnings (generally not taxed or taxed much later). This can be done directly by taxing the policyholders -- not too appealing an approach -- or indirectly by having a proxy tax at the company level.

On the consolidation issue, Doug referred to as something of importance: the mutuals seem to suggest that the use, largely by stocks, of nonlife affiliate losses (for example, from P&C companies) to offset life company income ought to be taken into account in some fashion in figuring out the life company tax. Stock companies would wonder why it makes sense to cure the creation of undue tax losses on the P&C side by raising stock company taxes or conversely by lowering mutual company taxes.

There is also another class of possibilities to be considered besides fixing 809; namely, complete structural change in how you deal with the dividend deduction limitation issue. There haven't been any really clear candidates that have emerged that are appealing to all parties and are preferable to 809. From the stock side most of our discussions seem to degenerate into a reinvention of a free investment income approach, similar to that in the 1959 act and its predecessors. On the mutual side most of the discussion appears to be centered on justifying no limit whatever on dividend deductibility, rationalized most often by what Doug has called the prepayment analysis. This theory, as Doug has mentioned, is based on the simple algebraic result that imposing a tax on a deposit invested and imposing no tax on the earnings derived therefrom is equivalent to imposing no tax on the deposit invested and taxing the earnings as they emerge. In this model, the tax on the deposit invested is the tax on the mutual company's "capital contribution" that is deemed to be included in a par premium by way of redundant premium, and the tax-free earnings then are the amounts included in policyholder dividends as owners' earnings. On the stock side of

the model the tax-free deposit is the stock company's capital contribution, not taxed on the way in, and the tax on the earnings on the way out is then the tax on the stockholder dividends.

As a theory, this is valid only if a number of key assumptions are also valid in the case to which this theory is to be applied. In particular, you have to assume that a mutual company's par premium is taxed at the margin when it's received. This is arguably not true for the source of virtually all the mutual company capital contributions received to date. Pre-DEFRA, it's arguable that there was no tax at the margin on premium, and no tax on organizational capital way back in the midst of time when the companies were organized, so it's hard to see how the mutual company's equity was, in fact, taxed on the way in. You also have to believe that marginal tax rates won't change between the time of the deposit and the time the earnings arise -- actually the entire time the earnings are generated. This clearly hasn't been true in the recent past, and I'm not sure why it would be expected to be true in the immediate future or even in the long-term future. You also have to believe that either the policyholder is taxed on earnings paid out by way of dividends, or stockholders are not taxed on dividends. Neither one of those things is true.

Another more slightly, more subtle assumption is that there aren't any special deductions in the tax system even if they are available to both stocks and mutuals. Now why is that a critical assumption? Well, tax savings on an accelerated deduction behave in the nature of an interest-free contribution of capital to both stocks and mutuals, but this contribution of capital is not taxed at the time of contribution as the theory would require. Perhaps the theory could be modified to take account of all these variances of assumptions from reality, but the result would probably not be a pristine 100% dividend deduction model, and would not be likely to be simpler than 809. It is interesting to note that 809 automatically corrects for capital contributions included in premiums, simply because it increases the average mutual earnings rate and hence reduces the differential earnings rate and hence reduces the mutual tax in an appropriately offsetting amount.

All this theory is nice, maybe even intellectually fascinating, but we live in a real world of mammoth budget deficits and tax base broadening on many fronts. What would 100% dividend deductibility actually mean? Currently, at least half, maybe as much as three quarters of the mutual tax is raised from the 809 limitation. Without the limit this tax would go away. Probably even more would go away due to the motivational effects of having dividends deductible at the margin. Certainly the brief TEFRA experience, when dividends were deductible at 77.5% for mutuals, would not give Congress a great deal of comfort in this regard. It would seem that a 100% deduction of dividends would not be a reasonable approach purely on pragmatic grounds.

Where do we go from here? So far the ACLI has excused itself from dealing with these stock/mutual controversy issues. But they are now taking a new approach to try to reach consensus on such issues. Bill Gibb will give a little synopsis of how that's going.

MR. WILLIAM T. GIBB: There is some question about whether ACLI excused itself or whether we were excused. I've done a little independent analysis of the speakers times. It has come up to be a 30/15 split, and I can either read from that that your case is twice as good as Doug's, or else it takes you twice

as long to explain your case. Anyway, I'll get back to some of this background.

