

RECORD, Volume 22, No. 1*

Marco Island Spring Meeting
May 29–31, 1996

Session 71PD

Life Insurance and Annuity Products Under Alternative Taxation Systems: “The End of Life as We Know It?”

Track: Product Development
Key words: Product Development, Taxation

Speakers: MARILYN BROWN
CHRISTIAN J. DESROCHERS
CRAIG SPRINGFIELD†

Recorder: CHRISTIAN J. DESROCHERS

Summary: This session addresses potential changes in life insurance and annuity markets under alternative tax systems, that is, value-added tax (VAT) or consumption taxes, and flat taxes. The session primarily addresses policyholder tax issues but includes some discussion of corporate tax issues. Other topics for discussion include:

- *Background on alternative tax systems*
- *Effects on life insurance and annuity products and distribution systems*
- *Outlook for legislative action*
- *Can the life insurance industry survive a consumption tax?*

Mr. Christian J. DesRochers: There are two very knowledgeable speakers joining me on our panel. Marilyn Brown has been very actively involved in product issues for many years and has done a great deal of work in the variable products area. Joe McKeever, who was scheduled to be on our panel, called me a couple of days ago and said that he was feeling ill, so he drafted one of his associates, Craig Springfield, to attend in his place. Craig is an associate in the Washington law firm of Davis & Herman, which specializes in life insurance and annuity issues. He is a graduate of the University of Florida Law School and New York University. What I

*Copyright © 1997, Society of Actuaries

†Mr. Springfield, not a member of the sponsoring organizations, is an Associate in the Washington law firm of Davis & Herman.

am going to do is begin the discussion by talking about some of the mathematics of taxes; then Craig will discuss some of the proposals currently in Congress on tax reform; and then Marilyn will speculate on the effects of tax reform, should it occur, on the life insurance industry.

Tax reform is not a new idea. One of the best books on the subject is David F. Bradford's book entitled *Blueprints For Basic Tax Reform* (2nd rev. ed., ed: U.S. Treasury Tax Policy Staff Tax Analysts and D.F. Bradford). It was originally published in 1977 and later republished in 1985. In *Blueprints*, Bradford and the Treasury staff, some of whom are still there incidentally, describe two tax systems: an income tax system and a consumption tax system.

The income tax system that they described in 1977 proposed broadening the tax base and lowering the rates. In fact, it served as the basis for many of the concepts enacted in 1986. Discussions have turned to the next phase of the Bradford proposal—the consumption tax. We are not breaking much new ground in our discussion of tax reform. These are not new issues and these are issues that have been debated among tax policy professionals for many years. Perhaps we need a tax bill every few years simply to relieve some of the pressure on the tax code, or perhaps we have had too many tax bills, and frustrations with the current code are increasing. Maybe the politicians need something to talk about to make us forget healthcare or simply to remind us that the U.S. was founded on tax reform. Remember the cry of “no taxation without representation?” After 200 years, representation has not proved to be much better.

Whatever the reason, tax reform has been actively discussed. If you look on the Internet, you can even find the flat-tax home page. There is quite a bit of activity currently on tax reform. Note that there are many possible alternative tax systems. Two years ago, discussion focused on a value or value-added tax. Now discussion has turned to either a wage-style tax or consumption tax. In my remarks, I am going to focus mostly on consumption taxes.

I would like to begin with some observations on the income tax system. This is the judicial perspective of income taxes and it is from Oliver Wendell Holmes. It says “taxation in most communities is a long way off from a logical and coherent theory.” I now would like to offer the scientific perspective. A quote from Albert Einstein said, “The hardest thing in the world to understand is the income tax.” My favorite quote is from the political perspective of Russell Long, who spent many years as Chairperson of the Senate Finance Committee. It says, “Don't tax you, don't tax me, tax the fellow behind the tree.” Given all of those perspectives on tax

reform, I think you get some sense as to some of the real problems in implementing basic tax reform.

A key issue in the debate on tax reform is the definition of an appropriate tax base, and that is what should be taxed. Although the idea of a consumption tax may sound like a radical departure from our current system, it is not that different from the current tax base. The current system, known as income tax, has many consumption tax elements in it. Under the current tax base, for example, if you consume all of your income in each year, as many Americans do, then the tax bases are identical. The two systems differ only in the area of savings.

Under the current system, qualified pensions and IRAs receive consumption tax treatment. Therefore, in theory, a consumption tax could be implemented simply by treating all savings as IRAs. If one simply enacted a tax system that said all of your savings will now be treated as an IRA, then, in fact, we would be on a consumption system. I think this concept is important to the introduction of a consumption-style tax. As we will see from going through the math, it is not necessary to divide the system to capture all of the consumption transactions in the economy to use consumption as the tax base. The current system can be used with few key modification, and, in fact, that is the way that I would expect that it would be implemented.

If we look at the basic algebra of the tax base, the current income tax base simply equals wages plus investment earnings. Here we are talking conceptually and I recognize there are certain types of investment earnings that already receive consumption tax treatment. If we think conceptually, your income is simply wages plus investment earnings. Therefore, if one were going to tax wages, one would simply say take your current income and exclude tax on investment earnings. Mathematically what you would have is a wage tax. In fact, the proposal by Representative Armev (R-TX), which is a wage-style tax, simply approaches the issue in that way.

