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DIGEST OF PANEL DISCUSSION ON THE IMPLICATIONS TO INSURANCE OF THE 1954 INTERNAL REVENUE CODE

Panel Participants:

ALBERT PIKE, JR., *Moderator*
JAMES A. HAMILTON RAY M. PETERSON
ERNEST J. MOORHEAD RALPH J. WALKER

MR. ALBERT PIKE, JR., moderator of the panel, opened the discussions by sketching how the panel discussion would be run. It was not expected that the participants would go into detailed analysis of a descriptive nature, but rather that the panel would confine itself to just enough background description to provide a basis for discussing the implications of the new tax code to life insurance and associated coverages, including annuities and accident and health insurance. Concentration would be on four main topics: annuities, by Mr. Hamilton; individual insurance, by Mr. Moorhead; group insurance, by Mr. Walker; and pensions, by Mr. Peterson. No discussion of taxation of life insurance companies themselves was planned.

MR. J. A. HAMILTON presented a discussion on how the new tax code affected the taxation of annuities, including life income and annuity certain settlements under matured endowments. He observed that the taxation of annuities could be reduced to a problem of determining how much of each annuity payment constitutes a return of the capital invested, and how much represents earnings on that capital. The history of annuity taxation in this country and elsewhere indicated a widely variant approach. In Great Britain, and in Canada prior to the recent law change induced by the paper by Mr. A. D. Watson in *TSA* XLI, 41, the capital invested was deemed to "evaporate" at the instant the annuity was purchased, so that all the annuity payments were deemed income. In the United States prior to 1934, all the annuity payments in early years were deemed to constitute a return of capital, there being no income until the entire purchase price was recovered. Between 1934 and 1954 the so-called 3% rule prevailed in this country, whereby 3% of the original consideration was deemed to be taxable income each year until the accumulated *balances* of the annuity payments equaled the original purchase price; thereafter the entire amount of each annuity payment was taxable.

There were two objections to the pre-1934 method of taxing annuities, a method which might be called the "0% rule" by comparison with the "3% rule." The first was that on nonrefund annuities no provision was made for possible capital loss in the event of early death, so that for a group of annuitants as a whole their investment in annuity contracts was a losing proposition taxwise. The second objection was that it often delayed the incidence of taxation until extreme old age, resulting in taxes when the annuitant was presumably least able to pay them, and also involved a possible wastage of annual personal exemptions during the earlier years. The 3% rule, as introduced in 1934, did not get around either of these two objections, but rather added a third in the form of an increase in the tax burden on annuitants. In fact, the motivation for the 3% rule, coming when it did in 1933, arose from a feeling in Congress that many wealthy persons were using annuities as a means of deferring income taxes to the financial disadvantage of the federal government.

One possible way of correcting these inequities would have been to reduce the rate of the 3% rule to a more realistic 1% or 1¼% rate (reflecting, among other things, the fact that the percentage rate is applicable to the original purchase price undiminished as annuity payments are made), and to continue that rate even after the original consideration is deemed returned. This approach had been given careful consideration by the Treasury Department but was finally abandoned, principally because its "simplifications" were illusory on deferred annuities, and on pension plan annuities where a pocketbook other than the annuitant's was involved. For these two types of annuities complicated adjustments would be required in order to subject to tax those amounts received by the annuitant which were attributable neither to his original investment nor to interest earned solely after the annuity begins. Congress, therefore, adopted the life expectancy approach as it exists in Canada, which defines the untaxed portion of each annuity payment as that amount resulting from averaging the original consideration over the life expectancy of the annuitant, instead of determining the taxable portion directly by some factor. Three departures were made, however, from the straight Canadian plan, namely:

a) Refund payments to the beneficiary are wholly tax-free in the United States, rather than taxable at the same rate as annuity payments. A modification of the life expectancy calculation for determining the amount taxable to the annuitant is therefore necessary, if the equivalence of the untaxed payments to the original consideration is to be maintained. This change improves the tax position of the beneficiary, who under the terms of the usual annuity contract receives back only what is defined to be part of the original capital, but introduces arbitrary distinctions be-

tween the taxation of annuity refunds and the taxation of annuities certain payable to a succession of lives.