We expect that 1989 will be a very active congressional year from the standpoint of raising taxes. I think there is a great deal of agreement in Washington right now that the size of the budget deficit has been masked this year, being a presidential election year. Next year they will have to adjust their assumptions, and the budget deficit will be much larger than anyone imagines. Also the first year of a new president's term is usually the one year that that president can do something innovative like increase taxes. So we see next year as being a very, very active year and a dangerous year for the life insurance business.

If you look at the tax expenditure budget, which is a document drawn up by the joint committee staff, and I think Treasury has done the same thing, where they try to measure in lost tax dollars what they consider to be tax preferences, such a list obviously becomes a source for Congress to look for revenue. Of the total tax expenditures which they now attribute to the income tax code, about one-third relate to items in which the insurance business is directly concerned. You can see the danger that really flows from that. The ACLI Board of Directors at the urging of Dick Schweiker, the president of ACLI, has decided to see if there is some process that can be started to try to bring the stock and mutual companies together, and that recommendation was made with this sort of a background in mind.

There is now on earth a new kind of specialty called *facilitators* or *conflict resolution facilitators*, and these are folks whose job is not to arbitrate or mediate the substance of an issue but to set up the process by which the issue might be dealt with by the two sides. The group that has been hired by the ACLI is a firm that sort of works out of Harvard. They are hired by different countries to try to resolve problems. The group is going to start this summer, and the basic format so far is that they are going to set up three task forces. (We're getting the names now for the various participants.) These task forces will consist of about three CEOs on each and a mixture of three tax specialists, lawyers, actuaries or Washington representative-types/legislative strategist-types. Of the three task forces, one will look at the possibilities for setting up a process to get these two sides talking with each other. A second will look at what the risks are of not reaching agreement. What can happen next year if the stocks and mutuals are fighting and there is this big tax bill trying to raise revenue going on at the same time? What are the dangers? The third group will begin to define what the substantive issues are between the two groups, and what would be some possibilities of resolving them. There's no guarantee that this process will work, and I suppose there's no guarantee that the process won't work. We think that this process has a chance to work if the two parties want it to, but we think the danger of the process falling apart could result next year in very bad problems with the life insurance business. You'll be hearing more as time goes on.

MR. HERTZ: I would like to comments on the quote from Cordell Hull. I would observe that he lost the argument in 1913 and dividends by and large under the law enacted then were, in fact, deductible, and indeed he may have misstated what the 1909 act did. If you check a case, *Mutual Benefit Life* vs. *Herold*, cited as 198 Fed 199, you'll find a holding that dividends reduce renewal premiums included in income. So it's not at all clear just what Cordell Hull has to do with it, other than, as John said, it's been a long discussion.

John was right. I certainly do believe that 1978-79 clearly was the most distorted point of the 1959 act and that reaching to those years in order to determine historical tax share so that you can continue the historical inequities perpetrated by the 1959 act, is to my mind a clearly unreasonable thing to do. John has observed that mutual equity base was overestimated in the 1984 act process. We can agree on that and disagree about what it means. John thinks it means we ought to raise the rate imputed to mutuals. I think that it gives some indication that people back in the 1984 act process just thought there was more mutual than there is and that the tax-paying capacity of the mutuals was, in fact, greatly overestimated.

I could go into a long discussion about whether you require a marginal tax on premiums for the validity of the prepayment analysis. I'll observe that under the 1959 act there was not, for most mutuals in most years, a marginal tax on premium simply because mutuals were being taxed on more than their gain. The argument that this invalidates the prepayment analysis involves saying that had we been given a tax break and had our taxes been reduced to a tax on gain, everything would be OK. Because we were overtaxed, the analysis is invalid, and we should continue to be overtaxed. I'm not sure that that's really a proper way of looking at things. I'll leave it at that.

MR. PALMER: I want to observe that that's correct; that you were taxed on more than your gain if you define gain as gain with full deduction of dividends. It's a question begging analysis of the deal. That's the problem. The whole thing is circular, and you find yourself begging questions every time you turn around.

DR. ANDREW D. PIKE: I'd like to say just a few words about section 809. When I was at the Treasury Department and section 809 was drafted, we had a very basic strategy: to state a broad general concept and ask the industry for their help and guidance in figuring out how to flesh out this concept. Most of the bad ideas concerning the details of section 809 came from our friends in the industry. In addition, we always thought if we got some advice from one segment, what we had to do was ask the other for a response to get a full and complete analysis. I will not try to defend any of the particulars of section 809. Indeed, many of them are indefensible. If I thought I were going to spend time talking about 809, I would have come with one of those old New Orleans Saints hoods, you know the paper bag with the eyes cut out. You can't do it. It is unfortunate that John and Doug, who are usually very civil and perfectly nice people, act rabid when the subject gets discussed.