Income also equals your consumption plus your change in net worth or your change in wealth. Therefore, a consumption tax simply is income minus the change in net worth. As I said earlier, without savings, consumption equals income and, in the absence of savings, the current tax base is a consumption tax. Therefore, it is not necessary to measure consumption directly to implement a consumption tax. All you need to do is maintain the current tax base and simply allow an unlimited deduction for savings and not tax the growth of that savings. In fact, that is absolutely the equivalent of putting all of your savings in an IRA. Therefore, to move to a consumption tax does not require major changes in the existing system.

If one looks at the incidence of tax or the incidence of incoming consumption, you would see that even the incidence of tax would not change dramatically by age under a consumption tax system. It is also important to note that in considering at the tax base, perhaps 75% of the current tax base, or current gross income, is made up of salaries and wages. No matter what system is implemented, we are simply talking about what to do with that additional 25%. Radical tax reform of pulling the system out by its roots simply is not dealing with 75% of the income that is earned. It is working with, at most, 25% of the income and probably, more realistically, somewhere under 10% of the total income.

In some of the discussion about tax reform, I think it is very important to look at the big picture issues. Those issues are that salaries and wages will continue to be taxed at some rate and the critical issue for most taxpayers may well be the rate at which it is taxed, and not necessarily the basis on which it is taxed. It certainly helped my understanding of the base to simply look at the similarities between a wage tax and a consumption tax and the current tax base and to recognize that there are no significant differences.

For the life insurance industry, which is our interest, the key issue in the debate is whether or not life insurance is consumption or savings, and this is more of a detail of the big picture issue, but it is a detail that will be of critical importance to our industry.

Some of the various proposals have addressed this to a small degree, but fundamentally the question is, is the cost of insurance a savings element or consumption? If it is consumption, then we would see some dramatic changes with respect to the taxation of insurance products under a consumption tax. If it is treated as savings, then we may not see any dramatic changes. The difference that we would see is that many other types of savings are treated the same way. There is not a good answer to this question, and there is certainly not uniformity among the tax professionals as to what the right answer would be.

In many of the products that are offered today, separating the savings and insurance components is often very difficult. One approach under a consumption tax system is not to try to identify individual policy elements, but simply to say that all insurance (this has even been extended to property and casualty, automobile, and homeowners) is simply savings. In this view, life insurance policies would be treated as pure financial and savings instruments and would get treatment similar to other savings instruments

On the other hand, there have been proposals that have said, Let's treat life insurance as having two distinct components: a consumption element, which is term insurance, and a savings element. In Bradford's book, which was published almost 20 years ago, he talks about a view of life insurance as having an insurance component which is a one-year term cost and then an option to continue the insurance next year, which is a cash value. In Bradford's book, they suggested that there would be this dual treatment.

There is not a clear policy answer as to the treatment of insurance, and we can expect if tax reform proceeds to actual implementation or a bill where people are serious about doing it, then one of the very critical issues for our industry will be this debate as to what is the nature of the insurance product and how is it treated versus consumption and savings. In the discussion of tax reform, that is certainly an issue that we, as an industry, should not lose sight of.

With that as introduction, I am going to turn the panel over to Craig. He will talk about some of the specific proposals in Congress and the likelihood that we will see some political activity on this issue in the next year or so.

Mr. Craig Springfield: The principal subject I want to talk about is where the current debate on tax reform seems to be. After this, I would also like to mention a few other proposals that are currently before Congress.

As most of you probably know, tax reform has received a great deal of attention in the past year. There has been discussion of flat taxes, consumption taxes, and national sales taxes in news stories, politicians, and others. The media has also devoted a great deal of attention to tax reform in the last year, which probably has received more news coverage in the last six to nine months than there has been in the prior ten years, going back to the 1986 Act.

There are a number of reasons why it is important to pay attention to the tax reform debate. First, and perhaps most obviously, if the tax system is changed, this could have a direct effect on the tax burden that individuals and companies face.

A second reason, and what is as important for the insurance industry, is tax reform could dramatically affect how long-term savings products are taxed. This would include annuities, life insurance, and pensions. These are products where the current tax system provides some substantial incentives for people to save on the long term. Tax reform is likely also going to affect the tax treatment of other savings vehicles: stocks, bonds, real estate, and mutual funds, for example. It is difficult to know how the current competitive position of long-term savings vehicles might be

affected by any tax reform that is done. It is possible that Congress would strive to continue current incentives for retirement savings. On the other hand, if you examine many of the proposals that have been made to date, they seem to be encouraging savings generally rather than retirement savings specifically.

A third reason why I think it is important to pay attention to the tax reform debate is that, if we do have tax reform, this could largely affect the types of products that the insurance industry is going to issue. Just to use one example, the types of cash-value life insurance that were issued by the industry changed dramatically after the 1982 and 1984 legislation, which defined life insurance contracts for tax purposes.