b) On deferred annuities the total net consideration paid is used for determining annual exclusions, rather than the cash surrender value at maturity as in Canada. This has the effect of throwing into taxable income the interest earned on the original investment during the period of deferment, a result which is not the case in Canada, presumably because in that country the excess of the cash surrender at maturity over the original consideration paid would not be taxable if the annuity were cashed in at maturity.

c) Pension plan benefits under which the retired employee will receive back his own consideration within three years are to be taxable in the United States under an adaptation of the pre-1934 rule, whereas in Canada employee pension plan contributions are generally deductible from taxable income when paid, and all pension plan benefits consequently taxable.

Using the 1937 Standard Annuity Table set back one year (the mortality basis underlying the proposed new income tax regulations), a "taxable income index" for the three tax plans in the United States results, if the index for the 3% rule is set at 100, in an index of 60 for the pre-1934 approach, and an index of 31 for the new life expectancy method when applied to immediate annuities. Therefore, on the average the new 1954 code serves to reduce the aggregate annuity income subject to tax by about 70% as compared with the previous 3% rule, and by about 50% as compared with the pre-1934 rule. This substantial tax improvement for annuities, however, is not general. Life income options under the older endowment policies, where the mortality rates assumed are so extremely unrealistic, will in many cases be taxed more heavily than before. Also, annuities already in the course of payment but still within the capital return accumulation period of the 3% rule will suddenly shift over to a higher tax basis. Special tax relief had been asked by the American Life Convention and Life Insurance Association of America for these annuities, by suggesting that the tax calculations be made as of the original date when the annuity payments began, but Congress decided not to go back of January 1, 1954.

A number of complications are to be expected in the actual application of the new life expectancy rule to various unusual forms of annuity. However, it is expected that life insurance companies will make the tax calculations, at least on request, so that the arithmetic burden on the taxpayer will be minimized.

MR. E. J. MOORHEAD spoke on individual personal life insurance

policies, as distinguished from group insurance, annuities, pension plans and business insurance. The new tax code affects such policies through three taxes: the estate tax, the gift tax, and the income tax. While the estate tax problem usually becomes financially important only above about $250,000, the gift tax only above that amount purchased by annual premiums of about $6,000, and the income tax only above about $80,000 (less, possibly considerably less, on outstanding policies with liberal options), the issues are important to a number of agents who specialize in sales to people in very high income brackets. Therefore, the problems are of considerable magnitude, even though applicable to a very small part of each company's business. They have resulted in difficult tax questions being posed to the Home Offices which cannot be answered with certainty until the tax regulations appear. In particular, three situations present themselves:

I. The change in the estate tax law eliminating the premium payment test.

II. Income taxes on death benefits payable in installments.

III. Financing of life insurance premiums by borrowing money.

I. Previously an insured who paid the premiums on a policy, directly or indirectly, could not escape having the proceeds subject to estate tax, even though the policy was given away to someone else. The use of life insurance to provide benefits free of estate tax was therefore very limited in the past, even among the larger policies. The change in the estate tax law altered this situation quite substantially. New sales opportunities now present themselves, and some new problems arise that relate to existing business as well as to new business. The situation is complicated by three outside factors: (1) hazy ideas as to what can be accomplished by various ownership rearrangements, (2) a tendency to haste, instead of waiting for clarifying government regulations, and (3) the undeniable fact that a first year commission on a new policy is considerably larger than a renewal commission on an existing policy, especially if the renewal commission is payable to somebody else. One difficulty is that transfer of an existing policy to a new owner might be considered to be a "transfer in contemplation of death," and the tax effect of a transfer thereby nullified. Another is that the proceeds of a policy will be included in the insured's estate, even though title was transferred, if immediately before his death he had a reversionary interest in the policy greater than 5% of its value.

To meet the contemplation of death problem, his company was suggesting to those who were unwilling to await definitive regulations that they purchase an additional term insurance policy, keeping both the old

and the new policy in force until regulations on the point are forthcoming. This course protects the insured's insurability and allows him to maintain whichever of the two policies appears the better in the light of the actual tax regulations; in most cases, the need for additional insurance can readily be shown.

