



SOCIETY OF ACTUARIES

Article from:

The Actuary

April 1973 – Volume 7, No. 4



The Actuary

The Newsletter of the Society of Actuaries

VOLUME 7, No.4

APRIL, 1973

REALIZED CAPITAL GAINS OF NON-QUALIFIED SEPARATE ACCOUNTS

by John C. Fraser

Realized capital gains of separate accounts funding variable annuities that are not tax qualified are subject to the 30% corporate capital gains tax if such gains are taxed as "long term" realized gains and are subject to substantially no tax if they are taxed as "short term" realized gains of the separate account, that is, if they are taxed on the same virtually tax free basis as the separate account's investment income. This peculiarity of the tax law has led some companies to consider "churning" their separate account portfolio every six months in order to generate short term rather than long term realized capital gains.

Before proceeding with such an investment policy, a company is advised to take a closer look at the situation; the mere "churning" of a separate account portfolio is not sufficient to achieve the desired tax free result. The capital gains tax is applied to the company as a whole, not to the separate account alone, and under current investment conditions where most companies have general account capital loss carryforwards and/or carrybacks to be used, this "churning" of the separate account will have no current tax effect, may very well have no future tax effect, may lead to bad investment timing because of forced selling and certainly to higher brokerage costs.

There are six capital gains tax situations that a company can be in (if we ignore the possibility of operations loss carryforwards and carrybacks, which would further complicate the problem).

1. If, in the current taxable year, there are both net short term gains and net long term gains, the former are taxed as investment income and the latter at 30%.

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WORK AND THE QUALITY OF LIFE

Work in America: Report of a Special Task Force to the Secretary of Health, Education, and Welfare. Foreword by Elliot L. Richardson, The MIT Press, Cambridge, Mass. 02142, pp. 252, \$2.95 (paper).

by Arthur Pedoe

An alternative title could be "Work, Health and Longevity" for life without health is a tragedy and longevity without health a disaster. President Nixon in his 1971 Labor Day address said: "The most important part of the quality of life is the quality of work and the new need for job satisfaction is the key to the quality of work."

In the article in *The Actuary*, April 1972 the writer referred to the 15-year study of aging by Professor Edman Palmore of the Center for the Study of Aging and Human Development of Duke University. His researches indicated that *work satisfaction* was the best overall predictor of longevity and the second was *overall happiness*, reflecting a person's general satisfaction with his or her situation.

This interest in the quality of working life led the Hon. Elliot L. Richardson, then Secretary of Health, Education and Welfare, in December 1971 to appoint a special task force whose report, "Work in America," was recently published. Seven of the ten members of the task force held doctorates and were assisted by a team of seven research associates. Fifty special papers were commissioned and the bibliography indicates the literature reviewed by the task force covers over 600 items.

One's prejudices may be aroused by these sociological studies which often merely confirm, after infinite labor, conclusions which could be arrived at by common sense. However, "Work in America" is an exception; the report

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SURVIVOR BENEFITS FOR THE UNIFORMED SERVICES

by Kriss Cloniger III

On Sept. 21, 1972, President Nixon signed Public Law 92-425 establishing a Survivor Benefit Plan (SBP) for the Uniformed Services. The SBP provides for survivor income of up to 55% of retired pay to the widows, widowers, and/or dependent children of retirees.

The most interesting features of this plan from an actuarial point of view are the premium formulas, the adjustment of premiums and benefits based on changes in the Consumer Price Index, the unique Social Security integration provisions, and a guaranteed annual income of \$2,100 for certain military widows.

Members of the Uniformed Services who retire on or after the date of signing will automatically be enrolled in the plan with maximum coverage if they have a spouse or dependent child on the date of retirement, unless they elect a lesser coverage or decline participation. Uniformed Service members already retired before the SBP's effective date are eligible to join the Plan voluntarily.

Premiums and Benefits

A premium which will cover a portion of the cost of the Plan is withheld from retired pay. The applicable premium depends on the beneficiary class, of which there are four: (1) spouse only, (2) spouse and dependent child or children, (3) dependent child or children only, and (4) other person with an insurable interest in the retiree.

The premium formula for Class 1, spouse only, is 2½% of the first \$300 of monthly retired pay plus 10% of the remainder of that pay. This premium is payable during the retiree's lifetime.

For Class 2, the premium equals the Class 1 premium plus an additional

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LETTERS

Department of Defense

Sir:

The Department of Defense is in the process of converting its actuarial activities from a military to a civilian basis.

Beginning with World War II, an effort was made to assign actuaries serving an obligated military tour, to duties of an actuarial nature. The first were Edward A. Lew and Jaywood Lukens. Subsequently, about 40 of the present Fellows and Associates were so assigned.

The change in the draft law has ended this source of talent, and the Department is under pressure from Congress to convert military positions to civilian whenever possible.

There is a substantial potential field for actuaries in the Department, but in general this is not presently recognized. The chief activity at present is in connection with military retirement and survivor benefits. Very soon there will be one million retired personnel with an annual budget of \$5 billion.

