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# INSURANCE TAXATION

Moderator: DONNA R. CLAIRE
Speaker: JOHN T. ADNEY*
Recorder: DONNA R. CLAIRE

- o What the Joint Committee is
- o What the government thinks of insurance products, such as
  - -- Inside buildup
  - -- Corporate owned life insurance
- o Any late breaking developments on insurance taxation

MS. DONNA R. CLAIRE: For all of you who were actually reading the program, Mary Schmitt was scheduled to speak. John Adney, who qualifies as an expert on the subject of taxes, is going to speak in her place. At the last survey done at the Product Development Section luncheon, we asked who you wanted to hear, and the majority response actually was a government speaker. Mary Schmitt is the Deputy Chief of Staff of the Joint Committee on Taxation. The minor problem is we don't run Congress. Unfortunately, they are still meeting and she was not able to attend. John very graciously agreed to speak at the last minute.

MR. CHRISTIAN J. DESROCHERS: I would like to give you a word of explanation about Mary Schmitt. When I first contacted Mary about speaking, she said she'd be glad to do it and the congressional calendar did call for adjournment about 10 days before now, so she was quite excited. When Mary called me about a week ago, I really did expect the call, because it's always a risk with government speakers that they will not be able to attend.

We will make an attempt to have Mary come speak in New Orleans.

When Mary called me, the first person that I thought of was John Adney. John gets part of the blame for this, because John helped me sign up Mary in the first place. And I called up and I said basically, "John, help. I certainly don't want to speak and if you have any ideas besides yourself to come and speak, let's hear them now." Well fortunately, John was very willing to help out and we do very much appreciate that.

John is a partner at Davis & Harman, a law firm in Washington. He is a frequent speaker at SOA meetings. John is, in many respects, a very talented amateur actuary. He knows Lotus and he knows Word Perfect, he runs his company's computer system, and he's very good with numbers.

John is a graduate of Yale Law School. He is a recognized industry expert in life insurance taxation. I first met John in the early 1980s, in the Section 101F, the definition

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of life insurance, and I know John had been active prior to that. He's been through several major tax bills and I can assure you, has been very involved in this one. So I'm sure that John will have some interesting things to say.

MR. JOHN T. ADNEY: I am a poor substitute for Mary, and I think you would very much have enjoyed listening to her and giving her your ideas. She would have benefitted from it as well. And I'm sorry that has not transpired, but no one, including about 535 members of Congress, expected the Congress to remain in session at this time. The deadlock that has occurred over the tax bill has simply pushed back all of the scheduling and made it extremely difficult for everyone in Washington to have a sense of what's going on.

The process that Congress is now working through is a process that no one has quite experienced before. It is simply paying tribute, on a delayed basis, to the existence of the Nation's deficit under the various budget measures that have been enacted over the years -- the 1974 Budget Act, the Gramm-Rudman legislation, and the like. It's really the concurrence of the increase in our deficit and a rising national will to do something about it. Unfortunately, the situation that the Congress and the President face right now is very much like that of a married couple, one spouse of which wants a luxury car and the other would like to have a nice boat to go fishing in. They can't afford both, but they buy both anyway, and then borrow the difference, of course. That's what the Congress and the President, on behalf of the Nation, have been doing for more than a decade now.

Now the time has come for the bank to collect on all those loans. They are very large, and it's difficult to come to grips with something like that. Yet that is the shape of the battle that is now proceeding. It will not be finished this year, whether or not we have a tax bill this year.

A recent cover of *Time* magazine had an interesting observation on it. It said that: "Looming recession, Government paralysis, and the threat of war are giving Americans the jitters." I can't think of a better set of reasons to have the jitters. I am not qualified to speak to you on looming recession, but others are doing that very well, and all I know about the threat of war is what I read in the papers and see on the television, and that looks rather real. But I do know something about government paralysis, since my office is located between the two institutions that are responsible for the paralysis. The paralysis that *Time* was referring to, that I believe most of our countrymen are concerned about, is the paralysis in determining what's to be done with the U.S. budget and, in particular, with the proposals within the current budget package to raise taxes.

