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PRODUCT DESIGN AND MARKETING UNDER SECTION 7702A

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Recorder: CHRISTIAN J. DESROCHERS

- SPWL: Is a modified endowment product salable?
- "7 pay": What sales applications are working best?
- Pricing and administrative compliance issues
  - -- Evaluation of "7 pay" limit
  - -- Material changes
  - -- Death benefit reductions
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MR. RICHARD R. RETTICKER: In this session, I will address the effects of section 7702A from a marketing point of view. With respect to single premium whole life (SPWL), we're seeing sales drop. Premium was estimated to be $6 billion in 1987, and $3 billion in 1988. No one is sure what production will be in 1989 and projections for 1990 are very uncertain.

The high point of the market was reached in 1987 -- I think it's safe to say that about 85% of those sales were from stockbrokers. At that time the Monarch-Merrill Lynch affiliation was very strong. The tax law changes that took place in 1988 began to drastically change the market in the last half of the year. The stockbrokers became somewhat disenchanted with the product.

One of our companies offered what was called the "congressional bail out." Under this program, if Congress made a change that was not favorable to the client, the company offered to return the money paid under the plan plus interest to all the customers. We felt that would encourage the stockbrokers to continue to sell this product, but the good news turned out to be some bad news. Many of them discontinued sales at the first sign of a problem.

In order to appreciate the problem, you have to understand a little bit about the stockbroker as he differs from a life insurance agent. First, the broker often deals on the telephone. It's very possible for a stockbroker, for example, to not know or not have personally met his ten top clients. Second, he also controls the client's account. By that I mean he can charge things. In other words, he says, "I'll liquidate you out of this and I will put you into this or I will charge it to your money market account." Unlike the insurance agent, the stockbroker doesn't have to pick up a check. Third, with respect to life insurance, the stockbroker is a part timer in the sense that he has choices not to do this product or any product in the life insurance business. He also has a crying need for products because of the changes in the tax laws that also affect the limited partnerships and so on.

So where does it all lead us to? The point is that nothing is really happening in the stockbroker market -- we're in a hiatus. It is very difficult today to get stockbrokers excited about life insurance products. Just as the Jackson National product began to create some interest, the tax treatment was restricted by the Kennelley proposal. The result is that the SPWL market is in constant turmoil and the stockbrokers are not interested in marketing the product.

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What will it take to get the stockbroker interested? It is difficult to say. The problem is that it is difficult to translate the product restrictions to a stockbroker. We give meetings to stockbrokers everyday. One of the things that we do is explain a product to them. In doing that it is necessary to concentrate on what you expect him to say to his customer. It doesn't pay, for example, to teach him the difference between the premium guideline test and the cash value test, because if you do that he thinks that's what he has to say to his client. The most successful wholesaling is to make it simple enough so he feels he can do it better than you do it. If you do that well, then he will market your product.

I'm beginning to think that with the new restrictions -- the seven pay test and everything else -- brokers will not be able to effectively market the products.

For a company interested in developing products for this market, I'd suggest to you that you need to be working with a wholesaling firm that has a presence in the stockbrokerage community. I believe that the time and expense of developing the market is prohibitive. If you're not there you need to get there in a hurry and you need to do it rather reasonably.

As far as product development is concerned, I would modify a universal life (UL) product to fit the stockbrokerage market -- implement the variations that are needed to make it fit that particular market.

The long-range solution I suggest is a change in the tax laws. We are sitting with a tax law on annuities that's the most unfair tax law that I think we've ever had to live with.

Annuities should not be purchased by anyone younger than 45 years old. I attended a meeting here in New York recently when we were introducing a new product -- we were trying to get stockbrokers to sell term insurance. In that meeting I asked anyone who owned an annuity to please stand up or raise his hand. Nobody in the room stood up. That's not a good sign of marketing a product.

In developing insurance plans, the industry has so worried over having a nontaxable product -- having tax-free buildup and having tax-free loans -- that we've completely ignored a taxable product. Unlike insurance companies, the issuers of mutual funds don't do this. They sell both a taxable fund and a municipal bond fund. I'm suggesting to you that there are certain things that an insurance company can do that a mutual fund can't do.

One thing that a mutual fund doesn't do is guarantee principal. Can a life insurance company do that? You bet it can. One of the things that you might assume is that if you were to have a taxable product, you no longer have age 59.5 penalty. You no longer have the inability to make a loan without having a distribution. It's changed the name of the game and that's where I think some of the new products will come from.

The history of single premium is illustrative of the problem with tax-sheltered plans. When the first single premium product was developed, it used 50 basis points to determine the amount of life insurance. It was a very primitive policy in those days. It was a life insurance policy that provided a 3% return on cash value, a 4% dividend and 50 basis points for life insurance. We didn't know how to do excess interest at that time.

Eventually, a second generation single premium life product was developed. That product had five basis points for life insurance. It had two interest rates, a basic interest rate and an excess interest rate. And it had two loan rates and back-end surrender charges. And that was the beginning of the modern single premium life product. Now, what we see is a product that we're trying to figure out how many basis points it takes to provide life insurance. I am amused that the problem of the Jackson National product seems to have a last-to-die approach which creates not too many points to buy life insurance and that's what we want to outlaw.