There are two natural solutions: the first allows a full deduction for dividends; the second limits this deduction. One is simple. One is extraordinarily complex. Anyway you cut it, a provision limiting dividends is going to be complex. If you believe a limitation is right, you're stuck with complexity. I guarantee that unless you go to full 100% deductibility, which I doubt you're going to see, something will come out that is unpleasant, complex and it's going to lead you to say, "How can rational people, how can sane people, how can intelligent people come up with something that looks like this?" My answer is I don't know. But you're going to see it again.

I'd like to move on to that other, simple, straightforward provision that I worked on at Treasury, section 7702. I need to disclose my biases. I am what's known in the trade as a bad loser. In 1983 I pushed very hard for a definition of life insurance that would approximate something like a ten-pay

model. Cash value could not exceed what would accumulate in a contract in which only ten equal annual premiums were charged. I lost. My bias is what's known as sour grapes. In 1984 the definition of life insurance that was enacted basically adopted a single premium model. If the cash value does not exceed the single premium at that time for the benefits under the contract, it will be treated as life insurance. What does it mean to be treated as life insurance? Basically there are four things that happen, all of them good if you want to buy life insurance. First, the inside interest is not taxed currently. Is that good? Yes, it is. Second, to the extent that interest is applied to purchase or pays mortality charges, that interest will never be taxed no matter what you do with the cash in the contract. Third, if the contract remains in effect until the insured dies, the interest is never taxed. And, fourth, if you want to get the money, you can get it without paying tax in two ways. First, you can borrow it. And second, you can take money out, and it is treated as a tax-free return of your investment rather than a payment of interest. It is not taxable until you take out too much. When 7702 was enacted, did we think that people could sell single premium life insurance? The answer, yes. When I was first contacted in early 1987 from some folks on the Hill, they asked if I was shocked at this. My answer was no. We expected this. That's what it means to lose a political battle. People will do what they want to do. People will write contracts that are more cash heavy than a ten-pay model.

MR. WAGNER: Why is ten pay good and nine pay bad?

DR. PIKE: I don't think that ten pay is so great either. I will get to that. I don't think nine pay is where I would draw the line. I would go more towards, for somebody my age, say about 30 pay. Roughly speaking, for those of you who can't guess my age, that's about a level premium model. What happened from 1984 to 1987 to cause the politicians to get upset? Two things. First, in 1986 there was tax reform. Tax reform did a lot of things. It made tax returns more complicated, but most significantly, it got rid of most of the good, easy tax shelters that were around. One form of tax-sheltered investment that was available to large portions of the population was retained. What was that? The tax benefits under life insurance investments. Why was that retained? Simple. The industry asked, "Why are you looking at this again? You looked at this two years ago. Leave us alone. Let us be. There is no reason to worry. Everything has been taken care of." Congress accepted these arguments. Well, tax reform got enacted in late 1986, and before year-end two groups started to act in a way that would attract legislative attention. First, the life insurance companies advertised the tax benefits of life insurance that have always been available. The advertisements called life insurance the last tax shelter. This was like walking up to a member of Congress who had busted his or he butt in enacting tax reform and poking them in the eye. I have a four-year-old who threatens that all the time. It gets me mad. It gets Congress mad too. The ads angered Congress. The second group to attract Congress' attention was the financial advisors and the financial writers. Evidence: Jane Bryant Quinn has written four or five columns on single premium life insurance in the last year and a half. She writes that life insurance is the last tax shelter around. It's easy. You don't have to have brains to buy it. You don't have to know anything about business. This led certain members of Congress to reconsider the tax benefits of life insurance.

To date, there have been a couple of proposals. First, the only piece of legislation that's in print, introduced by Congressmen Stark and Gradison, would change the distribution rules. If a life insurance purchaser keeps the cash in

the contract, there is no change in the tax law. All that changes is what happens when the money is taken out of the contract. The following changes would be enacted under this bill. First, the first dollar out would be treated as interest; not the last dollar. You don't get your premiums back tax-free first. Second, and this is something which the agents just drool over -- is it drool or go rabid? I'm not sure -- a loan would be treated as a distribution. Third, any cash received would be subject to a penalty tax similar to that imposed on distributions from IRAs and annuities prior to the age of 59.5. The life insurance industry has not embraced this proposal. Not surprisingly, actuaries testified that it would be a sunny day in Boca Raton in June before these laws changed.