As to the 5% reversionary interest, he observed that some companies were furnishing actuarial tables showing the combinations of ages of beneficiaries and insured that will keep the reversionary interest below 5%. Others were suggesting the addition of a succession of contingent beneficiaries, with the final reversionary interest passing to a charity. He thought these two approaches either unnecessary or likely to breed trouble for the future. Instead, his company was suggesting that regulations be awaited before action is taken, with the expectation that the regulations would stipulate that any reversionary interest to the insured which can be defeated by the beneficiary on her own authority and without the consent of the insured reduces the value of the reversion to zero, irrespective of the probabilities of survivorship.

II. On the question of income taxes on death benefits payable in installments, he observed that the new tax does not apply in two important areas: (1) existing settlements under policies previously matured by death and (2) installment settlements to a widow within the $1,000 annual exemption, produced by proceeds varying from about $20,000 to more than $100,000, depending upon the interest basis of the settlement option and also the mortality basis of a life income option. While the change in tax law produced a new income tax on life insurance proceeds, he did not think the situation was entirely to be deplored. On the contrary, we should have expected that the tax-free status of the interest element included in installments payable after death would be lost eventually anyway, and the salvage of the $1,000 annual exemption to the widow represented something of a victory. It might even provide a sales talking point.

III. On the financing of life insurance premiums by borrowing money, he observed that the existing ban on the tax-free status of interest on money borrowed to pay premiums on single premium life and certain limited payment life policies had now been extended to include single premium annuities and a wider range of premium deposit funds. Fortunately for those who have been inviting business of these types, the change does not affect existing arrangements. He thought that selling life insurance with emphasis on this borrowing device was not only dangerous for the individual but also unhealthy for the industry. Tax authorities are always looking for loopholes to be plugged, and the plugging process too often goes beyond what is really needed and invades normal and legiti-

mate activities. He hoped, therefore, that companies would continue to frown upon inordinate use of these arrangements.

MR. R. J. WALKER, in discussing the situation with regard to employer-financed group insurance, noted that the new tax situation was different as between group life insurance and group accident and health insurance.

On group life insurance the previous tax situation had been carried forward, namely, a tax-free status to the employee with respect to amounts paid by his employer as premiums for group term life insurance, with employer-paid premiums for certain forms of group permanent life insurance remaining taxable. The tax-free status for employer-paid group term insurance premiums was not spelled out in the new tax code, but was to be inferred from failure of Congress to legislate contrary to an old ruling that group term insurance premiums were not taxable. Whether or not the tax-free status of group term insurance premiums is soundly established legally, he believed that the situation is ultimately headed for trouble. Larger and larger amounts of group term insurance are being underwritten on smaller and smaller groups. Eventually some tax-exempt limitation is likely, the real question being a choice between the $5,000 limit in the new code for uninsured death benefits, the $20,000–$40,000 maximum appearing in the group life insurance statutes of an increasing number of states, and some other amount or principle. He personally favored a dollar limitation on tax-free group life insurance, over the present system of outright limitation of all group term insurance through state laws governing group insurance underwriting.

In his opinion, the extension of the $5,000 exemption for uninsured employer-paid death benefits to amounts paid where there is no underlying welfare plan will not infringe on the market for insured plans. He thought that group life insurance would continue to be popular and to have self-evident advantages over uninsured benefits.

On the matter of group accident and health insurance, the new tax code did two notable things: (1) it specifically provided that employer contributions to employee accident and health insurance plans (not limited to group insurance, but extended to individual accident and health insurance and to uninsured benefits) are not to be includable in the employee's taxable income, and (2) loss-of-time benefits in excess of $100 weekly, and certain other benefits payable during the first week of disability, are taxable for the first time. This new statute involves a great many difficult questions of interpretation. For example, it is not clear as to the tax status of hospital benefits payable at a fixed rate regardless of room and board charges. It is also not clear as to whether employer contributions

for dependents' medical expense coverage are taxable. No clear definition of a "plan" is contained in the law. Most important of all, it is not finally settled as to whether insurance companies will be required to withhold federal income taxes on nonexempt loss-of-time benefits, although a proposed ruling of the Internal Revenue Service would unfortunately require such withholding. And finally, in contributory loss-of-time plans, may the employee contributions be allocated first to those benefits which are not taxable, or must they be allocated pro-rata between taxable and nontaxable benefits?