The tax structure is such today that once you get something that works in the marketplace, you have the feeling that you will be put out of business before you can get going.

I had a brilliant idea about a year and a half ago to develop a policy. It was a thing called a New Century Annuity where we issued 100 annuities instead of one. It took about three months after we introduced it for the government to produce an aggregation rule which eliminated the tax

advantages of the plan. My point is that I think it's time to think again to the products we're coming with to take a look at what can happen on a taxable basis -- what we can do as an insurance company that a mutual fund can't do and take that to the marketplace.

MR. CHRISTIAN J. DESROCHERS: Until the early 1980s the insurance industry managed to get along without a statutory definition of life insurance in the Internal Revenue Code. In 1982, we saw the introduction of such a tax definition: first, under Section 101(f) and then under Section 7702 and, finally, now, under Section 7702A.

I agree with Dick's comments that one phenomenon that we've seen is as products have pushed the edges out of what the Congress, the industry, or the Treasury thinks is an appropriate investment orientation, there is an adjustment in the rules to bring the product back in compliance.

There is a willingness on the part of segments of the life industry to trade products that are sold by a few people, what some would view as innovative products, for continued favorable treatment on the majority of the insurance products.

I was very interested in Dick's comments that perhaps the answer to this is to develop some products which go back to some of the old features, but do it on a taxable basis. We certainly are paying quite a price in administration and in product development for the tax benefits that we get. Dick is one of the few people I have heard questioning the worth of the tax benefits.

John and I are going to talk in some detail about some of the technical aspects of the tax definition of life insurance. After you listen to what John and I have to say, I challenge you to decide whether it's easier to keep moving down the road that we are on in terms of compliance or to concede that perhaps Dick does have a good idea.

MR. JOHN T. ADNEY: We want to talk about, as Chris mentioned, some of the technical details. There are a number of open questions and issues under the seven pay test of 7702A of the code and, inferentially, the definition of life insurance provisions from which 7702A is derived, which we will discuss.

TAXATION OF LOANS AND DISTRIBUTIONS

The first subject which we will cover is loans and the treatment of loans and distributions in the case of a contract that is a modified endowment contract. That is to say, it's a contract that has failed to meet the seven pay test of 7702A or, as Dick put it, it's a contract which is paid in too fast.

In the case of the modified endowment contract, a policy loan, a loan from a third party taken against the contract as collateral, or any distribution from the contract would be taxed in the same manner as a premature distribution under a deferred annuity contract. This would be a cash distribution most likely, but it could be some other kind of deemed distribution. The result is LIFO or gain out first taxation and, in certain instances, the 10% penalty tax may apply.

LIFO income is defined as the excess of the cash value of the contract, that is, the cash value without regard to any surrender charges immediately before the distribution, over the investment in the contract as defined in section 72(e)(6) of the Code. Basically, it's what you put into the contract less whatever you took out previously without paying tax.

AGGREGATION RULES

As Dick mentioned, the 1988 law added a new aggregation rule, one of three that I counted in the insurance provisions alone. Section 72(e)(11)(A) of the code now says that for purposes of measuring that LIFO income (the excess of cash value over investment in the contract), the aggregation rules apply. In the case of a distribution out of any modified endowment contract, it's necessary to aggregate that one contract with any other similar modified endowments or, for that matter, any deferred annuity with any other deferred annuity sold by the same company or affiliate for the same policyholder within the same twelve-month period. This is a simple concept for Congress to articulate and a very difficult one, as you well know, to administer.

There are pending right now, in both the House and the Senate, bills which would deal with this year's budget. Parts of those contain revenue provisions which, in turn, contain technical corrections to that aggregation rule. You should be aware of what is in those bills even though we

do not know whether any of it is yet going to be in the final bill that Congress comes out with. The House bill would exempt qualified pension plans from that aggregation rule. I don't think there is anything controversial about that. It's what's left in the rule that's controversial.

The Senate went considerably beyond that and in the bill that the Senate has agreed to, they have made it clear that they're talking about contracts issued to the same policyholder. They also addressed the idea of a twelve-month period. No one quite knew when the 12-month period started and when it stopped. Some argued that it was one day less than the 24-month period, really. The Senate has substituted the notion of the calendar year which I don't think is too much in debate. I think everyone's using the Gregorian calendar these days and so all you need to do is follow the calendar-year concept. I think they did that as a matter of simplicity.

I believe that change is accepted by the Joint Committee on Taxation which means that if any of these technical corrections are in a final bill passed by Congress this year, I would guess that the calendar-year concept will be in the final bill.

The Senate went even further (and this is something I don't think the House agrees with) and said that the aggregation rule did not address the treatment of combination or split annuity contracts, that's their word, combination or split annuities. Basically, what I think they were trying to say was that an immediate annuity contract cannot be aggregated with a deferred annuity contract solely on the authority of the aggregation rule. The rule needs to be interpreted much more narrowly than that and that's fine.