While there are many tax reform proposals that have been made, the most serious discussion seems to be of consumption-based taxes, which Chris DesRochers has already talked about in some detail, and also, as an alternative, to just overhauling the current income tax system. Many of you may already be familiar with two of the most prominent consumption tax proposals—the first is Representative Richard K. Armey's (R-TX) and the other is by Senators Sam Nunn (D-GA) and Peter V. Domenici (R-NY). Both of these proposals would replace the current income tax system with what is effectively a tax on consumption rather than income, although, as Chris described, they accomplish this in different ways. Under the Armey proposal, there is a single tax rate and thus, you can call it a flat tax, while the Domenici proposal has multiple tax rates. Under the Nunn and Domenici proposal, a taxpayer would deduct investments in saving assets. This would be like an unlimited IRA. Under the Armey proposal, investment returns, such as interest and dividends, would not be subject to tax, and you could view this as an unlimited back-loaded IRA.

A third tax reform proposal has been made by Representative Richard A. Gephardt (D-MO). It is a broad-based income tax rather than a consumption tax and has a single tax rate; thus, you can think of it as a flat tax. There have been a number of other proposals that have been made recently and most of these are variations on these three different types of proposals. There have also been a number of proposals that are structured very differently and have not received as much attention, like a national sales tax.

Many factors are driving the tax reform debate today. Many people want tax reform to take place, but they come to the subject with many different goals and priorities. Some criticize the complexity of the current income tax system and it is true, in my understanding, that the current system places a \$300 billion burden on

the economy each year. Some also criticize the current system as being anti-savings. They say this is bad for the economy and individuals. In the last year or two, there have also been movements against the IRS. There are a large number of people who want to reduce the intrusiveness of a number of governmental organizations on individuals, the IRS being one.

There are also some other reasons why the tax reform debate has heated up in the last few years. One thing I have seen is that politicians on both sides of the aisle seem very reluctant to support the current tax system. They seem to either want to replace it with a completely new system, or they want to make a major change to fix what they view as a broken system. There has also been a proliferation of tax reform plans in the last few years. All of this creates an atmosphere and momentum for reform. One thing people have often told me is that when a great deal starts happening inside the Beltway, what eventually gets done may not look like any of the various proposals that are put forth, but oftentimes, once the momentum gets going, something will end up being produced by the system.

There are a number of factors that are going to affect the tax reform debate at a theoretical level. One that is more practical than theoretical is who are going to be the winners and losers. The current income tax system raises money and redistributes it among the population. Any change in this system is likely going to leave some better off and some worse off. It is also going to affect companies and industries differently. As to the losers, many people, especially the Democrats, believe that the middle class is going to be one of the big losers under a flat tax plan. If a single low rate is put in place, many believe that it will be impossible to provide a mortgage interest deduction, charitable deductions, and many other tax expenditures that are available in the existing tax system that a large number of middle class people like.

The Treasury Department has determined that under the Armev proposal, a family of 4 with \$50,000 in income would see an approximately \$1,600 annual increase in their tax bill. Older people are also potentially big losers under a consumption tax. The treatment of the elderly will also be affected by whether the consumption tax is similar to a wage tax, like that in the Armev proposal, or is more like the proposal of Senators Nunn and Domenici.

As to the winners, it is hard to say who would be a winner if tax reform is implemented. Certainly many people who are advocating reform believe that everyone is going to be a winner in the sense that tax cuts or tax reform could stimulate the economy and everyone could end up being better off. The Treasury Department has estimated that a family with \$200,000 in income would save around \$10,000

on its tax bill under the Armev proposal. From this point of view, some would say that the rich are going to be the winners in any tax reform. I must say that Representative Armev strongly disputed the Treasury's findings in this regard.

Two other factors that I think are going to affect the tax reform debate are somewhat related. One of them is fairness and the other is simplicity. In regard to fairness, people have different notions of what is fair. Some say that everyone should pay the same rate. Others say that people who are better off should pay a higher percentage of their salaries or income. For consumption taxes, another important issue is whether it is going to be considered fair to not tax investment earnings, basically interest and dividends. One possible response to this is that consumption taxes do actually tax these income amounts at the business level. It seems unlikely though, in terms of political reality, that this argument is going to carry weight, even if it is correct.

In regard to simplicity, the complexity of the current system is one of the things about which most people complain. The flip side of this, and this is something I have seen a great deal of as a practitioner, is that people seem to be willing to bear a substantial amount of complexity if they think it is going to reduce their taxes.

Another factor is going to be the impact of tax reform on the deficit. Deficit reduction is a very important issue to many Americans. As a result, most people assume that tax reform is going to have to be done on a revenue-neutral basis. For every tax that is repealed, you are going to have to put in place a new tax that is going to raise the same amount of money. It is difficult to balance revenue neutrality with a desire for a low flat tax rate and keeping existing deduction provisions like the mortgage interest deduction. When you try to do this, it becomes necessary to raise the tax rate and this becomes unpalatable at some point.

Another issue for people to grapple with is, how do we do transition? It is difficult to overstate the difficulty that transition issues are going to play in any tax reform that is actually implemented or comes close to being implemented. Just as one example, if there is a shift to a consumption tax, how are we going to treat savings that accumulated under the income tax? Are we going to run parallel systems for a while? How are we going to reconcile fairness with simplicity in this regard?