In his view, the new tax law would result in a further impetus towards welfare plans supported by tax-free employer payments, as compared with insurance plans purchased out of employee wages which first pass through the taxing process. In his view, this was a social result to be desired. In some ways, it might be regarded as paternalistic on the part of the government, but this was a much less important force than collective bargaining by labor unions. Therefore, the taxing process merely shares with collective bargaining the credit (or discredit) for moulding the economic structure of the country.

MR. R. M. PETERSON discussed the tax situation in the pension field. Not many important tax changes have been made in the new code which affect pension plans, but he listed four: (1) extension of the specific $5,000 exemption for employer-paid death benefits to vested distributions made at death under a pension plan, (2) long-term capital gains treatments for lump sum distributions made from nontrusteed annuity plans, previously applicable only to trusteed plans, (3) exclusion from estate taxation of the value of a surviving beneficiary's annuity under a pension plan contingent annuity option, and (4) prohibition against certain investment transactions for tax-exempt trusts. Equally noteworthy were three changes originally under consideration but not actually made: (1) substitution of certain automatic objective tests of nondiscrimination in pension plans, as opposed to the present system requiring case-by-case rulings by the Internal Revenue Service, (2) elimination of the discriminatory tax against insured pension plans, arising indirectly through the life insurance company income tax, and (3) elimination of the requirement, provided by tax ruling, that an employee must be allowed to select his own beneficiary without limitation to any classes specified by the pension plan.

On the issue of the extension of the specific $5,000 death benefit exclusion, he noted that the favorable new tax treatment for vested pension benefits applied only in cases where the death benefit is all paid within one taxable year. This, he thought, was unfortunate, since it favors lump

sum distributions over distributions received in budgeted installments. He presumed that the $5,000 specific exclusion did not apply to interest on a return of employee contributions, although in one sense it is indirectly attributable to the employer because of his having invested the contributions.

While the new capital gains treatment for lump sum payments under nontrusteed plans was a favorable tax result for group annuity contracts, he believed it to be something of a mixed blessing. The statute change had been urged in order to remove the distinction between the tax treatment of lump sum distributions under trusteed plans and those under nontrusteed plans, only the former being entitled to capital gains treatment under the old tax law. However, with the removal of the discrimination comes a demand from some employers for inclusion of a provision for lump sum distributions in their group annuity contracts. This will result in substantial antiselection against the insurance company, unless compensated by a higher premium or associated with a requirement of five years' advance notice of election as is commonly the case for optional annuity elections. Also, a lump sum option is likely to be availed of by lower-paid as well as higher-paid employees. The latter would presumably be attracted to it because of tax advantages, but the former might be attracted to it because of the attractiveness of having a large cash sum on hand. If annuities are cashed out just to get one's hands on the money, the whole purpose of the pension plan might be negated. He thought the tax system in the United Kingdom, under which only one-third of the value of a pension plan can be taken in a lump sum, to be better than the capital gains treatment in this country.

The new exclusion from an employee's estate of the value of a survivorship annuity, he noted, resolved a long-standing source of tax discussion and controversy. Prior to 1951 such survivorship annuities were subject to both estate taxes and income taxes, which in some quarters were considered to be double taxation. Since 1951, it was provided that there shall be a "new start" for income taxes with respect to a survivorship annuity, to the extent that the value of such annuity was includable in the employee's estate. This removed the double incidence of the two taxes, in a way favoring lower-paid employees because they generally do not get involved with estate taxes of any consequence. The new code reverses this situation, by eliminating estate taxes but imposing income taxes, except with respect to any part of the pension attributable to employee contributions. While this was generally disadvantageous to lower-salaried persons, he thought the final result could be defended as fair and theoretically sound. In any event, it ended a long-standing controversy.