The Senate continued a warning, and I think this is a very meaningful warning, that no inference was intended as to whether the Internal Revenue Service (IRS) could interpret current law before the aggregation rule was enacted -- basically, meaning the old regulations under Section 72 that have been around for nearly 30 years. The issue is whether the IRS could interpret those as requiring in effect some kind of aggregation of annuity contracts. There is aggregation authority in those regulations.

Essentially, what the IRS was going to be looking at, as I understand it, over the next few months, is whether 1987 Private Letter Ruling that enabled the classic split annuity to be written is to be revoked. Now, they're going to reconsider that based on the old regulation.

I don't know that the Senate narrowing of the 1988 statutory aggregation rule will pass, but it is certainly something to keep an eye on. It was good news from the Senate for a change. All of that goes to the measurement of what the LIFO income is in the event of a distribution and could broaden it or narrow it depending upon how those controversies play out.

TREATMENT OF SURRENDER CHARGES

As you know, surrender charges are not subtracted in making these determinations (of LIFO income) and the investment in the contract is increased by distributions described in 72(e)(4)(A). This section simply describes a policy loan or an assignment. So if the policy loan is going to come out taxed, it is going to increase the investment in the contract. However, other distributions that come out, including untaxed distributions, are not going to do that.

One question that has been raised due to the fact that the surrender charges are not subtracted in determining the amount of the LIFO income deals with the treatment of so-called back-end loaded contracts.

Under the deferred annuity legislation in 1982, back-end loaded contracts (contracts with surrender charges) do not appear to have as favorable treatment as contracts that have the charges taken out up front. Under the application of these rules, the back-end load contract will appear to have more income in it -- so that any distribution is going to carry with it more apparent income and more tax than in the case of a front loaded contract.

That's been well settled for annuities and that's just the way it is, but a question has risen whether it applies in the case of a modified endowment contract. If a number of distributions had taken out all of the income in the contract and the contract is then surrendered, there would be a loss thrown up by that surrender event. In the case of the annuity, I think it would be pretty clear you could deduct that loss for tax purposes.

The case of the life insurance contract is not as clear. Can you deduct the loss? That's the question that has been raised. The answer is no one's really quite sure whether you could deduct that loss or not. There are old authorities from the 1930s saying that you probably could not deduct the loss on a life insurance contract, but that would be because it would be attributed to mortality charges. Where you could show that the loss was generated more by surrender charges than by mortality charges, there may be an argument for deduction of the loss, but it certainly is not a clear case.

DISTRIBUTIONS DEFINED

The legislative history of the 1988 law said that distributions included policy loans. It included dividends or anything else you used to pay an outstanding loan or loan interest.

What is unclear is what obligation companies have to withhold and report on third-party loans that are secured by assignment of the contract. There is some taxable event generated by the assignment of the modified endowment contract as collateral to support a loan from a third party. But there is a lot of room for debate as to who has the withholding and reporting obligation.

I think there's a good argument to be made that it's the third-party lender and not the insurance company that would have the obligation. But I will defy anyone to interpret the current rule, including all of the regulations that were issued under Sections 3405 and 6047 of the Code a few years ago, the withholding rules on commercial annuities, to come up with any kind of a sensible explanation as to what's to be done in this situation. We've talked to the IRS about it and they don't know either, but I think they will probably work on it.

COLLATERAL ASSIGNMENTS

Collateral assignments, as a general class, are treated as distributions under the Modified Endowment Rule. But what do you do in the case of a split dollar plan where you use the collateral assignment method? Is that really creating a distribution of the sort that Modified Endowment Rules were intended to pick up? Well, I think the answer to that question is it was intended to, but the key will be whether it does or whether it will be interpreted to do so.

The IRS has in the past 25 years construed the so-called split dollar rule in Revenue Ruling 64328. It's construed those arrangements, not as distributions from the contracts, not as loans as such, but really more a distribution of a benefit to an employee from the employer. Using that interpretation I think you could say you would not have any income under the contract in the event of a collateral split dollar.

I understand the IRS is now rethinking that 25-year-old ruling in light of 1984 legislation dealing with interest-free loans. They think that maybe the Interest Free Loan Rule could be a better way to get at the treatment of split dollar. I think that's probably correct, in fact, but what I think isn't important to the IRS. What's important for you is what they think, and we don't know yet what that is. Right now my bet would be that until the rule is changed, the collateral assignment would not be picked up, but nobody knows that for sure.

AMOUNTS RETAINED

Trying to get near the end of our discussion on the treatment of distribution and loans, we deal with the amounts retained rule and withholding and reporting for distributions made in anticipation of status. Amounts retained are not included in income. That sort of makes sense when you think about it. If you didn't get it you shouldn't pay tax on it.

Of course, that's too simple. The rule in section 72(e)(4)(B) of the code states (and has stated since 1982 for annuity contracts) that amounts retained by an insurer as premium or other consideration under a contract when those amounts are in the nature of dividends or similar distribution (that's dividend in the tax sense, a very broad definition of a policyholder dividend) would not be treated as a distribution. Otherwise, these amounts could be considered distribution.

