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DEVELOPMENTS IN VARIABLE ANNUITIES

Variable Annuities was the subject of an address by John Antliff before the Chicago Actuarial Club April 24. We are indebted to Prudential's house organ "Ack Ack" for the material in this report. Mr. Antliff outlined the regulatory background, commencing with the 1952 formation of the College Retirement Equities Fund. This was followed by the 1959 enabling legislation in New Jersey; the SEC's claim, affirmed by the U. S. Supreme Court, of jurisdiction over variable annuity contracts; the Insurance Company Tax Act of 1959, which gave insurance companies treatment equal to that of uninsured pension funds in several respects, but exposed segregated accounts to capital gains tax; the 1962 relief from that tax and, in the same year, the SEC's no-action letter (in effect, a green light) on segregated accounts; the SEC's ruling in 1963 giving all insurance companies permission to issue, without registration under normal SEC rules, equity funding contracts to qualified pension plan groups of 25 or more lives; clearance in 1964 for a variable payout of the pension, provided no employee contributions are applied to the variable portion; and 1965 enabling legislation in New York. There are now 42 states where group variable annuities can be sold.

Variable annuities may be even more important for individuals than for groups because individuals do not have any chance of being given higher benefits to offset inflation. However, the Investment Company Act of 1940 introduces obstacles to the issue of individual variable annuities.

A few companies have arranged to have the investment fund under their contracts administered by a board of

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CANADA (A Continuation)

By J. Ross Gray

This final article on the proposals of the Carter Commission will point out some relieving provisions suggested in the report.

There is one correction to be made in the previous article in the April issue. The last sentence of the third paragraph should read:

> "When a family unit terminates by the last death, all unrealized capital gains are to be determined and income tax paid on them out of the estate. In addition, an heir outside the family unit will pay income tax on the net inheritance that passes to him."

Since the Commission's proposals will include more items as income, the rates of income tax should be lower than they now are, with the proposed maximum rate being fixed at 50%, the same as for the corporation tax. This assumes a disposition to reduce taxes, a trait not usually found in Governments.

Gift Tax and Federal Estate Tax are to be discontinued and income tax will be paid only by a recipient outside the family unit; thus money can be given or left to a spouse without federal tax effects. There is no assurance that Provincial succession duties on money passing to a widow will be discontinued.

Exceptions to the foregoing are to be the proceeds of group life insurance and the mortality gains on ordinary policies which are to be taxable income to the tax unit which paid the premiums. This is because tax credit is proposed with respect to the group life premiums and the mortality cost on ordinary policies. The entire proceeds are also to be taxable as income if left to a person outside the original tax unit.

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NATIONAL CONFERENCE ON MEDICAL COSTS

Most actuaries are aware of the problem of spiralling medical costs which are necessarily reflected in insurance cost estimates. As a follow-up to an earlier report to President Johnson, a National Conference on Medical Costs, called by Secretary Gardner of the Department of Health, Education, and Welfare, was held in Washington on June 28 and 29. Among those invited were several actuaries and other individuals prominent in Accident and Health insurance.

The Conference set up five panels to discuss the following subjects:

- *Hospital Costs* — panel came out strongly for development of cost reimbursement programs that would create incentives for increased hospital efficiency;
- *Community Systems* — panel stressed that community planning process should be comprehensive, recognizing that no one way is best;
- *Physician's Costs* — panel recognized shortage of medical manpower and gave attention to the lack of health care — not confined to the poor, but a growing problem with the middle class;
- *Cost of Drugs and Pharmaceutical Services*—the only agreement reached was that these services should be delivered at the lowest possible cost without compromising quality;
- *Third Party Payment - Cost and Impact* — the discussion was far ranging.

While the panel reports did not reach any definite conclusions, a number of suggestions were advanced for immediate study. Secretary Gardner said in the closing speech:

> "Everyone seems to agree that the existing system—or lack of system—

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VARIABLE ANNUITIES

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managers elected by the participants (employees). The insurance company still has some control over the investments made by such a board, since the board would choose the insurance company as investment manager — at least initially. Mr. Antliff mentioned that one company has a "captive" mutual fund registered with the SEC; its variable annuities are based on a separate account invested wholly in the mutual fund. Another company issues one-year temporary *fixed-dollar* annuities. This apparently avoids all restrictions on variable annuities, even though the annual amount of annuity varies according to the investment results of a custodian account held by a bank, and this fund may be invested heavily in common stocks. Another company has purchased a subsidiary which issues equity annuities that have been registered with the SEC as securities.