The Life Insurance Agents trade association and the ACLI have come up with a joint alternative proposal. Under this second proposal, if you act nice and behave yourself for a few years, nothing changes. Technically, if the cash value of a contract never exceeds what the cash value would be if premiums were paid in five annual doses, the current law remains in effect without change. If the cash value is greater than that but less than the current single premium limitation, then there will be a slightly different set of rules. For distributions that occur during the first ten years, the Stark Moore distribution rules would apply. To the extent that interest is credited under the contract, distributions will be includable in income. Second, loans would be treated as distributions. After year ten, current law would apply.

I testified at the Ways and Means Committee hearing on single premium life insurance, and I suggested that the definition of life insurance should be changed. I suggested that to qualify as life insurance for tax purposes, the cash value should approximate the cash value that would be generated under a level premium contract. I would allow some degree of flexibility so that you can avoid going back to the traditional participating level premium contract. Some of the flexibility incorporated in universal life design is just fine. Why did I suggest this? I have two reasons, one of which the other members of the panel may sympathize with. The legislative revisions won't stop if the NALU/ACLI proposal is adopted. Why do I say that? For two reasons. First, life insurance is sold, and the classic selling technique in American business is to use advertisements. When you have an advantage, you'll advertise it. You'll sell it. What will the advantage be? A parent with young children will be told that the purchase of a single premium life insurance contract is the ideal way to save for the costs of education. The income is tax deferred and if the insured dies, the cost of college is paid for. In addition, if the insured does not die, money is also available for college. When this industry has a marketing advantage, it is promoted. These ads are going to cause Congress to come back and revisit this shelter.

In addition, if somehow the industry works out an agreement never to advertise the tax shelter of life insurance, Jane Bryant Quinn will discuss life insurance in *Newsweek* once again, and Congress will see it again. This issue will not go away until lots of other tax shelters are put back in the code. Given the budgetary constraints that Bill Gibb is going to talk about, I don't see that happening in the next generation or two.

The second reason why I would change the tax definition of life insurance is that I question whether the inside buildup should be excluded from tax. I, like the analysts who worked on the Tax Reform Act of 1986, ask why this investment shouldn't be taxed. If you assume that somebody like myself, not wealthy,

dependent on salary for a living, wants to protect my family, am I going to allocate 10% or 2% of my family's income to life insurance? Probably 2% or 1%. Given that level of spending for life insurance, if I buy term insurance, I will be able to provide a death benefit that is adequate to replace my income. The tax, however, law doesn't encourage that. However, the tax law encourages me to buy cash value life insurance. Given the relative premiums for term and cash value contracts, I'll only be able to afford a contract with a death benefit equal to a small percentage of the amount that I need to protect my family. The tax code doesn't stop there. It encourages a person who has a level premium contract to put their dollars into a single premium policy, because that's where the tax benefits are magnified.

These results sound perverse to me. If you really believe that the tax code should encourage people to protect their family, you want to encourage them to protect them as fully as they can, not as minimally as the law will allow. In addition there are no dollar limits on the amount that I can invest in life insurance. In comparison, if I want to invest in an IRA, the limit is $2,000 per year; if I want to invest in a 401K plan, the limit is $7,000 per year.

MR. GIBB: It's OK to deduct the premiums for your insurance like you do for your pension plan.

DR. PIKE: That's right, but you exempt the income, and as the prepayment analysis that Doug and John referred to, they're equivalent.

MR. GIBB: Yes, but that's a much lesser tax benefit than deducting contributions. You really can't compare life insurance to pensions.

DR. PIKE: Economically, they're equivalent. As long as you exempt the income, it's like a deferral.

MR. GIBB: You get both in the pensions.

DR. PIKE: No, the income is taxed ultimately after you retire when the income is distributed to you. It's a deferral with a deduction on the way in. Mathematically, they are equivalent. The annuity is different. The taxation of life insurance and pensions are equivalent mathematically.

As long as tax reformers are going to focus on the dollars that are invested by the wealthy into big dollar single premium contracts, you're going to be fighting this political battle. The life insurance industry should focus its energies on selling life insurance without constantly being required to change its contracts. I don't think I have much support for this.