I think the 1988 legislative history makes clear the rule covers the dividends used to purchase paid-up additions and dividends used to purchase qualified additional benefits. Those amounts would not be considered distributions.

What is unclear is everything else that might be arguably in the amounts retained category. For example, if benefits are purchased and, for that matter future premiums are paid, by the

surrender of paid-up addition, I think it is unclear at the moment whether that surrender of paid-up additions will be treated as a distribution or not. The industry would like to think it is not. It's just simply a reshuffling of money inside an insurance company's pocket. But there is plenty of authority for the IRS to conclude otherwise. I understand they are continuing to study that question and if the surrender of paid-up additions is treated as a distribution, I think that will raise a lot of eyebrows, but it is a possibility. Another equally plausible interpretation is that it will not be considered a distribution.

Benefits purchased by deductions from the cash value of a contract may be somewhat in the same boat. Qualified additional benefits purchased by deductions from the cash value of a contract probably stand on a pretty sure footing as not being distributions. But it is not terribly clear that that's so. Previously, we didn't worry about them, because we had FIFO taxation for these contracts. The issue did not arise. Now that we have LIFO taxation for this class of contracts, the issue could very well arise and with a penalty tax on top of it.

When you branch out beyond qualified additional benefits into the nonqualified category (and there are a few popular benefits of that sort, business term insurance, long-term care riders on life insurance contracts) this issue will arise in spades.

Will these amounts be treated as amounts retained since the policyholder does not get them in cash or will they be treated as distributions in time to support additional insurance benefits? I would not want to speculate too much on that, but I think the latter answer is at least possible and I would hope we could get some clarification someday that said otherwise, but I don't know.

Finally, we shall consider the withholding and reporting requirements for distributions in anticipation of modified endowment contract status. This is a rule that was put in the 1988 law. The treatment of withholding and reporting is still very unclear. Those distributions, as you will recall from the 1988 legislation, are picked up retroactively for two years. If a contract becomes a modified endowment contract in its fifth-year, distributions in years three and four, as well as five and thereafter, will be considered treated under the modified endowment contract rule.

How do you go back and withhold and report on amounts that previously went out the door and all the tax reporting for that year is closed? I don't know and the IRS has not yet said.

DEFINITION OF MODIFIED ENDOWMENT CONTRACT

I want to talk also about the definition of a modified endowment contract -- a few of the definitional concepts. What I want to talk about is what's the contract, what's the contract year and what's the amount paid?

You may think you know what a contract is, but in the tax law everything becomes fuzzy and exactly where a contract leaves off is something that is not terribly must clear always. It is clear that life insurance contracts to which 7702 applies are amounts or contracts for purposes of 7702A. Annuity contracts and other things hanging off life insurance contracts are not subjected to any of these rules.

The legislative history said riders to contracts are to be considered part of the base contract, whatever that is, for purposes of the 7702A testing. That has led people to conclude, for example, that qualified additional benefit riders or paid-up additions riders are to be treated as part of the contract both for purposes of measuring the amount of premiums paid for the contract and for purposes of setting up the limit against which those amounts are tested.

What about other sorts of benefits? What about nonqualified additional benefits? Are those to be swept into this? One who would read the language of the Senate literally would say, yes, they are swept in. But those who would read it a bit more cautiously, given that the literal reading is not always the one accepted, would say maybe we ought to hold off on that. I would suggest to you for purposes of determining the amount paid in and making sure that does not exceed whatever limit exists, it would be a good idea to assume that paid-up additions, paid-up additions riders, qualified additional benefits are counted and that other things are in a suspect class. And anything else you proceed at your own risk. That's easy for me to say, but I think it's true.

In particular, what do we do with certain so called or supposed qualified additional benefits? There's been an argument in the industry over whether a rider of term insurance on the primary

insured, that is to say, coverage on the party insured under the base contract, is a qualified additional benefit. Is it a qualified additional benefit?

The 1982 legislative history under 101(f) says that it is. Much of that was carried over inferentially into the 7702 legislative history, but the 7702 history itself and the 7702A history do not tell you whether the primary insured term rider is a qualified additional benefit. Presumably, we'll hear about that whenever the IRS issues regulation under the definition. As they are now saying that they will not have even proposed regulations out until the end of 1990, it will be a long time before we find that out.

The contract year is another question. It is necessary to know what year in which a limit occurs to measure it against the premiums paid in that year. That's the only issue here. The contract year is a defined term in 7702A. When does that year start? What is the initial date?

The language is not crystal clear on that, but I think it is simply your policy's effective date. I think you can run everything from that. You might loosely call it the issue date of the contract and company's practices will differ on that. I think the language and the statutes can be reconciled with it. It is not, however, without ambiguity.

The next two points are the effect of material changes on the contract year and what happens when there are multiple material changes. These are different aspects of the same issue. Generally speaking, material change under the statute will start a new contract year, but that can also create a mess, because there could be several changes within one year. Changes will occur at different times during the year.