There is something less than a consensus in Washington as to the future of taxing and spending, a fact which has been evident for a good number of years. Subsequently I will offer you a personal point of view on whether this paralysis is going to end or whether it's going to take deep root and stay around a long time. But first, for you, focusing on the product development perspective, I think we need to talk about the provision in the pending tax legislation concerning deferred acquisition costs -- "DAC" -- or as we tried to rephrase it, "policy selling expenses," because that simply sounded more currently deductible.

# INSURANCE TAXATION

The current proposal to require capitalization and amortization of policy selling expenses for federal tax purposes can be traced back to a date prior to the 1984 life insurance company tax legislation. At that time, the staff of the Joint Committee on Taxation had suggested that one of the reforms that may be appropriate in insurance company taxation would be to require the capitalization of acquisition costs. As the 1984 law was put together, the Congress decided not to require capitalization, but it did place all companies on preliminary term reserves for federal tax purposes. And the purpose of this, at least in part, was to force a capitalization of acquisition expenses indirectly.

Since that time, although what I just said is true enough, revised thinking on the part of the Joint Committee and others has led to a retreat from a belief that the 1984 law effectively required some capitalization of acquisition costs. Whether it did or did not depends on whether Congress wrote the reserve rules correctly.

The current round of consideration of "DAC" got its start with a bill that was introduced by Representative Tom Downey of New York earlier this year, and then reintroduced with a co-sponsor, Mr. Moody of Wisconsin. These bills would have required the capitalization and amortization, essentially over a seven-year period, of a portion of acquisition expenses -- specifically, of a portion of agent commissions. I think it is fair to say from a press release that accompanied the introduction of the Downey-Moody bill that it was promoted by the Mutual Life Insurance Company Tax Committee, apparently for two reasons. First, the Mutual Company Committee foresaw that capitalization of acquisition expenses would eventually occur, as Congress searched for more ways of getting revenue out of the insurance industry and as this industry made more appearances on Capitol Hill for other reasons. So, creating a form of capitalization scheme was thought by the Committee, according to its press release, to be a good idea from the standpoint of preparing the industry for the onslaught and trying to control the outcome. Second, since the Mutual Company Committee was proposing the repeal of Section 809 of the Code, thereby granting mutual companies an unlimited deduction for policyholder dividends and losing some tax revenue in the process, the Downey-Moody capitalization scheme would replace part of that revenue (the bills proposed a proxy tax to replace the balance of it).

As it turned out, while in the thinking of the Mutual Company Committee the DAC proposal was very strongly coupled with the proposed repeal of Section 809, the linkage between the two was lost somewhere along the line. Even before the so-called "Budget Summit Agreement" was announced, *The Wall Street Journal* carried a story saying that, in the minds of a number of members of Congress, including the Budget Summiteers, they recognized that DAC was a free-standing idea that could be a very powerful revenue raiser. Indeed, there was talk of a revenue pickup in the neighborhood of $15 billion over the next five year period. And $15 billion over that five-year period would have gone a long way towards solving the deficit problem, at least in terms of the target that the Budget Summit was aiming at, i.e., $500 billion in deficit reduction over the next five years.

So the DAC proposal was placed in the original Budget Summit Agreement, but at an $8 billion level. As you can see, it was a revenue-driven decision. You know, of course, that the Agreement was defeated by the House when the agreement came up for a vote

at the end of September, and the government closed down, and very few people noticed (except those trying to get into the Smithsonian buildings in Washington). Then the government reappeared, all of a sudden, the following Tuesday, when there was a revised agreement worked out between the leadership of Congress and the President. They agreed to a tax provision that was simply a number lacking any substantive content. So, at that point, the industry had succeeded in deleting the DAC provision from the tax bill, but it was a transient victory at best.

In the end, the DAC proposal did not die. Once an idea like DAC surfaces and is agreed to by the leaders of Congress and the Administration, it simply does not go away. Hence, the bill now being considered on the floor of the House contains a DAC provision along the lines of the original Summit Agreement that would raise $8 billion in revenue over the next five years. It would be effective for premiums received beginning September 30, 1990, and would require a straight line amortization of acquisition expenses, computed as a "proxy" percentage of those premiums, over a 10-year period.