Why would I allow a level premium? In a level premium policy the interest that's credited will about pay for the mortality charges, and there is at least a linkage between the insurance protection and the interest that is not taxed. Is it precise? No, of course not. But it's close enough. I think that the disproportionate benefits resulting from the failure to tax the interest vis-a-vis the social goal of encouraging insurance protection is more rationally related in that type of contract.

Where do I see this legislation going? Something is going to happen. There's nobody supporting the status quo. Most people don't think that the ACLI/NALU proposal makes a lot of sense. Does that mean it's not going to succeed? Of

course not. Decisions will be made at a political level. Few people on the Hill understand anything about life insurance or the life insurance industry. This factor has kept life insurance from being taxed over the years. As people constantly see ads about the tax shelter, the benefits of life insurance to the policyholder will be nibbled away. How big the bites are, I can't tell you. But they are going to come, and eventually you are going to go to something that is very different than what you have today. Bill is now going to talk about the legislative outlook in a more general sense.

MR. GIBB: If I could just make one comment to follow up there. A lot of whether you think the proposal that the business made makes sense or not depends on what you view the problem as. I really don't think that Congress views the problem as saving to send your kids to school. At least the sense we've gotten is that it views the problem as being money that was going into tax shelters, real estate shelters or whatever which were shut down by the 1986 act, was moving over to life insurance contracts. That money isn't going to go long term. That's short-term money. At least we've been told that that's money people wouldn't be willing to put away for more than five years. That's the basis of the ten-year duration.

DR. PIKE: This is currently 1988. Does anybody know where the actuaries are having their conference in 1990-91? I will agree to speak and make the same speech after your proposal is enacted, and I guarantee you we'll be talking about the same subject. Tax-shelter money was usually invested for five-ten years. A real estate shelter doesn't turn around in two years. The money stays invested. The tax benefits stay.

MR. GIBB: Yes, but you got your benefits right away though. You got your tax benefits through deductions of losses or through income streams. You may disagree with the rationale, but there is a rationale for that ten years. We are trying to draw a line where the person that needed to borrow for real financial needs could borrow, but the person that was putting the money for investment purposes would have to wait an appreciable amount of time before he could start to draw the money out. We just don't think that investors will be willing to do that. You can debate both sides of it, but there's a rationale for what we did.

Do you want to talk a little bit about the single premium?

MR. HERTZ: I guess I'd like to go back to the first part of what Andy was talking about. His attitudes toward inside buildup are long known. I guess either an observation or a question to Andy would be, would you agree that the annuity rules, the rules proposed by Stark/Gradison are in substantial measure just plain wrong? What I'm thinking about is loans to pay premium or loans to pay interest where you don't have any cash coming out of the contract, and so even from your perspective it would be difficult to envision just what inequity it is that has been committed.

DR. PIKE: Let me see if I understand it. Let's say the contract specified that there is an annual premium due of $1,000, and the cash value is $10,000. The state law nonforfeiture option in effect says that in the event that a premium isn't paid, it will be paid out of the cash value. Now that should not be treated as a distribution to the policyholder. I would view that as a technical flaw in Stark/Gradison that should be fixed.

MR. HERTZ: Another observation on the nature of the tax shelter involved with borrowing would be that it is more in the nature of a tax trap. Today you don't get an interest deduction for interest that you pay on a life insurance policy loan. You also don't get a basis in your contract. Section 72 develops investment in the contract by reference to amounts paid for the contract, not paid for the use of money, and so the interest that you are paying into your contract if you ever surrender it is going to wind up being taxable to you. Again, this seems to be more in the nature of a trap than a tax benefit.

DR. PIKE: I will respond to that by seeking to eliminate my confusion. I think that the audience probably understands you perfectly well. Let's say you have $10,000 cash value in the contract, and you borrow it all out. And you have a no-net interest loan provision in the contract. Let's say that you leave enough money in to generate interest to pay the mortality charges. On the loan, you don't pay any interest. You don't get any distribution from the company. Nothing happens. Where is the trap?

MR. HERTZ: The trap is that over a period of many years you can be paying interest to the insurance company.

DR. PIKE: Do you pay anything on a no-net cost loan?

MR. HERTZ: Well, the no-net cost is achieved because the company is crediting interest in your contract, and so there is this large nominal cash value building up; no real cash. When you surrender the contract, your tax is going to be determined by reference to this large cash value that has purportedly built up. There won't be any money there to satisfy the tax that is thereby generated, and so basically the only thing you can do is either prepare to pay a heck of a lot of tax or die.

DR. PIKE: The last being inevitable, but a tough way to shelter some income.