One of the things that people in the insurance industry and also the pension community are focusing on is the effect of tax reform on long-term savings. Proponents of reform emphasize the need to make the tax system more savings-friendly. It is hard to quarrel with this idea. There is, however, a legitimate issue as

to the amount of new savings that would be achieved from the present tax reform proposals that have been made and, perhaps more importantly, what type of new savings would be generated. Consumption taxes are more savings-friendly than income taxes, but as Chris DesRochers was saying, our current system is not a pure income tax. It is a combination of an income tax with consumption tax elements, and those consumption tax elements are largely the pension, annuity, and life insurance provisions that are available.

If we do have tax reform, what is going to happen? Is there going to be a potential shift from long-term savings into short-term savings? There may be, in effect, a net increase in savings overall, but it may not be the kind of savings that is going to be most beneficial to Americans, especially given all of the concerns that have been raised recently regarding the social security system and the number of commentators who have said that the current level of savings by people for their retirement, even those who have 401(k) plans, is not going to be enough. People are overestimating how much they currently have available for their retirement for the potentially 20 years that they may be in a retirement phase.

I'm now going to return to the current political situation in terms of whether we might see tax reform or whether it is just going to fizzle out. As I said, there has been considerable concern among insurers and the pension community about radical tax reform. In the last three to four months, things seem to have calmed down. When the Kemp Commission report came out last January, it received some attention, but not nearly as much as people had anticipated. Where things are going to go next, I think, depends upon several factors. Probably the most important factor is going to be the presidential debate. At this point it is unclear where Senator Robert Dole (R-KS) is going to come out on radical tax reform.

In the past, Senator Dole has built a reputation as being very concerned about the deficit. He has not ever identified with those who want to have tax cuts to stimulate the economy. In fact, Senator Dole has publicly disparaged conclusions of supply-side economics in the past. In the last year though, Senator Dole has taken some steps to become involved in the tax reform debate. He has said, for instance, that the tax system should be fairer, flatter, and simpler. In addition, Senator Dole, along with House Speaker Newt Gingrich (R-GA), appointed a commission last year to study tax reform. This was the Kemp Commission that I mentioned earlier, which released its report last January.

When the report came out in January, it was somewhat anticlimactic, as I said, and some believe that Senator Dole's influence kept the commission from pushing consumption taxes more than it did. Despite this distance that Senator Dole may

have placed between himself and tax reform in the last year, it now appears, from things I have heard, that he is studying a number of proposals rather seriously. It has been reported, for example, that he is considering a 15% tax cut. In addition, supply-siders apparently are encouraging him to justify a tax cut using supply-side theory. At this point it is difficult to say where he is going. He may continue his past practices, focusing on deficit reduction and fiscal responsibility, and he might say that we cannot have radical tax reform or that it is not needed. On the other hand, it certainly seems possible that he may embrace radical change in the tax system, perhaps advocating a consumption tax, and this might be a major issue in the upcoming campaign.

It is also unclear where President Clinton is going to come out on tax reform. In the past, the administration and the Treasury have taken the position that we do not need a radical change in the tax system and we can change the existing tax system in certain respects to make it much better. At the same time, I think it is conceivable that the administration would change its position if Senator Dole made radical tax reform a major campaign issue this fall. There are rumors that the Treasury is now studying whether major tax reform would be appropriate.

In addition to the presidential debate, the House Ways and Means Committee will also generate discussion this year regarding tax reform. It is currently holding hearings on this subject. In regard to the Senate Finance Committee, at this point, it is unclear whether it is going to hold similar hearings and, if so, when.

There are a number of potential obstacles that could prevent tax reform from happening. One I alluded to earlier may be that Senator Dole will not make it a campaign issue, and if he does not, I do not think President Clinton is going to, so the issue may fizzle out. Another possibility is Congress might be distracted by overriding issues. Tax reform may turn out to be just the political flavor of the month. This is not the first time that tax reform ideas have arisen inside the Beltway. Just as an example, Nixon appointed a commission in 1973 to study tax reform and that never came to any conclusion.

Another potential obstacle to tax reform is gridlock. There is a real possibility that, if President Clinton is re-elected, we will not see any major tax reform. It is all well and good for all politicians on both sides to say that the current system needs to be fixed, but before you can have something that is going to replace it, you are going to need to have agreement on a new system, and this could be very problematic.

Another obstacle is the enormity of the task. Having a completely new tax system put in place and dealing with transition is an enormous task. It is difficult to overstate that. The U.S. has the largest economy in the world. In addition, even though a number of industrialized countries have consumption taxes right now, they don't have a tax system that is based exclusively on consumption. They usually combine an income tax with a consumption tax. At this point, it seems improbable that we are going to have something like that here. Little interest has developed in adding a consumption tax to a smaller income tax. Rather, those advocating tax reform more often want to get rid of the existing system.

Another potential obstacle is that there are some who, if they cannot have radical tax reform, will do all that they can to block more modest proposals. There is already a substantial radical element in the Republican House regarding tax reform. As one example, Representative Sam Johnson (R-TX) has introduced a bill to repeal the 16th Amendment. That would make sure that we never again, unless the Constitution were later modified, have an income tax. Certain members of the House have also pushed to require a two-thirds majority vote in Congress to have an increase in taxes, although that was voted down last month.