Any individuals interested should get in touch with me at the address below.

C. of the Assistant Secretary of Defense, Washington, D. C. 20301.

Joseph B. Glenn
Actuarial Consultant

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Nohow!

Sir:

Percy's report of my death (*The Actuary*, March 1973) is greatly exaggerated. (See Jub Jub's recent paper on Q_x becoming an imaginary number as it is for me.) Besides, "Jabber" Wock got the worst of it in that fracas.

Also, the time has come to banish the unffish thought that I am frumious (or, as Percy alleges, that my given name is Frumious. Mr. Carroll has even elevated Frumious to a principal in B & JJ!) No one has ever demonstrated that I am the least bit frumious, but the impression has led to shunning, which has probably contributed to the current ignorance regarding B & JJ's location. This inability to distinguish between a proper noun, an adjective, and a canard is deplorable and probably be traced to the elimination of the Society's English examination requirement a few years ago.

F. Bandersnatch

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Realized Capital Gains

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2. If there are both net short term losses and net long term losses, both are carried forward or backward as short term losses.
3. If there are net short term gains in excess of net long term losses, they are netted and taxed as investment income.
4. If there are net short term losses in excess of net long term gains, they are netted and carried forward or backward as short term losses.
5. If there are net long term gains in excess of net short term losses, they are netted and taxed at 30%.
6. If there are net long term losses in excess of net short term gains, they are netted and carried forward or backward as short term losses.

Note that in three of the six tax situations, Situations 2, 4 and 6, there are net capital losses and no tax is currently payable. In each of these three situations the net capital loss is carried forward or backward as short term, irrespective of the short or long term nature of the items from which it was derived. In these situations, which are undoubtedly the more common ones currently and perhaps even in the future, the "churning" of the separate account will simply lead to higher brokerage costs and possible bad investment timing.

Even in the other three tax situations, Situations 1, 3 and 5, where there are net capital gains, the mere "churning" of the separate account may not produce the substantially tax free result desired because of what is happening in the general account. Let us consider an illustration.

Suppose the separate account has a \$10,000 capital gain which it takes as short term.

- (a) If the general account has \$12,000 of short term losses and \$5,000 of long term gains, the company is in Situation 5 with a \$3,000 excess of net long term gains over net short term losses taxable at 30%. This final result would have been just the same if the separate account's \$10,000 of capital gains had been long term instead of short term. As a matter of fact, the "churning" of the separate account can never have any effect if the company ends up

in Situation 5 since by definition there are no net short term capital gains to be allocated to the separate account as investment income.

- (b) If the general account has \$12,000 of long term losses and \$5,000 of short term gains, the company is in Situation 3 with a \$3,000 excess of net short term gains over net long term losses. Here again the final result would have been just the same if the separate account's \$10,000 of capital gains had been long term instead of short term.
- (c) If the general account has \$8,000 of short term losses and \$5,000 of long term gains, the company is in Situation 1 with \$2,000 of net short term gains and \$5,000 of net long term gains. Assuming that the \$2,000 of net short term gains gets allocated entirely to the separate account, which is by no means certain on the basis of the murky examples in the Treasury Regulations, the company would pay a 30% capital gains tax on only its \$5,000 of net long term gains, and its capital gains tax would be \$1,500. Note what happens, however, if the separate account had taken its \$10,000 of capital gains entirely as long term instead of short term. In this case the company would be in Situation 5 with a \$7,000 excess of net long term gains over net short term losses and its capital gains tax would have been 30% of \$7,000, or \$2,100, which is only \$600 higher than before. Thus, by "churning" the separate account the company avoided the 30% capital gains tax not on the full \$10,000 of capital gains but only on \$2,000.

We have shown that in all of the six possible capital gains tax situations the "churning" of the separate account to obtain short term rather than long term capital gains may have little or no effect on its capital gains tax. Consequently, before a company embarks on such a course it is well advised to determine if there really are any tax savings and, if so, do such savings justify the higher brokerage costs and the possible losses due to bad investment timing.

And finally, if a company plans to "churn" its separate account merely as a justification for charging no capital gains taxes to such account, it should

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THE MEREU AMBIGUITY

by Frederic Seltzer

John Mereu's letter in the November, 1972, issue of *The Actuary* presented two different interpretations of the insurance symbol $\bar{A}_{vw:\overline{2}}^{\overline{2}}$ and asked our readers' help in resolving the problem. The readers of *The Actuary* rose to the occasion, and we have received many replies. Mr. Mereu's letter and excerpts from the replies follow:

"Perhaps the readers of *The Actuary* can help with the following.

"Consider the insurance benefit represented by $\bar{A}_{vw:\overline{2}}^{\overline{2}}$. Is the benefit payable if the last survivor status \overline{xyz} terminates after the joint status vw ? Or is it payable on the termination of the joint status of (a) the joint status vw and (b) the multilife status \overline{xyz} ?"