MR. HERTZ: That we can agree on.

DR. PIKE: You're right. Somebody my age should not start borrowing because that cash value is going to be eaten up. If you get to a more advanced age, say during retirement, and you don't take huge amounts out, you can probably structure it so it's almost certain that your death will occur before the cash is dissipated. It's a trap, but a trap that the sophisticated probably will not fall into. However, it would be a trap for the unwary. In a sense that's unfair. So let's fix it and treat the loan as income when it's taken out. Do I have a supporter?

MR. HERTZ: Well, no.

DR. PIKE: I didn't expect so, Doug.

MR. GIBB: As I mentioned, I think 1989 is going to be the start of a real fierce effort on Congress' part to raise revenues. I think taxes will be a front burner item in this process. It may be that Congress is going to have to turn to some new revenue-raising format like a Value Added Tax (VAT) or a new form of excise taxes. But whether they do or not, I'm fairly certain in my mind that tax reform will be a major part of the tax-raising effort, and will be something that goes on for several years. This is basically because there is a lot of

money to be raised by changing the tax code. Moreover, most of the congressional staffers and treasury staffers tend to be tax-reform-oriented people. That's the reason they come to work for those departments. That's the reason I went to work for the Treasury Department and probably the reason that Andy did. It doesn't make these people bad.

MR. GIBB: But that's a fact of life that we really have to face. The congressional staffs are very interested in fashioning the tax code in their concept of equity. So we are going to be facing tax reform. I think it's important to note, too, that these staff folks are very bright people, and they're very devoted people, and they work very hard. So you should look at the tax reform process with that background.

Moreover, it's important to remember some other things. Because of the complexity of the tax laws, the staff, both congressional staff and treasury staff, have a huge influence on what's finally enacted. Very few tax issues get to the member of Congress level so that they comprehend them. The staff makes up the agenda. The staff draw up the list of reform items to give to the committee to draw from, and they make up endless lists.

They're the ones that construct the details of a proposal, and they're the ones that fashion the compromises. So while whether something is going to happen to life insurance reserves or not happen to life insurance reserves may be decided by the members, the decision of how it happens and if it makes sense or not will basically come from the staffs.

Also the staffs view tax reform as an ongoing process. So they're willing to take half a loaf this year because they know that next year they can maybe get the second half of the loaf. So they don't mind compromising because, I think, they see that they're going to get where they want to go down the road anyway. A good example would be life insurance reserves. In the 1984 act, Congress adopted the Commissioners Reserve Valuation Method (CRVM). In 1987, it replaced the prevailing state interest rate computation with a single prescribed federal rate. I think they probably would like to get to a reserve basis that uses cash value, and way down the road I think the time value of money concept would take them to no reserves. But this is something that they're willing to work at year by year, and if the past is an indication, it is sometimes a very successful tactic.

Andy has put the single premium issue in context. Many people feel that if Congress does something to single premium contracts this year and evokes a five-pay limit on current law, that's just the first step. Next year they'll go from five pay to ten pay, and 15 years from now, we'll be where Andy said we would be, and nobody would be able to afford to send their kids to college. So that's kind of a background on the way that the tax reform process works now.

Where can the life and health insurance business expect their attacks? In connection with the legislation last year, the congressional staffs gave us a blueprint. They put out a booklet that lists various revenue-raising options, and many people believe that that's the blueprint or the index of where they're planning to go down the road. Many life and health insurance sacred cows are included. In fact, so much so that there's a whole special section for insurance companies. One thing, of course, that's listed is inside buildup, and they list many different variations of getting to where they want to get. They include narrowing the definition of life insurance, taxing loans, LIFO, etc. Hopefully,

if we can deal with the single premium issue this year in the context of the technical corrections bill which may go through Congress, we can keep the inside buildup item off the congressional agenda for a couple of years.

Conventional wisdom is there's about a 50/50 chance that a technical corrections bill will really get through Congress this year. However, if it does, there will be a single premium provision in it. But, the whole bill may not get through Congress, so we may be forced into next year which would not be nearly, I don't think, as good a climate to be in, because next year they may spend more time looking at the revenue that they can get from a single premium provision than they will this year.