Finally, perhaps one of the biggest obstacles to any tax reform is going to be in the details. Right now, people can talk about it in the abstract and they can come to some degree of agreement. But, as the details come out on any tax reform proposal that looks like it might actually pass, I think people who view it as harmful are going to oppose it. What we see in support now may quickly vanish. In this regard, one can remember the healthcare reform debate that occurred in 1994. That went fairly far through the political process, but it ended up self destructing.

As to predictions, I think debate is likely to continue throughout the next year. Flat and consumption taxes will be at the center of the discussion for some time to come. The political vulnerability of flat taxes, especially in regard to the middle class, is going to become clearer. At least the advocates in this regard are going to become more vocal. I think it is very possible that the debate may ultimately start shifting to reforming the income tax we currently have instead of replacing the existing system. I understand that Representative Armey has repeatedly railed against any idea that we can just live with a modified current system.

Eventually, I think it is possible that the treatment of annuities and life insurance products may again be questioned and proposals for change might be discussed. In such an event, I think it is going to be necessary to remind Congress and others of the need for long-term savings and of the roles that life insurance and annuities have in encouraging this. It is important to emphasize that, if individuals end up not

saving for their own retirement, the political reality is that the government may end up picking up the check for them if they encounter hardship later in their retirement years.

I'd like to turn to just a few miscellaneous proposals that might be of interest. With respect to healthcare legislation, it looks like it has a decent chance of being passed this year, possibly including medical savings accounts (MSAs). There is a considerable amount of talk about having MSAs as a demonstration project, perhaps with employers only, and probably with a sunset provision so we can see how it works for a few years. There is also a good chance that pension simplification could be passed. Right now it is part of a minimum wage package that has a great deal of support, and at this point, it has a number of popular items that Republicans want to see passed. It has passed the House, and I understand that the Senate is going to take it up. What they may do may be somewhat different, but I think there is a great deal of political momentum and we may actually see some pension simplification being done.

In regard to capital gains, as I understand it, the current Republican plan for reconciliation is going to be a three-part process. The first two parts are going to be spending-related, and the last part is going to be for tax cuts. I think tax cuts, at least in this election year, will contain one of the biggest items and priorities on their agenda: child credit, not capital gains, although it is possible that capital gains could be included. There is a great deal of uncertainty about this, in large part because of the political vulnerability of capital gains tax cuts. It is much more politically vulnerable than the child credit is. Because of this, there is probably not much of a chance that capital gains tax cuts are going to pass this year and if they do, I think it is likely that President Clinton would veto the bill. I believe there is some incentive and maybe some planning on the Republicans' part to have some tax bill that Clinton would end up vetoing right before the election. It remains to be seen whether this will actually happen.

I'd now like to turn it over to Marilyn Brown who is going to talk about the effects of tax reform on insurance products.

Ms. Marilyn Brown: As you heard from both Chris and Craig, the individual tax proposals have a variety of approaches, but what's common in almost every one of them is they remove the tax deferral of earnings; that is one of the main foundations that we have based most insurance sales on. We never dreamed a year ago that instead of losing the inside buildup that we could possibly be hit from the side with the fact that there would be no need to defer tax earnings at all, because they were

not taxed anyway. There are a variety of proposals coming through and a no-separate-capital-gains tax might be one of them. We also have heard that there might be a compromise in that quick fix since the current tax structure is entrenched, at least from the Congressional Budget Office's (CBO) perspective. They understand much of what is going on right now.

This is important for annuity writers now that we have no relative investment advantage over other institutions like the banks and the mutual funds. We saw some of these approaches for instance in the CD annuity, which banks attempted to introduce last year. We are going to have to respond to this in some ways to reposition ourselves. When you think about the fact that tax-qualified does not even make sense in the future, this is not a term that would have any appeal to anyone if savings are not taxed at all. It changes everything we focused on in the past. The sales focus would totally be changed if it removes the relevance of what a customer's tax bracket might be, what their investment horizon is, or the fact that there is inside buildup. It is going to have to change to focus on the protection elements that we offer in the insurance industry.

There are quite a few uncertainties that we have not even come close to addressing in any of the tax proposals. One of them is, Are in-force policies going to be grandfathered? Everyone assumes that, but we cannot assume that anything in the past would apply to the future. We hope they would. They did it with the wrap-around annuities in 1981 and flexible-premium universal life products were grandfathered on their no-cost loans or their preferable tax treatment on loans. We do not even know that would happen. Can you imagine if the pretax principal on some of the qualified business, which was never taxed before, suddenly became released into income?

What if this penalty-on-withdrawals-before-age-59.5 was removed? That is probably a likely scenario if there was some major tax overhaul. We do not know if any of these things would continue; there are very different consequences depending on what the scenario would be. If we did have this tax rollout of principal and earnings, one possibility could be because the joint committee on taxation for the CBO wanted the one-time revenue offset.

There have been similar situations before, such as when they proposed the MSA in the last year or two. That was one revenue offset that they could look to to cover some of the revenue deferrals that they were incurring. We do not think this is too likely, but we have seen the logical situations before from some of these revenue seeking bodies and, of course, these changes would be drastic for insurance companies.

What are some of the changes that would be necessary to make this more of a level playing field? We in the insurance industry have some disadvantages already. Right now we have very conservative statutory reserves and risk-based capital requirements. I believe these are stricter capital and reserve requirements than other depository institutions have to comply with. We have the state filing complexities that are much more costly and time consuming than the other indefinite type products out there. If this is going to be a level playing field, there has to be some removal of some of the unfair advantages of what we have put up with up until now, because we do have the advantage of the tax deferral.