Will it be necessary for your systems to start testing for new years at material change dates and, in particular, what happens when there are multiple material changes within one year? Does that not give rise to some abuse in a tax sense or at least could it not give rise to an administrative mess?

The ACLI working group on this issue has been looking at the question and I think they are going to propose to IRS that these rules be interpreted to provide that multiple material changes within one contract year will all be considered to occur on the first day of that year.

What is the amount paid which is measured against the seven pay limit?

There is a definition of premiums paid in 7702A that looks very much like the definition in 7702 itself. There's a reason for that. It was modeled on it. But it strays from it in a couple of respects and in other respects you can probably apply a few things we know about the 7702 definition to the 7702A construction. For example, under 7702 itself, premiums separately stated for nonqualified additional benefits that don't go into the cash value can be excluded from the 7702 testing. Probably the same rule exists under 7702A. We're not sure, but I think it's a fair reading of it to say that it is in there.

What do we do with cash values that materially change contracts, particularly contracts perceived and exchanges that are treated as material changes?

The definition of amount paid in would suggest that the full cash value is part of the amount paid, but it is not. The definition doesn't directly say that, but the rollover rule by inference does say it. So one needs to try to reconcile those two.

Finally, what do you do with the timing of premium receipts? Suppose somebody pays a premium early? How do you handle that under the amount paid in rule?

I think you handle it the same way UL contracts are currently handling or trying to handle that problem in the case of the Guidelines Premium Test. It may be necessary to simply hold the premium at the door, not credit it to the contract until the next year rolls around whenever that starts and the limit goes up.

MR. DESROCHERS: I'm going to talk a little bit about the calculation of seven pay limit, particularly with respect to a product which Dick referred to earlier, which is the last survivor single premium plan, the subject of some current legislative activity in Washington.

CALCULATIONAL RULES

We've talked about 7702A and the seven pay rule, but quite simply stated, qualification under 7702A, or the avoidance of classification as a modified endowment contract, is based on the calculation of the seven pay limit. This is a seven pay premium based on the mortality and interest as set forth in section 7702.

The limitation under section 7702A is determined using computation rules similar to those used under 7702 to determine such things as net single premiums and guideline premiums. For the most part the rules are identical, but where there are differences it leads to some interesting results.

The first difference is that under 7702 the contractual pattern death benefits are deemed to be provided until age 95, while under 7702A the death benefit is set at the initial amount. Whatever the death benefit is during the first seven years is used to calculate the seven pay limit.

The second difference, which is a consequence of the first, is that if there is a scheduled reduction in death benefit after the first seven years, it is not taken into consideration in the seven pay limit. There is some controversy as to how it's reflected in 7702, but most calculations reflect the scheduled reduction. Unlike 7702, there's a look-back rule in 7702A which John referred to earlier, providing that if there is a reduction in benefits during the first seven contract years, then the seven pay limit will be recomputed as if the limit had applied since issue and any distributions made within two years of the time of the change would be considered taxable.

A third issue which arises in the calculation of seven pay limit is whether or not a so-called Option II contract would have its limit computed as if it were, in fact, a level benefit plan or if there is some sort of an Option II seven pay limit. I believe it's still generally assumed that the limit is calculated as if the death benefit were level; however, Congress has not been willing to say with certainty that this is the case. Thus, there is some possibility that the seven pay test could be expanded slightly, but it's not one that appears very likely.

As I have mentioned, under 7702A a scheduled decrease during the first seven years is ignored until it occurs and then the look-back rule applies. Scheduled decreases after the first seven years, although they're taken into account in 7702, are generally also ignored in 7702A unless they happen within seven years of material change.

SPWLII -- SINGLE PREMIUM LAST SURVIVOR

All of that is background to a discussion of product which I'll call SPWLII. The product is simply a single premium plan sold on a last survivor plan basis designed to take advantage of the decrease rule and, also, to take advantage of the fact that there is an inconsistency in treatment between the computation rules under 7702 and those under 7702A.

The plan developed by Jackson National which has been the subject of so much publicity qualifies under the cash value test of 7702, but it's really irrelevant to the product design as to whether it's done under the cash value test or the guideline premium test.

Under the plan, one calculates a face amount pattern such that the seven pay limit and the net single premium or the guidelines single premium are equivalent.

That this type of plan was possible was recognized when the rules were written, but in looking at the economics of the plan it was believed that it would not work for investment-oriented products. While that may be true for a single life basis, no one appears to have considered a last-to-die product where the mortality expectation during the first seven years is quite a bit lower.

The face amount is designed with a reduction after the first seven years so that after that time the product looks very much like the traditional SPWL plans that Congress really believed they had eliminated through the passage of 7702A. Utilizing this design, however, companies are able to bring to the market plans which had all the characteristics of traditional single premium life. They avoided the LIFO treatment under 7702A and produced a "net cost" plan that looked and smelled very much like what Congress had said should not be allowed.