Another issue, as I mentioned, would be life insurance reserves, and the staff pamphlet sets forth various proposals that they are thinking about: from no reserve deduction to cash value reserves to the federal interest rate which they adopted last year. We have four technical amendments to the Applicable Federal Interest Rate (AFR) provision adopted last year that we're trying to get adopted in this year's technical corrections bill. One would put a cap on the maximum differences between the state prevailing rate and the federal rate to prevent the reserve computation from completely going wacky if there's a huge spike in interest rates. Another provision would try to make the new rates work better for annuities. A third set of changes would put some tolerances in so, hopefully, you wouldn't have to use a new interest rate for each year's issue. It's not clear whether we are going to be successful or not, and I think that will depend on the nature of this technical corrections bill.

But I think the reserve area represents what's going to be a continuing tax reform saga, and that is trying to remove the advantages of the time value of money. Congress pretty much has gone through the various deductions and exclusions that they can get rid of, so now they're moving to try to time the income with the deductions. Another area that gets caught up with the time value of money would be the way that you treat agents' commissions and acquisition expenses. Right now those are currently deductible in full. The staff pamphlet would say that they should be spread out during the average life of a policy. The first step in this direction was taken in 1986 as part of the new alternative minimum tax computation. There is one segment of that in which they require that the acquisition expenses be amortized. There was another more general proposal that was considered in connection with the 1987 act but was not enacted.

There's the continuing threat of the taxation of the value of group health insurance and group life insurance. Part of that is the treatment of flexible spending cafeteria accounts. I think this is one area where we will be very vulnerable next year.

Pensions is a source of a lot of funds. It's probably the largest tax expenditure that's listed in this tax expenditure budget. My guess is we'll see attempts at a further lowering of the various limits: the limits on 401(K) plans, the limits on the maximum pension that can be given to an individual, etc.

Another thing to keep an eye on would be the indirect approach of adding various life insurance preferences to the alternative minimum tax. There's some feeling that the alternative minimum tax is starting to get so broad now -- it has got a catchall provision which is tied to your book income or your adjusted current earnings -- that without very much more the alternative minimum tax

could become the regular corporate tax base. It's not going to take very much more of a broadening and a relatively small increase in the rate for it to become the corporate tax base, and that would be a huge tax reform move right there.

Lastly, what I would like to do would be to run through very quickly the tax reform atmosphere in Washington now. It's kind of a scary process when you think of a representative government and how a government works in the textbooks, but it may be that there are so many lobbyists now that there's no other way for Congress to work. But for whatever reason, and whether you agree with it or not, these are the ground rules that we have found in Washington. Back in the good old days, Ways and Means and Senate Finance Committee hearings would be held on an actual legislative proposal. So you could look at the proposal, and you could make your comments. Now the hearings are generally held at the very beginning of the process, before they have refined it down to a proposal or details. So the hearings become very profanatory because you just can express broad principals and not much more. I think hearings really have little relevance to the way tax proposals get designed. They have relevance as to who is for them and who is against them, but the actual design of the hearing process has really become useless.

The revenue that gets raised from a proposal is at least equally important as the tax policy behind the proposal and in some cases more so. I think the reserve interest provision they put in last year was a very good example of that. There's just no rational reason that I have heard for replacing 56 different state prevailing rates with one federal rate; and then we're told to use the highest of the two, so we lose no matter which is higher. It just makes no sense, but that raised some money that they needed. Also there's a concept that when there is a broad revenue raising bill, each of the major segments of the American economy are expected to contribute. So really whether you need to be reformed or not you're expected to give some money to the whole system, and that makes for funny kinds of decisions.

Tax packages are usually developed under a very fast time schedule. Congress will talk about them for months, and then they'll start one day and finish the next morning. As you can imagine, this makes lobbying very difficult because they lock themselves up in a room someplace. It's a system which has not lent itself to trying to work out rational details.

Most tax packages are now put together in secret. Congress nominally has passed rules saying that their markup sessions are to be public. There's one of two things they do. They either meet and then vote to make them closed; or they get the members together in a caucus, and they decide what they're going to do, and then they come to the public session with the entire package done. I'm sure, as you can see, that's a very difficult system to deal with when you're trying to lobby, and it also makes for surprises. They can dig things up because they need some money, and do them to you when you don't know you're really being threatened. The life insurance reserve provision last year was much like that. We had had no indication that that was a possibility we really had to worry about, and it came up in the middle of the night.

So this is the system that we're faced with in Washington. It makes lobbying very difficult. It makes it particularly incumbent on the ACLI to make our committee system as flexible as we can, and we have really tried to do that with a special CEO task force and two groups working with it. It would be good if tax reform matters could go through the regular ACLI committee system because

that gives the best procedure to get the views of various companies. But as the system works now so that there is just not the time to do that, so we have a special system for tax reform.