The worst one of all is this deferred acquisition cost (DAC) tax that was laid on after products were priced. We have a premium tax. Our tax reserves have effectively caused an extra tax rate on our products because of that differential between certain tax reserves. We have quite a few things that need to be delved into if some sort of flat tax did come through. Also, we don't have the FDIC guarantees that the banks have. All of these would create an unfair advantage over insurance products if the inside buildup is removed.

How do we respond to this? I know many of you out there work at companies that have been working to reduce your distribution costs and reduce the expenses and the overhead in the company. A number of people have been changing jobs due to that.

Let's discuss higher investment yields. Each of these trends has been moving to improve the yields of insurance products, especially investment products over those of mutual funds and banks. We then must emphasize the insurance provisions more. The long-term guarantees we offer in the insurance industry and the reserves we have to back it up are critical. We may have to focus much more on that, on real risk protection and on savings for retirement some day, and avoid any discussion of tax deferral or investment yields. Ratings of companies will become much more important because the whole baby-boomer generation is relying on the insurance industry to provide for their annuity retirement. We are going to be focused much more on that long-term issue.

Also, I think that the winners in the industry are going to be developing new products and focusing on new products very quickly to respond to these changes. Some products will come back into favor. One product that I think will do very well will be variable immediate annuities because of that long-term-mortality guarantee and the demographics. We could also more easily combine health protection products such as long-term care with life insurance and annuities, which

right now we have had a great deal of trouble doing. We tried to get some private letter rulings or worry about how you can mix these products. Primarily we have not done that because of the tax code.

Let's focus on these insurance provisions, of which I am sure all of you are aware. They have always been there. For the variable annuities, the guaranteed death benefit, the guarantee of the principal or more on deposit, free transfers among the funds (which we do not have in a mutual fund or other products), annuitization, the payout guarantees, and the fixed account guarantees (with principal and interest for more than a year) all are advantages to focus on. At the session on equity-indexed annuities, where you have protection from the equity downside, as Tim Pfeifer said, the industry has to make sure that it does not shoot itself in the foot to focus more on the investment side rather than the protection side of this product.

For whole life, obviously the death benefit and the fact that you do not have to get re-underwritten later on and have the level premium will be a big plus to emphasize. But we are probably going to see much more of this "buy term and invest the difference" philosophy (as described in the Bradford book that Chris commented on), where buying the term and some sort of guaranteed purchase option is going to be more what the focus is for the insurance industry. The investment side will be secondary to the extent it can compete with other investment products. As long as the guaranteed account offers a guarantee that people are interested in, which they cannot get in other products, it will still be attractive.

I know that life insurance was sold even before we had income taxes. That product does not seem like it is going to be in too much jeopardy, but we must worry about the other products that we have sold and focused on as investment products. In the future scenario, we can see that reduced annuity sales could happen. Obviously, that's just for those that are sold for investment advantages. The low-cost sales would predominate, those that have higher yields, such as at Fidelity, Schwab, and even Internet sales where there are lower distribution costs.

The distribution retrenching is probably the biggest focus here. I know a large number of companies are concerned about how their agents can make money, especially companies that have trained new agents. The agents are even more concerned, but at one conference, they mentioned "There is not any other product we can make more money on, so we will probably stick with these products we are selling; we are just going to have to sell more volume or our income may have to come down."

This is the scenario that I told you about that could be drastic—with mass surrenders under certain conditions. If there was a situation either in the interest environment, such that people were better off to invest in other products, or if there was this immediate release of pretax earnings, we could have quite a few unusual scenarios in the industry.

One scenario could be that if interest rates were fairly low, there could be a huge windfall of profits for the insurance industry. That would be because you would have to liquidate assets when their market value is relatively high. There could be a short-term huge gain for the industry and an opportunity to invest in new products and to respond to the change.

If interest rates were relatively high, this could create huge losses on liquidation of the assets in the industry, and possibly some insolvencies would occur. What is more likely is that the losses would gradually occur over time with increased expense ratios on the smaller in-force business and the smaller new business in some of the companies that were heavily focused on the annuity and investment type products. We would just see much more industry consolidation and reduction, such as we have already seen, but this would accelerate as the low-cost, higher yielding companies acquire the weaker ones. The winning companies will be the ones that reposition themselves quickly, develop new products, and increase sales. In the demographics, there will still be a huge need for an institution to provide a vehicle for baby boomers to save.

I have had to work with some law firms on compliance, and when you deal with stockbrokers and their attitudes for sales, you are enlightened when you realize what their focus is. What one of them described to me is that the annuity block had reached the maturity age, and when I asked what that was, he said that is the end of the surrender charge period. You start realizing that they have different terms than what we have. I thought maturity age was when it expired without annuitization, which is anywhere from age 80 to age 90. They call it “repositioning the assets of the customers”; they feel they need to service the customer and update the products. In the industry, we actually have hurt ourselves because we have a hard time explaining to them when they replace a product how the customer is hurt. The customer may have basis point charges on their products. They had that on the old products. They have incurred a new surrender charge which takes away a put option for them to surrender. If they were intending to keep the product long term, the stockbroker/agent can say, “How are they worse off? They are getting the same yield they would have gotten.”