He noted that the prohibited transactions newly applicable to tax-exempt trusts included an item which prohibits lending any of the trust funds to the employer without adequate security and a reasonable rate of interest. He observed, in passing, that this provision could be gotten around by temporarily "unfunding" the pension trust. An employer could skip contributions for a few years within the limitations set down by Mimeograph 5717 of the Internal Revenue Service, and use the money temporarily saved for his own purposes. This would be essentially the same as borrowing money directly from the pension trust to further the employer's normal business affairs.

On the retention of existing rules for qualifying pension plans as being nondiscriminatory, which are of a nonautomatic character requiring individual interpretations by the Internal Revenue Service in the light of the facts surrounding each particular pension plan, he noted that the House version of the tax code had originally substituted objective quantitative tests. However, these substituted tests were quite impractical. They would have permitted serious discriminations in favor of highly compensated employees, as to both benefits and contributions, and prohibited other types of plans which were not discriminatory at all by any reasonable criteria. Also, the proposed tests would have destroyed the foundation for the funding requirements of Mimeograph 5717, which requirements he thought beneficial. It was understood that a new try would be made in the next Congress for a revised plan of objective quantitative tests, but he preferred the present qualitative tests and doubted whether specific quantitative tests could be satisfactorily devised.

The discriminatory federal income tax on insured pension plans had been commented upon in the presentation made to the House Ways and Means Committee in July 1953 by the American Life Convention and the Life Insurance Association of America. No specific solution to the problem had been suggested, although the proposed 3-prong federal income tax formula developed by the life insurance business in July 1954 would eliminate the discriminatory tax burden on insured pension plans. He thought it imperative that this discrimination be removed, and observed that a similar discriminatory situation had been found to exist in the United Kingdom, where a governmental report had recommended its elimination.

The prohibition against limiting an employee's right to select his beneficiary, now set forth in ruling P.S. 19 of the Internal Revenue Service, has the practical effect of prohibiting provision for widows' and orphans' annuities under pension plans, except when taken as an option in lieu of part of the employee's own pension. This results because the plan itself,

rather than the employee, would designate the widows and orphans as beneficiaries. Such widows' and orphans' annuities can, of course, be equivalent to very substantial amounts of life insurance. While the House version of the new income tax bill had eliminated the grounds for P.S. 19, the final version did not, although since then the ruling has been revoked in part. It is, however, still not completely clear whether widows' annuities can be underwritten as part of a pension plan. A definitive answer is vitally important, because of the increased interest in such annuities following the pattern common in Europe. If widows' and orphans' annuities become general, they may have quite an impact on the sale of group and individual life insurance.

A QUESTION AND ANSWER period followed. Opening the discussion, Mr. Pike inquired of Mr. Peterson as to what had happened to the Jenkins-Keogh Bill in Congress, which would have given the self-employed the same tax deferment advantages as employees eligible to participate in a pension plan financed by their employer. Mr. Peterson replied that the matter was still on the agenda of the Treasury Department, that the outcome was very much in doubt, but that if he had to guess he would not expect anything very concrete to develop in the near future. Mr. Paul Walker (Attorney, Life Insurance Association of America) asked Mr. Peterson as to whether his stated preference for the existing qualitative tests of nondiscrimination under pension plans, as compared with the proposed objective tests of the House version of the new tax code, extended to opposition to a compromise which would eliminate part of the discretionary authority of the Internal Revenue Service. Mr. Peterson replied that he thought that some such compromise existed in the present law, and that he would not object to it being extended if some discretion was retained.

Mr. M. T. Lake asked whether, in the taxation of matured endowments settled under income options, the premiums paid for disability and double indemnity benefits should be subtracted from the "investment in the contract." The reply was that the issue had not heretofore been raised and that the answer was therefore uncertain, but presumably such premiums were to be deducted, whereas the cost-of-insurance part of the premiums was presumably not to be deducted. Both answers would, however, have to await the regulations.