MR. LARRY R. ROBINSON: John, is there any chance of putting dynamic interest rates into 7702? I'd understood that you were involved somehow in the technical corrections act on that.

MR. PALMER: No. We've talked about that in the past in the industry. I don't think we've ever been able to find a dynamic interest rate that we thought would be reasonable to plug in that was more favorable to us than what's there.

MR. ROBINSON: Well, one of the problems that I see in the guideline premium test is that you've got a 6% rate, and you're having to sell contracts on a 5.5% basis now.

MR. PALMER: That's correct. You'd have to argue that you'd use the reserve rate and not the nonforfeiture rate as the rate that you attach yourself to, and that would take some extended conversation and you might come up with the wrong answer. But I don't know of any active effort at the moment to try to get 7702 numbers indexed. On the other hand, rates have obviously changed since the time 7702 was adopted, and one could probably go back in and try to liberalize the rates. This wouldn't seem to be the most auspicious atmosphere, though, to try for a liberalization of 7702 rules.

MR. ROBINSON: We hear rumors of AFR perhaps being appropriate for that also.

MR. PALMER: It's hard to keep a bad idea down.

MR. GREGORY WILLIAM HINTZ: Do you anticipate that the alternative minimum tax is going to affect the segment balance since the mutuals don't have to file GAAP statements?

MR. PALMER: Starting in 1990 the Alternative Minimum Tax basis is something called adjusted current earnings which is going to be the same for both sides. It imposes an adjustment, or talks about an adjustment that Bill mentioned, that tries to get a GAAP-like effect on acquisition expenses. So I think there will be parity in that regard.

MR. HAROLD G. INGRAHAM, JR.: Regarding leveraged corporate-owned life insurance (COLI), what do you see happening in 1989? I am thinking of the kinds of cases involving thousands of employees, millions of dollars, Fortune 100 companies, and the utilities. They're trying to prefund postretirement health care benefits. In that regard what do you think would be any retroactivity of an effective date, and what kind of grandfathering would apply?

So far there's been relatively little discussion about the COLI provisions; except just the haunting feeling that when the staff comes out with their single premium package, there will be some part of it that will address the COLI issue. I guess the problem is those plans that are going in and insuring the whole work force. I would be very surprised, if the staff package did not include a provision on that, and I would hope the grandfather clause would be a clause which would not go backwards.

MR. PALMER: If you're talking about leveraged COLI, then I think a full-blown Stark Gradison approach would get you on the loans. And I think there may still be a nontrivial insurable interest question if you're going after the entire work force.

DR. PIKE: I'd like to mention an experience we had in 1983 when we were talking with the company representatives. The stock company folks said we should do something about corporate owned life insurance. They said that they couldn't take a position because the agents would kill them. They indicated that the company folks felt very uncomfortable with leveraged life insurance and all its guises. The mutual company representatives told us to be sneaky. The moral that we've learned from dealing with the agents is that anytime you deal with loans, and the corporate-owned life is one example, you must legislate in the dark of night towards the end of the legislative process. I agree with Bill that it is not the right way to legislate. But the up front way sometimes just doesn't work. I think that it's coming. I don't know if it's 1988, 1989, 1990 or 1991, but it's coming. With regard to grandfathering, I suspect they will not go back to prior years because the law is what the law is. But I would not expect the policies themselves to be grandfathered.

MR. MARK E. KINZER: We have a lot of health insurance claim reserves, and I'm just curious if there's any late breaking news in that category. I'm speaking of the discounting rules that have gone into effect for the claim reserves, where they have to be discounted using that AFR rate.

In particular there are certain types of reserves that are defined as property casualty reserves in the law, but there are other types which aren't mentioned such as credit disability. The question is whether that is treated as all paid in the following year or whether you can spread it out over three years or the full life of the expected claim.

MR. GIBB: We have a group within the ACLI that has been working on the application of the discounting rules to these claim reserves.

MR. WAGNER: That group pretty well decided that there weren't any major problems that they needed to address.

MR. KINZER: All I know is that some of the people at CUNA Mutual are not quite sure how things are working. We're the largest credit insurer around, in terms of life insurance, (I don't know how we rate in terms of credit disability), but some of the top people there don't seem to know exactly what's going on. I don't have all the knowledge that they do, but I know they have some questions.

MR. GIBB: If you give me or Bill Schreiner a call, we'll get you in touch with the right ACLI person that's working in this area.