I point out that the insurance company would be worse off because they are paying out these up-front commissions again that they did not anticipate paying with the higher lapses, and over time, they would pass these costs on to the customer by charging higher expense charges and crediting lower investment returns.

That is more of a pooling approach, but it is very difficult to come up with an argument one-on-one to justify why they should not move the business. We all know that the advantages in a variable annuity are the guaranteed death benefit, the availability of a fixed account, transfers without charges, and the annuitization options. These are what variable annuities should be sold for and they should be sold for the long-term investment horizon. We have to face the fact that there are sales representatives who will be focused on short-term investments and relative investment potential; they will not value these.

Given that, say we have a scenario where the capital gains tax was lowered down to 20%; just as an example. Someone on Capitol Hill told me he thought this was the most probable change to happen in the next two to three years, because it was simple and therefore more likely to be accomplished. This is a very crude example and you may not agree with some of these assumptions. The net earned rate I used on the variable annuity was 9%, which has been an average over the last 10–20 years. The no-load mutual fund is at 9.5%. That differential has been analyzed in the industry for a long time. You have probably read about differences in average yields on these products. This is just an arbitrary choice based on what one or two people have voiced.

On the taxation basis, these are nonqualified annuities, which of course makes them more likely to benefit from a replacement like this. If you had a qualified annuity, it would take a very tough salesperson to convince someone that taking a tax penalty on the full amount could in any way benefit him or her. I am not going to discuss that because it should not happen. If these were nonqualified, the taxation would occur on the income over the basis at time of surrender, and then on the no-load mutual fund, we are assuming here 40% of the capital gains are realized annually and 60% are unrealized until surrender; this is a rough average. Bill Johnson at Fidelity gave me some figures for this, but if you had a bond income fund, this would look very different. The mutual fund would not look good at all compared to the annuity if you had income taxation. The argument about capital gains goes away if you are applying income tax. Assume this is more of an equity-type mutual fund. If you are in a fund where the investment manager is turning the investments more, you are going to have more of them realized annually than in this example, but it is just an average.

To give an example of an annuity in its fifth duration for Joe and third duration for Chris, we will just say, for argument sake, both of them have a pretax account value of \$100,000. Obviously the basis for Joe is going to be smaller because he came in much longer ago than Chris, but that does not make the outcome much different from what we are showing. Chris has a 4% surrender charge because he is only in year three, so that is the one we want to look at. You cannot imagine how someone would be better off incurring a surrender charge. They are both less than age 59.5 for the 10% penalty tax. Suppose you add a surrender charge and a 10% penalty tax to a surrender situation into a mutual fund. Now, Joe is in the 28% bracket, in this example. On Chris' side, the 39.6% bracket, to use the other extreme, will give you an example of that. In a third example, for Al, the only difference is removal of the penalty tax.

The point that I am trying to make here in the first two examples is, you keep your variable annuity for five more years and then surrender it. In example three (Al), you immediately surrender your variable annuity, and take the surrender charge, and then you hold a no-load mutual fund for five years. These are the after-tax values. Joe is better off if he had no penalty on the annuity, that is, if he was older. He is worse off than if he took the penalty. The point here is that if you are in a 28% income bracket, you do not come out much better to surrender your variable annuity; you should hold it.

If you go to Chris' example, even with the 4% surrender charge, as well as the 10% tax penalty, after only 5 years, he is better off than either scenario with or without the penalty. If you take it one step further for Al's example here, Al does not have the 10% penalty tax. You see that he is in an even better position to go to the mutual fund from the variable annuity. Five years may not be long enough to truly look at anything, but I wanted you to see how quickly it passed over. Actually, in Al's example, in the second year after tax, he was better off with the capital gains and the mutual funds.

Instead of five years, we go on for ten more years, which is a likely environment investment horizon for one of these two. In one instance, you keep your variable annuity for ten more years and then surrender it. In another instance you have stayed in the no-load mutual fund all that time after surrendering. For Joe, he still does not come out ahead in the no-load mutual fund. That tax differential does not ever catch up. In Chris' and Al's examples, the no-load mutual fund is at 278 versus 251, and 284 versus 251. In both of those examples, the mutual fund has come out quite a bit ahead because of the 20% tax bracket upon surrender versus the 39.6%

tax bracket. If you were in the 36% tax bracket, you would come out ahead. It just takes longer than two years to do that; it may take five years.

You might say it is not realistic to hold a mutual fund for 15 years. In fact, Craig gave an example when we discussed it that people do not hold investments long term under this new tax horizon, if you are in the flat-tax situation. People will go for short-term investments. One advantage of having the current tax system is you will keep a variable annuity or some retirement vehicle for a long time. The baby boomers, who like to have choices and move money around, will likely do that. It would be very unusual to hold a mutual fund investment for fifteen years. I think the average is about three to four years. You are going to incur some penalties and charges in moving it around in that environment.

Keep in mind that these are equity funds for this example and generally you could say that, if you are in the 28% bracket, you are going to come out better to stay in a variable annuity if you are only doing it for investment purposes and you are under age 59.5. However, in almost every case, if you are over 59.5, almost all tax brackets perform better even with a surrender charge because you do not have that 10% penalty.