President Guest asked if there had been any consideration given to the mortality table to be used in calculating reversions in order to test again the 5% estate tax limitation. He observed that under some of the more modern population mortality tables the value of the reversion does not change with the passage of time, so that only the value as of the moment

of original determination had to be considered. Mr. Pike answered that there had been no discussions of what table was to be used, but presumably beneficiary designations would be made in most cases so that any reversionary value would be so far under the 5% limit that the precise calculations would not matter.

Mr. G. H. Amerman asked whether the $1,000 exemption from income taxes for life insurance proceeds payable in installments to a widow applied to the whole of the installments or to only interest included therein. Mr. Moorhead replied that it applied only to the interest plus any mortality gains because of the use of a mortality table with higher rates than those used for determining the life expectancies. Mr. Amerman further asked whether it applied to interest on proceeds left on deposit. The answer was no. He then asked whether a reversionary interest was possible if the insured never owned the policy in the first place, some disagreement having arisen over this point because of the special definition of "reversion" set out in the tax law. Mr. Moorhead and Mr. Paul Walker both replied that they thought there could be no reversion where there was no original ownership. Mr. Walker also replied to a question as to whether the possibility of inheritance constituted a possibility of reversion "by operation of law," by saying that in his opinion it did not. He also replied to another question as to whether a right of the beneficiary to defeat a reversion by surrendering the policy affected the reversion question. He stated that his belief was that such a right would reduce the value of the reversion to zero, because no one would pay anything to buy a reversion subject to such a right, irrespective of the probabilities of survivorship. Mr. Moorhead observed, however, that other tax lawyers had taken contrary positions. With all this uncertainty, President Guest asked Mr. Paul Walker whether there was any way of buying a new life insurance policy so that it would be reasonably certain that the proceeds would not be subject to estate tax. Mr. Walker assured him that there was.

Mr. E. L. Bartleson asked about the tax treatment of installment settlements defined not by the period over which they are paid but by the amount of each installment, usually expressed as a periodic payment of principal and interest until the principal is exhausted. There was no definite answer, but Mr. Pike observed that the ALC and LIAA had filed a memorandum asking that such installment settlements be treated as annuities certain. He said the issue was important, because if such installments were not deemed to be annuities certain the $1,000 specific annual exemption to a widow receiving life insurance in installments would not apply. Mr. Bartleson further asked what would happen if the installments were commuted in mid-course; how would the government get taxes on

the excess of interest actually earned over the averaged amount of interest originally assumed on the supposition that the installments would continue for the full period? Mr. Pike stated that the law seemed clear that the lump sum commutation, in that case, would be deemed to include some "backed-up" interest and that therefore that part of the lump sum payment would be taxable when made.

Mr. W. J. November asked Mr. Hamilton as to what were the expectations of the Treasury Department as to the life insurance companies making the annuity tax calculations for their customers. In reply, it was stated that the Treasury officials clearly recognized that there was no legal obligation on the part of the insurance companies to make such calculations, but that they hoped the companies would make them. Also, most insurance companies were planning to make the calculations, either in bulk or on request, as a matter of good customer relations. Mr. W. M. Anderson then asked how the calculations would be made if the insurance company was small and had no actuary, or if the annuity was not paid by an insurance company at all. He observed that in Canada a panel of members from the Society of Actuaries performs these services free for the Canadian equivalent of the U.S. Internal Revenue Service.

Dr. J. P. Stanley asked whether the $100-a-week specific exemption for loss-of-time accident and health insurance benefits paid by an employer extended to disability annuities payable under pension plans. The reply was that this issue was still to be settled. Mr. M. G. R. Wallace then asked whether the insurance companies, in making information-at-source tax returns to the government, would be allowed to report taxable income on each annuity just at the beginning, or whether they would have to continue the present system of reporting it once a year. Mr. Pike replied that the one-report system had been recommended to the Treasury, but that the Treasury Department has shown little disposition to accept the idea.

The panel discussion concluded with appropriate remarks by the President, who observed that he thought that the panel method of handling very large topics had advantages over the usual formal discussions at meetings of the Society.