Why does the proposal use a proxy scheme? In defining what the policy acquisition expenses are, I think the Joint Committee staff, among others, came to the conclusion that it would be extraordinarily difficult to write an adequate definition of such expenses into the tax law. So, in order to avoid that and give Internal Revenue agents peace of mind when they conduct their audits, the Joint Committee constructed a proxy scheme for determining what the acquisition expenses are. The proxy scheme, of course, has the same merits and problems of any proxy scheme. The merit is that it's somewhat simple and the problem is that it does, at best, rough justice and many times does injustice.

The DAC proxies being considered by the House are a specified percentage of premiums based on line of business. For the record, we'll note what those are: for group life insurance, 1.65% of premiums would be subject to the capitalization and 10-year amortization; for annuities, 1.40%, and for other life and noncancelable or guaranteed renewable A&H, 6.25%. Now, these percentages are not to apply just to first-year premiums, but rather to total premiums. The reason for doing this on total rather than just first-year premium was to avoid any possibility of gimmickry, whereby a company would start out with a negligible first-year premium and subsequently collect the single or other substantial premiums. There was also a concern, I believe, that if the proxy scheme were not based on total premium, it would be necessary to draw up special rules for single premium and other policies that were fully paid up early on.

The various proxy percentages were set up at a level thought appropriate to track the actual acquisition expenses. Since there was no good definition of what the total acquisition expenses were, let alone the deferrable piece, there was a good deal of guessing going on. There was also a lot of argument back and forth between the Joint Committee and the industry. There were, for example, a number of points made that if annuities were to be subjected to the DAC provision at all, they should have a much lower percentage of their premiums being subjected to it.

Qualified pension product premiums are excluded from the DAC provision under the House bill, as are premiums reinsured. With regard to reinsurance premiums received (which are subject to the capitalization requirement), we have been told that the new

DAC scheme will supplant the capitalization requirement under the Supreme Court's decision in Colonial American. The bill also extends the rule put into the law in 1986 for property and casualty companies, the so-called 20% "haircut" on the increase in the unearned premium reserve, to the cancelable A&H business of life companies.

The House bill's DAC provision contains no fresh start, and I suppose the only good piece of news in any of this is that the DAC requirement in the alternative minimum tax is being repealed by the bill. It is not, however, being repealed for calendar year taxpayer in 1990. That will start in 1991 -- more specifically, in taxable years beginning after September 29, 1990.

For year-end 1990, assuming all of this passes into law, the amount of premium subject to amortization will be determined by using a pro rata rule. Rather than looking at a company's actual premium from September 30 to December 31, 1990, there will be a fraction -- the numerator of which will be the number of days in the remainder of the year (93 for a calendar year taxpayer) and the denominator of which will be all the days in the year -- which will be multiplied by the total 1990 premium (net of reinsurance ceded) to determine the premium applied to the proxy percentages. A half-year convention will be used for the amortization, and we understand that a full half-year's amortization will be allowed in 1990.

When the House considers the bill with the DAC provision in it, two amendments will be offered -- one from the Democratic side and one from the Republican side. The Democratic alternative retains the DAC provision with some modifications. The Republican alternative eliminates the DAC requirement, along with most other tax increases, and confines itself to spending cuts. It suffers from one disability: it doesn't cut enough, falling substantially short of the $500 billion goal in deficit reduction. Nobody believes the Republican alternative will pass the House, because the Republicans are outnumbered two to one, I believe. The Democratic alternative will very likely pass the House.

The Democratic alternative, with respect to the DAC requirement, incorporates the $8 billion DAC provision we just noted, and then makes a couple of changes. First, it incorporates a special rule for small companies, that is, companies eligible (in general) for the small life insurance company deduction under Section 806 of the Code. A company so qualifying will be required only to amortize over a five-year period. Since the $8 billion revenue increase associated with the DAC provision is revenue driven and must remain constant, the revenue lost by moving to a five-year amortization needs to be made up in some other manner within the DAC provision. Under the Democratic alternative, this is done by increasing the proxy percentages for all companies. Thus, the 1.65% for group life goes to 1.8%, the 1.40% for annuities goes to 1.50%, and the residual category goes to 6.75%, an increase of .5%. Another provision partly responsible for these increases provides that the capitalization requirement does not apply to any qualified foreign contract, as defined in Section 807(e)(4) of the Code. These are essentially specialty contracts that are written by U.S. companies operating overseas. Instead of the capitalization requirement, the alternative minimum tax DAC provision will continue in operation for these contracts.