Where it is not totally clear if you are better off from an investment, is if you are in the 36% or 39.6% brackets. Over a period of time, two to six years, most of them outperformed and they cross over faster. The higher your initial tax bracket is, the lower your penalty on surrender and the shorter your annuity holding period is. If a flat tax came through or any other much lower income tax rate, in most of these examples, it would look even more extreme because of the lower tax rate on surrender.

You may ask what are we going to do about this if it does happen, and obviously how the product is sold is going to make a difference. I do not believe that the insurance industry is going to benefit by coming out against tax reform or against any of these proposals. It would appear self-serving, although we did do pretty well under the healthcare reform scenario. This system would stimulate the much-needed savings for individuals in this country that are fairly low compared to other industrialized nations. I think our best position is to continue to emphasize the suitability of sales. Our position is managing long-term risks, providing guarantees for consumers, and retirement planning. This position would look good for the baby-boomer demographics, and if products are sold for these reasons, they should not be replaced. I hope the tax rates upon retirement will be lower. You never know, with the demographics showing people not saving now, how high tax rates might be at retirement.

Mr. DesRochers: I would like to pick up on a theme Marilyn mentioned. As I have gone to various sessions at the meeting, I have heard a great deal of discussion about the need to revitalize cash-value life insurance. A key issue the industry is facing seems to be related to the future of cash value life insurance in the face of flat or declining sales. In another session at this meeting, Commissioner Wilcox urged the industry to support some of the proposals for change in the nonforfeiture law based on the need to better serve the public and to produce products that really do a better job of delivering protection. In another session, Shane Chalke talked about the need to rethink some of the products and the way that they are designed and the way that they are offered, to integrate a great many coverages into one product.

I do not think there are any of us here who would easily give up tax deferral on the inside buildup; it is a valuable option that our product has had. I know, in some work that was done several years ago, it was characterized as being about as valuable as FDIC insurance. It is definitely worth something in the market. On the other hand, the conditions under which we get inside buildup, particularly 7702 and 7702A, I think are stifling product development a great deal. The notion of bringing more contingencies into a life insurance product, opening up our product creativity and product development runs into the brick wall of the inside buildup.

To try to bring health or annuity coverages and integrate them in life insurance, as desirable as that might be, simply is not doable in the near term because of the deficit situation. There are many people in Washington, the Treasury, and congressional committees who feel that the inside buildup is enough of an advantage already for our products, and therefore, even if the public could be better served by more creative products, we have to deal with this issue. In some respects, if tax reform could be accomplished in such a way that all savings had some benefit, then I think there is a very strong potential that we could see tremendous creativity released in the life insurance industry. We could do many things with many types of investments and contingencies that are integrated in life insurance without losing the value of the inside buildup.

At the same time, however, what would be critical is how quickly we can also lose some of the regulatory constraints. The worst fear of the people in the pension area is that in a broad tax reform, everything will get the same benefit, and yet pensions will still have some of the same restrictions. Marilyn put it very well when she said, "Look at all these disadvantages that we have."

Another critical issue for our industry certainly would be the speed at which we could put some of those restrictions aside in an era where everything was open. I

do not think it is a gloom-and-doom scenario, and in fact, the ultimate answer to revitalizing cash-value life insurance may well be broad-based tax reform. What we might be able to do is to put our unique skills in covering contingencies to work in a much more creative and flexible environment.

My fear is now that we have such a restricted environment to operate with, that we simply cannot be creative, we simply cannot deliver the kinds of products that many companies, actuaries, and product designers would like to deliver to the public, simply because of the restrictions that we are operating under. On the other hand, I do not think there is any of us that could rationally say to our management, Let's do one that does not have the inside buildup. That is not going to happen.

We do not know whether or not tax reform will occur, but I believe that should it occur and in such a way that many savings vehicles are tax deferred and deductible. Then we could see a renaissance of product development in the industry, and I think that would be a very positive occurrence.

Mr. Springfield: I agree with Chris that it would be beneficial if the current tax rules regarding life insurance and annuities allowed a greater degree of product development to go forward. But I point out that the reason for such a strong straight-jacket is largely because the current tax system has rules that have been put in place to ensure that these instruments are used for long-term savings. In fact, this long-term savings purpose is a substantial justification for the current tax treatment for these products.

If we go to a system through tax reform where we are not going to have incentives for retirement savings and we are just going to encourage savings generally, I want to reemphasize what I said earlier that this could cause some substantial policy problems. If people do not save during their working years, this may lead to increased poverty of elderly individuals and also to greater governmental spending for the elderly, as long as the government is going to have some minimum safety net for people in retirement. I do not think we should be encouraging people to rely on Social Security, for instance, if they have the ability during their employment years to save for their own retirement. I think pensions, life insurance, and annuities are vehicles, at least in the current system, where they can do that. We need to keep an eye on whether we are going to try to retain that system. In that regard, I think it might be beneficial at some point, if tax reform looks like it might occur and is going to disadvantage long-term savings products, for the insurance industry and the pension industry to oppose tax reform. It depends on what any forthcoming proposal looks like.

Mr. DesRochers: It sounds like we have a disagreement on the panel as to whether the tax reform should be opposed or supported.