In his comments, Dick was discussing the shortening of product life cycles. This is a product that certainly got a reaction very quickly.

In the tax bill that's currently in the House, an amendment by Congressional Representative Kennelley would restrict the product design in such a way that it no longer has the favorable treatment. What they're currently proposing is to extend the look-back rule that we've talked about. If there is a reduction in death benefit within the first seven years, then any distributions made within two years of that time and anything going forward would be taxed on a LIFO basis. What they are proposing for a last-to-die product is to continue the look-back rule for the life of the contract, so that no matter when a last-to-die product had a decrease in face amount, it would be retested and any distributions from that point forward or from two years prior would be taxed.

The status of this bill is that currently it is a part of the House version of the budget reconciliation bill. It is not in the Senate version of the bill and there's some debate as to why it's not there. One theory which John has mentioned is that the Senate just doesn't care about such things. The second theory is that they have decided that they'll resolve the issue in conference and, perhaps, the result will be more restrictive. There's some suggestion on last survivor plans that perhaps they will always be modified endowments, that is they would eliminate the requirement of a decrease prior to becoming a modified endowment contract.

This is an interesting development and one that we'll continue to follow and see what happens. But, clearly, there's an interest in Congress in pushing back the edges of the favorable tax treatment, and as products come out like the SPWLII we will get a response.

One potential loophole in the proposal is that it does depend presently on a decrease, and it has only a two-year look back. Even if you were to write one of these plans which ultimately became a modified endowment contract, any distributions that came out within the first five years, as an example, would still be treated under the traditional cash recovery rule. They would not be treated on a LIFO basis but they would be treated as recovery of basis first.

One of the concerns that has been expressed by Congressional Representative Kennelley's staff is whether or not it's possible to modify this product design to go out ten years or twenty years before the drop in face amount and secure the FIFO treatment for the practical life of the plan. They are very concerned that the industry, again, will just design around any change that they make. That is the reason to make a more restrictive rule -- the conclusion that they could not eliminate only the investment-oriented plans, and so as a matter of preventing abuse they would just go after the entire class of last-to-die plans.

In the Kennelley amendment there's also some good news. Currently there is really nowhere in 7702 that a last-to-die plan is mentioned. Most companies have developed these plans and brought them to the market under the assumption that they are life insurance. But if one looks through the legislative history, there may be one or two places where joint plans and last-to-die plans are mentioned. So one of the positive things about Congressional Representative Kennelley's amendment is that it would certainly put last-to-die plans clearly into 7702 and 7702A.

TREATMENT OF EXPENSES

I'd like to talk now about some other features of the calculation rules that are present under the seven pay test.

There's a rule dealing with expenses that says policy expenses are not to be reflected in the calculation of the seven pay premium. There's an exception for small policies which, essentially, provides a $75 allowance for a small policy. However, there's also an aggregation rule and the effect of the aggregation rule is such that you are allowed one $75 allowance for each policy or each insured.

This is a rule that there's probably no practical way to take advantage of as very few companies have the ability to track policies by individual. So even though there is a provision in the statute for a small policy allowance, for all intents and purposes, it's really not effective.

There's also some discussion in the legislative history that there be an allowance for collection expenses. This is something that is currently not available to companies in doing their calculation and may only apply to small policies if and when the IRS permits it.

As a consequence, in practice the calculation of the seven pay limit should be done without any allowance for expenses.

MATERIAL CHANGES

The second concept that we've touched upon here is the concept of material change. In 7702A there is a provision that says if a contract is materially changed, then it should be retested under the seven pay rule and, in effect, the seven-year period should be restarted.

What has been interesting is the definitional problem of trying to determine what, in fact, is a material change. What I'd like to do is just go through some of the things that may or may not be material changes and make some comments on them.

It is generally assumed that an underwritten increase is a material change. This is in the category of likely, because it appears that there may be one sort of underwritten increase that is not -- one in which there is no additional premium paid in so the contract is under what's called the necessary premium for the base contract. Thus, it may be possible that there are certain types of underwritten increases which are not accompanied by premium which would not be considered material changes but, generally, one would expect an underwritten increase to be a material change.

A decrease is not. A decrease has its own rules and that seems to be pretty clearly set out.

Change in a nonqualified benefit clearly is a material change.

Change in ownership is unlikely to be a material change.

Substitution of insureds is quite interesting. If one makes a critical assumption and the critical assumption is that a substitution of insured is an exchange of contracts under Section 1035, then it's likely that would be a material change. However, there is significant risk for that assumption. A substitution of insured may be, in fact, a taxable event and the issue of a new contract -- under which case it would not be a material change. If one can reach the conclusion that the substitution of insured is an exchange of contract, then it would fall into the material change rule.

Another interesting problem is what to do about the option change from a level to an increasing option or in the other direction. We have generally argued, I think, that an option change in a UL policy is not a material change for purposes of 7702A. If it were to be characterized as a material change, then the risk is that option changes go in both directions. In some cases it's an increase. In some cases it's a decrease. Since the material change cannot be a decrease, a decrease has its own rules.