The version of the tax bill being reported to the floor of the Senate by the Finance Committee also contains an $8 billion DAC provision. The Finance Committee version is worth watching carefully, for a couple of reasons. One is that the Finance Committee believes that it has been able to construct a bill that will be more acceptable to both Democrats and Republicans. In addition, the President has indicated he would like to see something like the Senate version become law.

The Finance Committee's DAC provision does not contain a small company carve-out, although it does provide the exclusion for qualified foreign contracts. Moreover, it adds authority for the Treasury to provide more categories of acquisition expenses with differing percentages attached to them. The authorization, however, is rather unusual in that it provides that whatever the Treasury does, it must not lose revenue. Hence, the other percentages will have to go up whenever the additional category or categories come into the law by Treasury fiat. The $8 billion DAC is, after all, a revenue-driven provision. Finally, the Finance Committee plan contains a very specific reinsurance rule: if the reinsurer is a company not subject to taxation under subchapter L, no "credit" is given for the reinsurance.

Where is all this going? I think that if a tax bill passes at all, it is pretty obvious a DAC provision will be in it. The tax writers have adopted the $8 billion revenue figure associated with the DAC provision -- it's just that simple. That it was despite a lot of lobbying and outcry from the industry. I think that in the push and shove that went on in the creation of this tax bill, the cry of outrage from one industry simply got lost. In the lobbying, the stocks and the mutuals and the agents were all united in saying there should be no DAC, or there should be as little as possible, and certainly far less than $8 billion over the next five years. The Congress has refused to listen.

Will the bill pass? I don't know, but I suspect that we're going to have a major partisan battle. It appears to me, and I suspect that it appears to many of you, that what we're seeing is a lot of partisan posturing right now, particularly in the House measure, as the members go off in the next few weeks to face election. The Democrats simply want to label the President and his party as being greedy and themselves as being the party of the middle class. The Republicans would like to take a hard line on no new taxes, but the President seems to have given that away. So I don't know quite what the Republicans are going to do, come the election. But I think you will see a bill coming out of the Congress. It will contain the DAC provision, with one or more of those additions by the Democratic alternative or the Finance Committee as ultimately hashed out in conference. That bill will get to the President in a timely fashion.

Lost in all of this is the stock-mutual battle, which has been proceeding in varying degrees of rancor over the last five or six years. I think that while many in Congress earlier this year believed that this would be an appropriate time to again take up the question of Section 809, and primarily the question of what should replace Section 809, during the great crisis over the budget all of that got lost. And in particular, what we saw earlier this year was a great antipathy on the part of Ways and Means Committee members to step in the middle of the "gunfight" between the stocks and the mutuals. That is understandable. I don't think that anyone, but particularly any politician, really wants to get in the middle of a battle when there are friends on both sides. So there is

nothing in the pending legislation on the stock-mutual issue. The Administration, during the Summit negotiations, had argued in favor of the Treasury plan for solving the stock-mutual issue, i.e., to repeal Section 809 and allow an unlimited dividend deduction for all companies, including mutual companies, and to impose a proxy tax which was a rather thinly disguised inside buildup tax on the investment income of all insurers. The Summit did not agree to that.

If the DAC provision passes and the stock-mutual issue carries over to the next Congress, does that mean we will have one or more additional years of arguing between the stocks and the mutuals on Capitol Hill, with Congress perhaps acting in 1992 or 1994? I have no answer to this, other than to observe that many people, in and out of Washington, are tiring of this continual fight. So it's hard to predict precisely what will happen, but my prediction would be if the bill passes with a DAC provision in it, the battle between the stocks and the mutuals simply will continue. I think there may be some additional motivation now on the stock side, in that the stock companies will see their taxes go up by the amount of the DAC and believe that, perhaps, they are even more overtaxed than before -- relative to mutual companies.

If, however, the DAC provision does not pass because the tax bill does not pass, it would be evident that Congress would consider a new tax bill next year. You could then envision an intensifying of the battle between stocks and mutuals, as stock companies come to understand that, to the extent mutual companies do not have their taxes increased, stock companies will have to pay the difference. That could emerge as a major industry bloodbath.