"Under the first interpretation the insurance is payable on the death of the last survivor of x , y , and z except if both v and w are then living. Under the second interpretation the insurance is payable on the first death if v or w dies; otherwise it is payable on the second death.

"How should we resolve this ambiguity?"

John Boormeester, Chairman of the Society's Committee on Standard Notation and Nomenclature, stated:

"I believe the difficulty mentioned should not exist in connection with the symbol $\bar{A}_{vw:\overline{2}}^{\overline{2}}$. The general multilife status symbol has the form $\overline{r}_{\overline{xy\dots z}}$, where the r must be placed over the end of the symbol. When $r = 1$, a last-survivor status is denoted and, by convention, the 1 is not inserted over the end (Jordan, pp. 217 and 221). Now, if a function is to be valued by a status being the r th of r or more statuses to fail, then the r must be 'written above' according to Jordan, page 240. 'Above,' I believe, should be interpreted to mean 'in the center' and not at the end of the symbol, because the end portion has already been reserved. For example, see the symbols $\bar{A}_{\overline{xy}:z}^1$ and $\bar{A}_{\overline{xy}:z}^2$, where the numerals 1 and 2 have been placed directly over the middle of the joint-life status xy (Jordan, pp. 233 and 234).

"One might avoid all ambiguity if one were to use Jordan's suggestion given on page 203 by writing the stricter but more cumbersome symbol $\bar{A}_{vw:\overline{2}}^{\overline{2}}$ to correspond to its shortened version $\bar{A}_{vw:\overline{2}}$ and the symbol $\bar{A}_{vw:\overline{2}}^{\overline{2}}$ to correspond to its shortened version $\bar{A}_{vw:\overline{2}}$.

"In summary, $\bar{A}_{vw:\overline{2}}^{\overline{2}}$ should have only one meaning: the present value of a unit payable upon the death of the last survivor of x , y , and z provided that at least one life of v and w has already died, and, furthermore, $\bar{A}_{vw:\overline{2}}$ should have only one meaning: the present value of a unit payable upon the first death if v or w die first or, otherwise, upon the second death.

"You will note that this letter quotes liberally from Wallace Jordan's textbook *Life Contingencies* (1967). Wally, who is also a member of the Society's Committee, concurs with the interpretations."

Michael Bennett, David Libbey and Walter Trice, and Michael Hoy suggested the same solution. Stephen Margolies and Luke Han, while concurring in the above solution, noted that the symbols $\bar{A}_{vw:\overline{2}}$ (double status) and $\bar{A}_{v:w:\overline{2}}$ (triple status) should not be confused, since they have different meanings.

Robert Rosati suggested that $\bar{A}_{vw:\overline{2}}$ be written as $\bar{A}_{(vw):\overline{2}}$. Barry Triller offered $\bar{A}_{\overline{vw}:\overline{2}}$, and Chris McElvaine indicated $\bar{A}_{\overline{vw}:\overline{2}}$.

Zehman Mosesson also agrees with Mr. Mereu's interpretation but prefers the following representation to clarify the problem:

"In my opinion one should not have to resort to this strict and overtechnical reading of the notation. I suggest the following as possible alternatives:

"1. For $\bar{A}_{vw:\overline{2}}$:

- (a) $\bar{A}_{vw:\overline{2}}$
- (b) $\bar{A}_{vw:\overline{2}} - \bar{A}_{vw:\overline{2}}$
- (c) $\bar{A}_{\overline{2}} - \bar{A}_{vw:\overline{2}} + \bar{A}_{\overline{1}:\overline{2}}$

"2. For $\bar{A}_{vw:\overline{2}}$:

- (a) $\bar{A}_{vw:\overline{2}}$
- (b) $1 - \delta \bar{a}_{vw:\overline{2}}$

"If I were a Part 4 student and encountered this ambiguity as a multiple-choice question, I should spend five seconds cursing the Part 4 Committee and then go on to the next question."

Realized Capital Gains

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carefully consider the effect on its general account. If such a practice were to increase the present or future capital gains taxes charged against the general account, which would happen, for example, if the effect of charging no capital gains taxes to the separate account is to use the general account's capital losses carryforwards without reimbursing the general account for their use, some adjustment may have to be made to avoid harming the interests of the company's fixed benefit policyholders. □

Letters

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Professional Conduct

Sir:

Mr. Germain's letter in the March issue prompts me to write.

At a recent workshop of the Canadian Institute of Actuaries, I was amazed at the number of people present who had not read the "Guides to Professional Conduct" of either the Society or the Institute. There were a number of visitors

present from the United States who fell in the same category, so it is not simply a Canadian failing.

As a member of the Institute's Committee on Qualifications and Conduct, I find this most disturbing. Perhaps we should consider having examination questions on the "Guides to Conduct" and perhaps even requesting that existing members write a periodical examination on the "Guides" just to make sure that they have read them.

J. Bruce MacDonald

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