The implication of interpreting an option change or at least some option changes as being material changes is that some others are decreases and this is a conclusion that very few people are willing to reach. Certainly, the hope is that the government's not going to reach this conclusion.

Change in permanent guarantees is change in the mortality guarantee; change in the underlying interest guarantee is likely a material change where the values would have to be recalculated.

Misstatement of age is one that creates a number of problems under 7702, so it's not a material change but rather it is just a complete regeneration of values.

Change in dividend options probably is not. Change in loan provision is not. A lapse to extended term probably is not.

An exchange of contracts is pretty clearly a material change. The real issue on an exchange of contract is what is the premium to be applied? This is the issue that John referred to earlier. Where it is generally thought that you can rollover the cash value and not have that count against the seven pay limit, that seems consistent with the rules, but it's not clear that that's the case.

Finally, a change in the premium mode is not a material change.

The point I'd like to make is that there are a number of contract administration issues which people need to deal with and there are few "nos" on the list. There are also very few "yeses" and there are many things uncertain on the list. But whether the list is 100% accurate or is not -- and I suspect the "is not" is probably more likely -- these are things that administrators must deal with everyday. At some point you've just got to take your best guess as to what something is.

NECESSARY PREMIUM

I'd also like to talk about the concept of necessary premium. The principal effect of the necessary premium rule is that if increases to the face amount are made and are attributed to the payment of what are called "necessary premiums," then those increases are not material changes.

What's a necessary premium? Quite simply, a necessary premium under the guidelines test is the guideline limit. The one exception to that may be if there is a scheduled decrease in face amount, then it would be something different than the guideline limit. But for all intents and purposes under a guideline test, the necessary premium would be the guideline limit.

It's a little less clear under the cash value test as to what the necessary premiums are. Sections 7702 and 7702A make an assumption that what you're dealing with is an unbundled contract and so the necessary premium is calculated in terms of a deemed cash value, such that the premiums for the contract when accumulated at the contract guarantees do not exceed what's called the deemed cash value.

The rule does not deal well with the traditional plan where it's almost impossible, even on a guaranteed basis, to take the gross premiums for the contract, accumulate them at contract guarantees and arrive at the guaranteed cash value which we believe to be the deemed cash value under a traditional contract.

One of the difficulties in sorting out what are material changes and what aren't is the whole concept of necessary premiums. This is especially the case in dealing with something other than a UL plan.

EXCHANGES AND THE ROLLOVER RULES

Finally, I'd like to talk about the rollover rule as it applies to the treatment of exchanges as material changes.

One issue which comes up is the treatment of surrender charges on exchange contracts. If one were to be totally consistent with the rules, you would apply the contract cash value, the accumulation value, to the new contract. The reason you need to do this is consistency with the existing plan. What would happen if you had a material change to an existing contract? You would ignore surrender charges in going through the material change calculation.

If you're changing an old plan to a new plan and treating that as a material change, where does the surrender charge go? In theory you need to apply the previous accumulation value in doing the calculation. However, in practice, what most people have is a certain amount of cash in hand. There is no way of really knowing how much was surrendered on the prior contract. As a practical rule what most people apply in doing this material change as a result of a contract exchange is the money that comes in.

A second issue is the possibility of a negative seven pay limit. What happens, in fact, if in going through the calculation, the seven pay limit ends up negative?

There is some legislative history to suggest that that's okay so long as you get no additional money into the contract.

What we've attempted to do is give a sense of what some of the issues are that are involved in calculating the seven pay limit, what's involved in administering it, and what's likely to come next. We've got one more short part of the presentation. John is going to talk very briefly about some of the effective dates in grandfathering rules. These have been the subject or will be the subject of some proposed technical corrections.

MR. ADNEY: The pending technical corrections will be helpful to the industry in administering the seven pay test and, particularly, in applying the grandfather rule. For example, the negative seven pay limit problem that Chris talked about would be clarified in the technical corrections bill to say that you don't worry at all about a negative seven pay limit. That's all right.

From a grandfathering standpoint, the technical corrections bill would also say or would clarify that the rollover rule is used in the event of any material change, including an exchange of an old grandfather contract or a brand new contract. That was apparently left somewhat unclear in the

1988 legislation. There was some debate in the industry over that. The legislative history would simply clarify that the rollover rule is there anytime. Cash value from an old contract is being rolled over whether 7702A ever had a chance to apply to that old contract or not.

The liberalization in the effective date rules is really the greatest boon that could come to the industry from enactment of the technical corrections portion of the pending legislation.

I'm going to assume you're all familiar with the grandfathering rules and effective date rules and 7702A. They are convoluted rules. They are not easily comprehended, but if we assume we all have a basic understanding of that, I will talk about what the technical corrections bill would do to change it.

First, for contracts that have required premium payments, there was already a rule in the grandfathering provisions that said regardless of any death benefit increases that you may have in the contract to which you were unilaterally entitled, you can never lose the grandfathering so long as at least seven premium payments, level annual premiums, were required and so long as you keep paying those level annual premiums.