So, we will have to wait and see what happens. The last item I have on pending legislation is simply the bill that Representative Kennelly had introduced concerning corporate-owned life insurance (COLI). She had introduced the bill earlier this year at the urging of the National Association of Life Underwriters (NALU), whose members were concerned that current practices under COLI may result in Congress simply repealing the deductibility of interest on policy loans under COLI. The bill proposed to put a variety of collars around the practices, e.g., it proposed that in determining the amount of deductible interest on a COLI policy loan, the interest rate used could not exceed a reasonable market rate for life insurance policy loans. Although this bill initially was gathering support, it lost momentum after the Joint Committee examined it and concluded that it lost revenue. Apparently, this issue will carry over to the next Congress.

There have been other suggestions from government agencies about legislation in the future. The General Accounting Office (GAO) earlier this year, and the Treasury Department also earlier this year, filed reports on how Congress should change the tax treatment of life insurance products. This was in response to a mandate under the 1988 law that the current tax treatment of the inside buildup of life insurance and annuities be examined and, in particular, that the treatment of distributions under policies be examined in light of the rules that the 1988 law enacted.

Both the GAO and the Treasury said that the inside buildup of insurance products, under appropriate tax theory, could be taxed to the policyholder on a current basis.

Having said this, however, the GAO stopped short of recommending current inside buildup taxation to Congress at this time. Perhaps they simply wanted to have authority to keep studying it for the next two decades -- an annuity of sorts for them. Perhaps they also were concerned about being visited by scores of insurance agents. For a variety of reasons, they said they would not recommend taxing inside buildup. They did say, however, that they thought there was no justification at all for allowing tax-free policy loans and recommended that loans under life insurance policies, and I assume they would include partial withdrawals in this as well, should be taxed under the annuity rules. This was essentially what was proposed in the Stark-Gradison bill in October 1987, when the Congress first dealt with the single premium life insurance question.

The Treasury Department also stopped short of recommending current inside build up taxation. But they did have a few recommendations. In particular, distrusting the modified endowment rules, they recommended that during the first seven years of any policy, the annuity rules should apply to loans and other disbursements, so that any loan taken out in the first seven years would be subject to LIFO taxation and a penalty tax. Treasury also recommended, with respect to COLI, that the interest deduction for corporations on policy loans under COLI be repealed, saying that there was too much leverage. Finally, the Treasury came to annuities, saying that there's not much justification for taxing nonqualified deferred annuities, as they are written today, differently than passbook savings accounts or certificates of deposit. They did see a reason for allowing tax deferral, however, where the annuity is to be used for retirement purposes. So they said, as long as the annuity is dedicated to that, they would not insist on current taxation of the inside buildup.

What sort of dedication to retirement is the Treasury talking about? They are essentially saying that a deferred annuity must be committed virtually to life annuitization. They have something of a cutback from there, but it's virtually life annuitization, and I assume the way they would go about it is to require anyone buying a deferred annuity to sign an IRS form, very much like the form you sign when an individual sets up an individual retirement annuity, saying that the money under this contract is being dedicated to use for retirement purposes -- a sort of pledge to annuitize, if you will.

These two reports are sitting somewhere on a desk on Capitol Hill. What is to happen with them? Obviously, nothing is going to happen this year. The Hill staffs simply have not had the time this year, given everything else that was going on, to assimilate what these reports said. But, there's always 1991 and 1992. The Joint Committee staff, I think, strongly shares many of the views stated in the reports, and perhaps would say that the Treasury did not go far enough in its recommendations. So I think you will see Hill focus and activity in a subsequent year on these reports, and it will be terribly important for this industry to do some work, some hard work, to try to ward off as much of this as is possible.

The last topic I'd like to cover involves a few administrative issues. The IRS has been very quiet lately, and that's disturbing. If any of you have small children, you know what happens when they're quiet.

As far as annuities are concerned, the Service people recently told us they continue to be concerned with split-funded annuities and they continue to be concerned with variable annuities that have, in their judgment, too many investment choices and too much ability to move money around quickly.