Meanwhile, banks have an unfair advantage over insurance companies in setting up variable annuity funds in that they can use employee contributions to provide variable annuities and need not be concerned about SEC restrictions on advertising.

Mr. Antliff gave some figures on the growth of separate accounts for 18 large companies. During 1966 this business doubled in assets from $251 million to $501 million and more than doubled in number of contractholders from 244 to 548. All 18 companies offered equity funding, but only 3 had variable annuities in force.

Most of the plans, said Mr. Antliff, available on a fixed-dollar basis can also be made available on a variable basis. If, when switching from fixed to variable, annuity credits are converted to the variable basis before retirement, the company may find itself with unfunded *variable* liabilities, which may be an undesirable situation.

He explained the significance of the assumed investment result (the interest rate assumed in the insurance company's purchase rates, with any excess interest or capital gains actually earned providing an increase in the pensions — or decrease, if negative) and said that under pension plans most employers are choosing an assumption of about 4%. Under profit sharing plans, on the other hand, employers seem more likely to elect 5½%, since group annuity contracts for profit sharing plans are on a terminal funding "money purchase" basis and the employees like maximum initial annuity payments comparable to fixed-dollar annuity rates on a non-par basis. An assumption higher than 5½% might give too great a likelihood of dissatisfaction with later variable annuity payments.

Mr. Antliff showed slides summarizing theoretical case histories going as far back as 1900. In general, variable annuities would have compared very favorably with fixed-dollar annuities and quite well with the consumer price index. They would not usually have kept up with the wage index (a rough measure of trends in the real standard of living). He pointed out that if the study had gone back only as far as 1918, instead of to 1900, the variable annuity would have shown up still better — much better, in fact.

CREF reports virtually no complaints from its participants in any of the stock market downturns (1957, 1962 and 1966). Possibly it was lucky in choosing March 31 as the annual revaluation date for variable annuity unit value. Some companies prefer more frequent revaluation, such as monthly, to avoid getting stuck with a low valuation for a whole year (and also for other reasons).

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IRS Statement

(1), provided that the portion of the unfunded present value claimed is no larger than under aggregate funding. In the context of the paper, C_t is fully deductible if $k + d \ngtr 1/a_t$, where a_t is the average temporary annuity to retirement age at time t.

With respect to minimum contributions, the author had hoped to establish $c = k + d$ for the initial year to reproduce minimum funding under the Subparagraph C entry-age normal method; and to get IRS acceptance of the concept that a plan would be considered adequately funded for IRS purposes in years after the first (or at least until a plan revision) if, in the aggregate, contributions based on C had been made. Such an approach would have had the practical advantage of eliminating the Subparagraph C calculation and the need for an accrued liability concept after the first year. The IRS did not accept this principle, feeling that the approximations involved might be too significant in extreme cases. Accordingly, it is held that a determination of minimum funding requirements for a plan utilizing the modified aggregate method shall be made by Subparagraph C methods.

The summary paragraph of the technical advice reads as follows: "In summary, contributions determined in accordance with the modified aggregate method would be within the limits under sections 404(c)(1)(A) and (B) of the Code, and accordingly would be deductible under those sections. However, a determination of whether the minimum funding requirement of section 1.401-6 (c)(2)(ii) of the regulations has been met should be directly determined by a method appropriate as a basis of limitations under section 404(c)(1)(C) of the Code."

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CANADA

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The receipt of lump sums to be taxed at the progressive rates of income tax could cause real hardship. Three methods of relief are proposed:

(1) If the recipient is not over age 70, and is not already covered by Registered Retirement Income of the equivalent of $12,000 per annum at age 65, he may pay a lump sum into such a plan and pay income tax only as the payments arise.

(2) If the recipient is not over age 60, he may deposit the money with the government in a non-interest Income Adjustment Account and pay income tax only as money is withdrawn. It must all be out by age 60.

(3) He may recalculate his income tax averaging his income over two to five years, except that this cannot be done over any years involved in a previous averaging process, unless it is death or emigration which causes the second averaging. This presents no advantage to the man in the maximum tax bracket ($100,000 income).

These articles are over-simplified summaries of the Commission's proposal. The interested reader is referred to the 2,695 pages of the Report itself.