The enacted legislation in 1988 said continued paying them for life, or over the term of the contract, or something like that. The liberalization in the technical corrections title would say that you only have to pay seven premiums and then after you've paid at least seven required level annual premiums you can stop that premium. You will not lose your grandfathering. It's still possible to lose grandfathering on such a contract if you have a voluntary increase or a qualified additional benefit or something like that. But that's a different way of losing the effective date.

The other change is in the application of the $150,000 amount. This is Section 512(e)(2) of 1988 legislation. The rule as it came in said that you could have increases in the contract and increases in the death benefit and that would not necessarily lose the grandfathering so long as the policyholder was already entitled to those increases. However, if the increase exceeded the October 20, 1988, death benefit by $150,000 then you have to go back from June 21, 1988 and test for material changes.

If you ever paid more than the necessary premiums for the June 21, 1988 death benefit, you were on the road to a material change. There was a question of time whether the change would get there or the policyholder would die first. You hoped he would die first, because the material change is not something you wanted to deal with. You had to warn people that if they had paid more than the necessary premiums and had not yet reached more than $150,000 above the October 20 death benefit, there was a material change in waiting.

The technical correction would change this to say that the material change would first be applied or the material change testing would first be applied on the date that the $150,000 threshold is exceeded. That was really a change as much as a clarification.

Under the bill, in testing for a material change, the benefit to be used is not the June 21, 1988, death benefit, but the October 20 death benefit plus $150,000. That is what Congress thought it was giving away in 1988. Apparently they had priced that into the bill (into the revenue estimate), but they didn't say it right. That's perfectly understandable, because I don't think they quite understood the material change rule themselves.

The way this is now working, you can include $150,000 over the October 20 death benefit and test for material changes beyond that, which I think means that the necessary premiums now are for a benefit of October 20 plus $150,000. That is a considerable liberalization. That is in both the House and the Senate bills. There doesn't seem to be any argument about it.

The final thing that I will mention is a contract issued prior to effective date of Section 7702. And I'll just end with a little anecdotal history. We asked the congressional staff to clarify that contracts to which 7702 did not apply could not have 7702A apply to them, because by its terms it only applies to contracts to which 7702 applies. They looked back and said, "Why are you asking that? Of course, that's so." So we do not have a clarification in writing, unfortunately, but I think we've got some kind of an understanding.

MR. JAMES R. THOMPSON: I'm asking a question about the material change rule and starting a new contract year. Would it be possible to simplify the administration for a company just to state in its contract that you could only make one material change in that year? And I was wondering if you saw any contract design around this as used by current companies.

MR. ADNEY: Why not?

MR. ALAN DUBIN: It's just a comment that the problem with the decrease on the last survivor policies is not limited to single premium tax avoidance type policies. It was also applicable to the regular last survivor policy in the marketplace in that most of them are sold with these term riders.

They were sold on some projected basis with a decrease. Either the term rider dropped off or the face amount could decrease at any time and it has to be pointed out to the policyholder they'd better keep that term insurance in-force by paying their premiums; if not, they'll find themselves with modified endowment contracts.

MR. DESROCHERS: That's right. That's a good comment. Certainly, where they've chosen to drop off a term rider on last survivor products the plan may be reclassified.

If anything, I think we can look forward to using more restrictions on that and other plans.

MR. ADNEY: That's true. I think what Congress was reacting to very specifically, very simple-mindedly, was a plan that provided for paid up coverage with one premium. That was all they were concerned about and, certainly, others are equivalent to that over a period of time. You know it is not logically satisfying to see such a distinction being made, but that is the distinction Congress has made in the seven pay test.

The point you mentioned about decreases -- a term rider going off or some other decrease that may actually happen somewhere later in the life of a joint last survivor policy -- I know has been brought to the attention of Hill staff. It is possible that there will be some modification.

MR. ROBERT E. RICH: In the operation of the typical guideline premium policy testing for compliance with 7702, you get a situation where you have a seven pay premium under 7702A that ranges somewhere between 15% and 30% of the guideline single premium under 7702. It creates an intersection in about the fifth year where the payment of the seven pay premium is no longer possible under 7702 rules.

Is it clear and effective for these policies that you really have a five pay rather than seven pay test and is there any movement to try to have the seven pay premium accorded equal status under 7702 so that the seven pay premium could actually be paid and still comply with 7702?

MR. DESROCHERS: I know it was a surprise to the IRS when pointed out to them that, in fact, it was really not a seven pay limit but it was a four or a five pay limit.

If there is some clarification that, perhaps, the Option II could be applied as part of the seven pay, that might create some more opportunity to pay additional premium. To pay the full amount of the seven pay you need to design a plan under the cash value test rather than the guideline test.

MR. ADNEY: That was complained about a year or so ago when all this was under consideration. I think your observation is perfectly correct and as far as any movement afoot to try to liberalize the definition of life insurance, I think the movement is to try to not deal with the definition of life insurance at all, but to keep it totally closed up and not have Congress even acknowledge its existence.