With respect to split annuities, the Service people point out that they have withdrawn the one private ruling that treated the split annuity as if it were two separate pieces for tax purposes. They further point out that there's been a regulation on the books for more than 30 years which provides that, when two or more annuity elements are sold for single consideration, they will be considered a single contract for federal income tax purposes. The Service people caution that the industry should read the regulations before issuing split annuities and promising policyholders the immediate portion will receive immediate annuity exclusion ratio treatment, and the deferred portion will be a deferred annuity. The IRS is not so sure that that will be the case and is waiting for an opportunity to assert that the contrary is the case.

For variable annuities, the situation is even less certain. I don't think the Treasury and the Service are very much agreed on what should be done with respect to variable annuities on the perennial issue of "control." Control means the policyholder thinks he's managing the money -- it's an issue of perception. But it's a very big issue for the IRS. They have issued a number of rulings on it, have fought court cases on it, and they have been winning. What will be done? I think it is quite possible that the Service will attempt to write some regulations, hopefully with prospective effect, that will say that a variable annuity or a variable life policy, which has more than X number of funds allowing more than Y number of switches per year, will simply not be respected as an annuity or a life policy for federal income tax purposes. We don't know, however, that that will be done by regulation. It may be done by ruling, and if so, it could have retroactive effect. All I want you to know is that they're watching the industry on this issue very carefully.

Turning to life insurance, the Service had promised regulations on what mortality charges are reasonable for purposes of the definition of life insurance, under Section 7702 of the Code, by January 1, 1990. It is now a bit beyond January 1, 1990, and the regulations are still pending at the Treasury. They're supposed to be out soon, according to the IRS. The Treasury people said that they will be rather "bare bones." They will probably allow 80 CSO-based charges as reasonable mortality charges, but I doubt that they will give the industry any relief, the way I read it, on substandard issues, or guidance on joint life policies, or on much of anything else. On most categories, I suspect that companies will be told that actual mortality charges expected to be imposed will be reasonable charges, without allowance of any redundancy beyond 80 CSO.

As to the Section 7702 regulations generally, the Service continues to work on them. They have actually hired a new staff person whose focus is Section 7702, including the regulations. The ACLI also continues to cooperate with the process in response to Service inquiries. So, this will likely be fruit for discussion, perhaps, at your meeting next year and the year after.

That about sums up the tale of woe coming out of Washington these days.

MR. WILLIAM L. HEZZELWOOD: I've heard some talk but I haven't seen anything in writing about the idea under the DAC proposal of having group contracts, that have characteristics of individual, such as group ordinary or group universal life (UL), falling under the 6.25% rate. Is there any validity to that?

MR. ADNEY: I suspect there is validity to it. I think that you haven't seen anything in writing simply because a great deal of this has not yet been put in writing. You will probably see it in writing when it's too late to do anything about it, and that will be in the Committee reports. The Joint Committee staff, however, to the extent they have focused on the question, will put in something to the effect that a policy written in a group form that is essentially a collection of individual policies will get the higher rate, the residual rate. Now the question is, have they focused on it, or has the discussion you've heard simply been within the industry? And I don't know. But I would say that within the industry, if people are saying that it should get the higher rate, that sounds reasonable. The Joint Committee, to my knowledge, has not focused on that question, but every day they're learning more about this, and they're thinking about more pieces of it. And I don't think that after they heard about it, it would take them more than two seconds to reach the conclusion that was suggested.

MR. STEVEN A. EISENBERG: Can you tell us what the discussion has been so far with the treatment of vanished premium, where you're using partial surrenders of paid-up insurance to pay premiums or dividends to pay premiums; how is that going to be treated under the new tax rule for DAC?

MR. ADNEY: My understanding is that the annual premium coming into a policy will be the amount on which the amortization will be based. There is no provision for reducing that amount by dividends or anything else. By the same token, however, the congressional documents do indicate that, in determining what the premium is, Section 808(e) of the Code will not be used. Section 808(e) provides that amounts that are subject to deductions as they're paid out, and then are paid back in, are treated as new premiums. So I would guess that without the effect of that and without the dividend deduction, you would largely just be looking at the annual premium. If a policy, as you're suggesting, is paid up through partial surrenders or dividends or the like, I think that the future premium simply would be counted as premium. And then there would not have been a reduction, or any kind of credit given, for the amount of, say, the partial surrender. So, simply put, I think what this vanishing type of policy is trying to do is reach into itself to pay future obligations under it, and I would suspect that as the future obligations are paid, they will probably be counted as premium. The only thing that I am a bit uncertain about is if the dividend itself were used, rather than a partial withdrawal or surrender of a paid-up addition. If the dividend itself were used, then you may be able to exclude the premium generated by the retention of the dividend, because Section 808(e) is not going to apply.

MR. EISENBERG: So it basically sounds like flexible premium UL has somewhat of a tax advantage, if you cease premiums. Correct?

MR. ADNEY: That could very well be. I know that there is desire on the part of the Joint Committee not to create such advantages. But on the other hand, I don't think

that they have focused on this particular product design, and it may very well be that it would be necessary to talk with them to try to make sure that these products are handled in a neutral fashion.

MR. EISENBERG: Has there been any discussion at all about including the DAC in surplus for the mutual company surplus tax?

MR. ADNEY: Well, the stock companies have talked about it a lot. To themselves. I don't think the stock companies have bothered to raise that with the congressional staff. I'm sure the congressional staff have thought about it too. But if the unamortized acquisition costs were put into the Section 809 formula, I don't know that it's clear that that would necessarily increase mutual company taxes. It's going to have an odd effect on the earnings rates, because it would have to go into the determination of the stock as well as the mutual earnings rate; the differential is already hovering around zero. It could drive it below zero, in which case the Service would cut it off at zero, and zero times the equity is zero. So, I think the stock companies believed that Section 809 was already hopeless and that there was no point in trying to go in and refine it very much. There was also a concern, I think, that if this became an asset under Section 809, it could become an asset somewhere else as well, such as in determining the small company deduction.

MR. STEPHEN N. PATZMAN: Could you comment on these tax percentages? Looks like it favors buy term and invest the difference, or buy term and an annuity, versus buying permanent.

MR. ADNEY: Well, certainly if you're looking at the percentages that are attaching, there might be some benefit to buying term and putting the rest in an annuity. If you got the pricing advantage down to where this DAC tax provision was the only difference, then certainly the annuities would have the lower DAC tax rate, and they may wind up being somewhat advantaged over it. The individual term life insurance would be in the 6.25% category, it's not going to be broken out of that, and therefore, it would be subject to that. So I guess what you're saying is you're comparing a $1000 premium say, that might be split $100 to term and $900 to annuity; would the $900 be better off generating the 6.25% or the 1.40% tax for the company? And what sort of pricing advantage is going to be passed back? That's a distinct possibility. I'll let all of you determine how you're going to pass that on through and bring it to fruition. I'd also say that if the Joint Committee learned that this would force things more into a buy term and invest the rest mode, they wouldn't lose any sleep over it.

MR. PATZMAN: I guess I'm not so concerned with the tax. It is a concern, but also A. L. Williams, isn't this just a big club in his hands?

MR. ADNEY: It could very well be, although I'll tell you, the A. L. Williams people are less than totally happy about this entire situation. One of them calls me up and complains rather regularly. Their acquisition costs exceed that of the Prudential, and they are quite concerned over the DAC provision. I would guess that they remain very concerned, but as you're suggesting, and I certainly find no fault with your logic, this

could ultimately play right into the hands of their basic sales philosophy, as opposed to their tax bottom line, which is what they were complaining about.

MR. WILLIAM E. MASTERSON, JR.: Could you comment on the DAC percentages that might be applied to corporate-owned life insurance? In some cases those are written in the form of a collection of individual policies of the single premium type.

MR. ADNEY: I'm sure if the Joint Committee staff had their way, it would be above 100%. Corporate-owned life insurance is not too popular up there either. I would suspect, Bill, that for the group COLI product, that would probably not get in the group life category; at least I think you could get a lot of argument on that. And I suspect, insofar as the policies essentially function as individual contracts, you may have to settle for the 6.25% category. Now one way, though, that you could seek further clarification on it would be to try and find out what the acquisition expenses of that product are, relative, say, to a typical group term contract on the one hand, and on the other hand just the free-standing whole life or UL contract. If it gets a lot closer to the group life percentage, it may be possible to convince somebody on the Hill or at the Service that that percentage would be more appropriate. I wouldn't rule that out. I have not heard of any effort afoot to rule either one of them in as such yet. But again, well, I suspect that there are going to be a number of surprises for us all in the committee report language when it emerges.